

The impact of corporate governance mechanisms on firm performance: A literature review

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Keywords

audit committee characteristics, board characteristics, corporate governance, firm performance, liquidity, and profitability.

Abstract

This literature review examines the impact of corporate governance mechanisms, particularly board characteristics and audit committee characteristics, on firm performance. The study synthesizes findings from empirical research focusing on non-financial companies listed on various stock exchanges, with an emphasis on how these governance factors influence profitability and liquidity. The board characteristics investigated include board independence. The audit committee characteristics analyzed encompass audit committee meeting frequency.

The review highlights that greater board independence often negatively impacts profitability. Conversely, this board attribute tends to reduce firm liquidity. Regarding audit committees, frequent meetings are associated with improved profitability and liquidity.

By integrating diverse research findings, this review provides a comprehensive overview of how specific corporate governance mechanisms shape firm performance, offering insights for academics, practitioners, and policymakers aiming to enhance governance practices and firm outcomes.

Introduction

Good corporate governance is a very important topic that merits careful consideration because it plays a significant role in enhancing economies and the standard of living in countries around the world. High-quality governing practices lead to improved firm performance, which in turn causes improved economic conditions in countries, indicating that corporate governance (CG), firm performance, and economic development are positively correlated. Among the many facets of good corporate governance, the oversight duties of the board of directors and audit committees have drawn the most attention from policymakers, legislators, and researchers. This concentration is based on the idea that independent, informed, and proactive audit committees and boards of directors should be the main guardians of shareholders' interests (Sarbanes-Oxley Act, 2002 [SOX]). In this research, I'll investigate how boards and audit committees' characteristics affect the performance of businesses.

Corporate governance is a set of laws, regulations, and rules that outline the way a corporation must be managed and operated to ensure integrity and equity in its dealings with shareholders. This framework, which consists of internal and external relationships between employees and shareholders, regulates the distribution of obligations, demands, and incentives to avoid conflicts of interest. In 2001, a broader concept of good corporate governance was accepted by the Organization for Economic Co-operation and Development (OECD).

In every country, the laws governing corporations require the creation of boards of directors, which are tasked with monitoring and advising executives on significant company decisions (Baldenius et al., 2014). To safeguard the interests of all parties, it is the board's duty to make sure that all decisions are made in accordance with the company's corporate governance. To increase the efficacy of governance, the board should establish several committees, including the audit, nominations, and pay committees. Such committees will oversee making sure the business abides by all applicable laws, as well as by its own policies and procedures and any guidelines relating to corporate governance. Not only will this improve corporate governance and prevent a company from engaging in unethical behavior, but it will also result in a rise in firm performance because investors will have more trust that their investments will be safeguarded (FRC, 2014, 2016).

The effectiveness of the audit committee is turning into a more important component of the strong corporate governance agenda for both established organizations and those in emerging markets. (Shbeilat, 2018) The committee for auditing is essential in the selection, monitoring, and administration of the company's auditors to maintain and disclose financial information. As a result, the audit committee serves a consultative role and sets a higher standard for the degree of dependability that investors might anticipate from financial reports. When investors have access to clear financial data, they can enhance management supervision and the performance of their investments.

An impressive performance from the company is necessary to give investors the assurance they need to maintain their investment opportunities (Harrison & Wicks, 2013). Notification of improvements in performance can be accomplished through the utilization of a wide variety of factors, such as corporate governance (CG) characteristics. This has led a lot of scholars in the fields of finance and accounting to focus more on how important it is to figure out which parts of corporate governance are best for making a company perform better.

Good corporate governance has been increasingly significant to Egyptian businesses in recent years, especially in the wake of the 2011 uprising. In 2003, the Egyptian Institute of Directors (EIOD) published rules and recommendations for the use of firm corporate governance. These regulations and standards were created in compliance with the laws that govern Egyptian businesses. These rules and guidelines were derived from the best practices followed in other nations. The Egyptian Code of Corporate Governance (ECCG) was originally released in 2005 and is written in Arabic by Egypt's Ministry of Investment and General Authority for Investment and Free Zones. This code of conduct serves to advance the most moral and successful business practices while safeguarding the interests of all shareholders and investors. All businesses that trade stocks are required to abide by the transparency and governance laws. The EIOD created the Corporate Governance Code (2006) for publicly traded corporations in later years. This code's primary objective was to make it simpler to manage and monitor the public sector.

