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Developing Corporate Governance Quality and it's Impact on Firm Value

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Abstract

This proposition research aims to explore on a variety of measurement of the corporate governance quality and its influence on the firm value. Various models of measurement of the quality of corporate governance in the form of an index has been widely used by researchers on several dimensions. Further development, the governance quality measurement through the implementation of the rating performed by using a governance index that has been built in European countries, Korea, USA and some developing countries are getting a response (criticism), especially from the information technology experts, as has been done by Grzybkowski and Wojcik (2006). The quality of governance is proxied by IBCG Rating has been tested by Hartono *et al.* (2013) and shows that its effect on the firm value while giving recommended on the proxy shortage by recommending the addition of resource development plan, especially human resources, disclosure regarding whistleblowing system, and threats litigation adapted to the conditions of each country. The contribution of this paper is focus on methodological development. From the methodological point of view, the paper introduces Internet Based Corporate Governance (IBCG) rating modified with adapted to the conditions of each country-a system for the evaluation of the use of Internet in the governance of companies. The propositions of this research include: 1) there is no difference between the IBCG Rating and the IBCG Rating Modified; and 2) there is positive influence of IBCG Rating modified on firm value.

Keywords: Corporate governance, Firm value, Internet, IBCG rating modified.

Contribution of Study

This paper contributes in the existing literature focusing on the disclosure of corporate governance on Internet. this paper introduces new estimation methodology by the modified IBCG rating. This study is one of few studies which propose the use of Internet as a communication tool of corporate governance quality.

1. Introduction

How strongly important does a firm's corporate governance matter? Good corporate governance is not only impact on performance, furthermore, will be responded positively by external parties (potential investor) that is indicated by the rising value of the company. Shleifer and Vishny dan (