Literature review

Corporate Governance

Corporate governance describes the procedures used to balance the responsibilities and rights of the owners with those of non-owner executives. According to Prowse (1998), corporate governance includes the laws, rules, and institutions that define the duties of company owners, shareholders, and managers to external investors as well as the behavior that is expected of them. For instance, Cadbury (1999) defines GCG as the framework by which firms are governed and monitored, with a focus mainly on the interactions between key internal governance processes to maximize shareholder profit. According to Chamlou and Iskander (2000), corporate governance is crucial for developing and expanding local financial markets by attracting both institutional and private local investors. This is in addition to attracting long-term foreign capital. Corporate governance, according to Solomon and Solomon (2004), is a system of checks and balances that guarantees that businesses fulfil their obligations to all of their stakeholders. Corporate governance maintains equity between shareholders and employees, as well as ensuring that both parties carry out their duties and receive the proper compensation (Buallay et al., 2017).

Corporate governance is described as "a set of interactions between management, its board, its owners, and other parties" in the (OECD) Guideline for CG (2015), which implies that it affects every employee of the business. It guarantees that the business is growing healthily and that investors can have confidence in the financial statement's performance data. As part of their responsibility to maintain good corporate governance, shareholders must select qualified boards, auditors, and accountants to monitor the company's operations. The job of these boards and committees is to keep an eye on how the company runs daily. They do this by setting up a good system, and the auditors of the company make sure that the financial information given to shareholders is correct and easy to understand (Hamidah and Naimah, 2017).

Corporate governance has become more well-known because of recent business scandals and failures involving giants of the industry like Enron and WorldCom (Claesens, 2006). Previous research has employed the compliance-index model and the equilibrium characteristics model to demonstrate an empirical relationship between internal governance and business performance. According to the

equilibrium characteristics model, each firm has an optimal governance structure from which it can select, and internal governance mechanisms and firm performance are associated (Gyakari, 2009).

Firm Performance

Daft (2000) claims that the performance of a company is how well it meets its goals and objectives. Firm performance has long been a topic of discussion among academics and practitioners, but it has also become the focus of management scholars' research as they look for factors that influence performance variation. This is the main distinction between studies of strategic management and other management-related studies. Many authors define and measure a company's performance in different ways. This means that the public, shareholders, employees, and investors all have different expectations (Kaplan & Norton, 2005).

A company's performance reflects its accomplishments and financial position as detailed in its financial report for a specific time. Periodically, a financial report is published for the benefit of investors, creditors, potential creditors, management, employees, the government, and society at large. For instance, while deciding whether to keep their money in a firm or look for alternatives, investors need information about the company's performance. Such details also demonstrate a company's reliability to potential customers.

Profitability proxies such as ROE, ROA, and ROI. Also, gross profit, revenue growth, stock price, current ratio, and operational efficiency were used in previous studies to evaluate the performance of the company. While Schendel (1991) recommended the use of ROA, earnings per share (EPS), ROE, and gross margin as the most common measures, Doyle (1994) stated that profitability was the most employed measure of performance by most commercial companies. According to Hoskisson et al. (1994), other measures like operational efficiency and customer satisfaction must be used in addition to financial measurements to be effective for decision-making.

Babatunde and Olaniran (2009) looked at the link between corporate performance in Nigeria and its governance structures. The results indicate a negative relationship between independent directors and ROA. Ibrahim et al. (2010) investigate how corporate governance affects the performance of Pakistani chemical and pharmaceutical companies. The study's conclusions show that independent directors significantly enhance return on equity but have no discernible effect on return on assets.

According to Jose et al. (1996), liquidity has a big impact on a company's capacity to stay in business. This is mostly because of the effects that liquidity has on the company's level of risk as well as its effects on growth, sales dynamics, and the reduction of financial costs. A company's liquidity (current ratio) is a key marker of its success and position in the market. Additionally crucial to the company's expansion is liquidity.

Board Independence

Most board members ought to be independent to oversee and control management, in accordance with agency theory (Al-Janadi et al., 2013). This perspective holds that managers only care about their own interests and are self-interested. Since agency issues between managers and shareholders are anticipated as a result of the separation of management and ownership, independent board members are required to protect shareholder interests (Padilla, 2002). Because this would regulate the managers' behavior, it is anticipated that the company's performance will increase if a sizable portion of the board's directors are independent. Additionally, Fields and Keys (2003) discovered that executive directors are more effective than internal directors at selecting, rewarding, and dismissing top executives.

Stewardship theory, in contrast, rejects the idea of self-interested managers by arguing that CEOs are accountable individuals whose interests coincide with those of shareholders (Clark, 2004). The stewardship hypothesis postulates that inside directors make better judgements and improve the success of the company because they have a deeper understanding of and more relevant business expertise. Independent directors, however, are less committed to the company and lack the requisite skills, which has a detrimental impact on the success of the organization (Koerniadi et al., 2012).

Coles et al. (2008) looked at 8,165 publicly traded companies in the US between 1992 and 2002, in contrast. They found a link between independent boards and poor business performance and profitability. Similar findings were also observed by study conducted in Australia and Canada (Bozec, 2005). Another study by Barnhart et al. (1998) found insufficient evidence for a curvilinear association between

independent boards and business success. This result implies that if the percentage of independent boards is either too high or too low, it will have a detrimental impact on a company's success. However, studies (Mehran, 1995; Wintoki et al., 2012) indicate there is no relationship between board size and company performance.

El Mehdi's research into the connection between independence of boards and company performance in developing nations yielded contradictory results. Independent directors' participation enhances listed companies' performance in Tunisia, according to El Mehdi's (2007) study. The political connections of independent directors are also a useful asset that improves business performance, according to Zheng (2010). Several studies from Malaysia (Shukeri et al., 2012), Nigeria (Garba & Abubakar, 2014), and Mauritius (Mahadeo et al., 2012) have discovered a bad association between the company performance and the independence of the board. According to studies (Rashid et al., 2010; Haniffa et al., 2006), a firm's performance in a developing country does not seem to be related to director's independence numbers.

Audit Committee meeting frequency

To fulfil its oversight responsibilities, the audit committee must hold meetings. In contrast, fewer meetings are interpreted as the audit committee not being engaged and/or not spending enough time monitoring, according to Bedard and Gendron (2010). The quantity of audit committee meetings is a reliable reflection of the committee's dedication, diligence, and amount of monitoring time. According to the 2018 corporate governance, the advisory committees of each listed company are required to hold a minimum of four meetings annually (BSEC, 2018).

However, Bedard et al. (2010) discovered conflicting results regarding the association between the number of audit committee meetings and the effectiveness of the committee. According to studies (Sultana, 2015; Krishnan et al., 2007), the frequency of audit meetings is advantageous for financial reporting, the accuracy of financial information, and internal control activities. Regular audit committee meetings also offer continual scrutiny of financial reporting, which reduces the cost of funding for organizations (Anderson et al., 2003). The frequency of audit committee meetings, according to Al-Okaily et al. (2019) (also see Bédard et al. (2004, 2005)), has little impact on the performance of businesses but has a significant positive impact on the performance of non-family organizations.

However, other studies (like the one done by Alqatamin in 2018) have found that business performance is negatively impacted, sometimes just marginally. According to Rahman et al. (2019), audit committee meetings are inversely correlated with firm performance in Bangladesh. This demonstrates that the audit committee itself may occasionally be ineffectual and that the frequency of meetings is not necessarily a reliable measure of the degree of monitoring.

Other Research Findings

Board Independence and Firm Performance

According to many studies, Yekini et al. (2015) discovered a positive association between board independence and information disclosure, as defined by the percentage of non-executive boards. According to their research, companies with independent non-executive directors are more likely than other companies to disclose information that can improve company performance. According to Rosenstein and Wyatt (1990), the proportion of independent non-executive boards has a positive effect on the share price and business performance of a company. Due to their management and oversight obligations, boards managed by non-executives have been proposed to lessen agency conflicts brought on by managers' opportunistic behavior (Dalton and Dalton, 2005). By influencing the caliber of board meetings and decisions as well as by offering strategic direction, non-executive-dominated boards could enhance performance (Deegan, 2006).

On the other hand, the stewardship hypothesis contends that internal directors are aware of major resources that improve the performance of the firm because they have a thorough understanding of the business (Donaldson, 1990). Other researchers contend that internal directors are dependable managers of a company's resources and enhance performance due to information asymmetry (Nicholson and Kiel, 2007). Board independence and business performance were found to have a strong negative association (Agrawal, Klein, and Knoeber, 1998). According to stewardship theorists, most of the board of directors are to blame

for the company's improved success. Since they are more familiar with the company than outside directors, they can make better judgements to maximize shareholder wealth (Masulis and Mobbs, 2011).

Audit Committee meeting frequency and Firm Performance

To ascertain whether the audit committee's frequent meetings affect the performance of the company, several research studies have been conducted, and these studies have yielded contradictory results. Researchers like Khanchel (2007) and Kyereboah-Coleman (2008) found a connection between the frequency of audit committee meetings and a company's performance. Regular audit committee meetings can dramatically lessen agency issues and asymmetric information inside an organization, according to research by Al-Mamun et al. (2014). This is because keeping in touch with investors regularly will protect their interests. In addition, Almoneef and Samontaray (2019) found that the number of audit committee meetings was significantly and positively correlated with the performance of Saudi banks

In contrast, according to a study by DeZoort et al. (2010) Azam et al. Ojulari (2012) failed to discover a connection between the frequency of audit committee sessions and business results. Nonetheless, this relation has negative effects in a variety of other contexts (Vafeas, 1999). According to Bansal and Sharma's (2016) research, audit committee meetings have no relationship with company performance. Moreover, Kichia (2014) investigated the relationship between audit committee meetings and company performance using a sample of non-financial companies listed on the Amman Stock Exchange between 2010 and 2012. There was no relationship that was statistically significant between the variables. Alqatamin (2018) examined the effect of the characteristics of audit committees on firm performance using a sample of 165 non-financial firms listed on the Stock Exchange of Amman between 2014 and 2016. According to the findings of this study, there was no relationship between audit committee meetings and the performance of the company.

Conclusion

A well-run corporation is increasingly valued for having corporate governance. The need for corporate governance has been recognized by the world's economies due to investors' reluctance to invest in companies that do not follow these standards. The audit committees and the board of directors are significant components of internal governance that aid management in achieving goals and enhancing the performance of Egyptian listed companies, it has become obvious from analyzing many theories of corporate governance.

Several studies show that board independence has a strong negative impact on a company's profitability, which means that businesses where a single person serves as both the board chair and CEO have a negative impact on profitability. The outcome might suggest that, despite the companies having the highest percentage of independent directors, this did not always translate into better firm performance, and vice versa. Therefore, it is important to keep an eye on independent board members to promote increased profitability. According to many studies, board independence negatively affects a company's liquidity and those companies with a single person serving as both the board chairman and CEO have a negative effect on the liquidity of those companies. The findings might suggest that even though the companies had the most independent directors, their performance would not have improved with more liquidity, and vice versa. It's crucial to keep an eye on the participation of independent board members if you want to boost shareholder value and the company's liquidity situation. This result was backed by several studies, including Bhagat & Fauzi's research, which found that the board's independence had a significant detrimental impact on the performance of companies. These findings show that the presence of independent directors does not ensure improved firm performance, and as a result, businesses should appoint independent boards that can effectively conduct supervisory duties. According to their research, there is a considerable inverse association between board independence and corporate performance (Beasley, 1996; and Klein, 2002).

In conclusion with many studies, As the frequency of audit committee meetings rises, so do the performance and profitability of the company. This finding suggests that the number of audit committee meetings is directly related to the degree of success of an organization. In other words, regular audit committee meetings could greatly reduce agency issues and knowledge asymmetry inside an organization. This is because keeping in touch with investors regularly will protect their interests. This conclusion was backed by several studies in the literature, including Hsu (2010), who looked at the impact audit committee

meetings had on the financial performance of 220 U.S. corporations between 2000 and 2002. The results of this study indicate that the performance of American corporations is favorably correlated with the frequency of audit committee meetings. Significant data backup Kent and Stewart's (2008) claim that more audit committee meetings result in higher firm performance.

Significant findings were obtained with a positive coefficient for the number of audit committee meetings, suggesting that as the number of audit committee meetings increases, the company's performance will advance. Numerous studies in literature, such as those that found a significant link between the frequency of audit committee meetings and the performance of the firms (Al Farooque, Buachoom, & Sun, 2020), provided evidence to support this conclusion. The exact same statistically significant positive connection was found by Almatari et al. (2012).

Recommendations for Future research

In the future, there are several different opportunities that can be considered to carry out additional research.

Future researchers should be able to compare listed and unlisted companies to determine whether their corporate governance practices are comparable.

Secondly, future research and studies could investigate the impact of external mechanisms for good corporate governance, such as the managerial labor market, the market for company control, interest rate policy, foreign exchange, the macro economy, inflation, and other external factors impact firm performance. In addition, it is suggested that future research consider the interdependence or interconnection between external and internal mechanisms, as well as their impact on firm performance.

Finally, to fully understand how good corporate governance affects a company's performance, future research should take into consideration a variety of legal, social, economic, and political issues. These include the board's commitment, the attending rewards, compensation for the board and committee members, the risk committee, the remuneration committee, and corporate social responsibility.

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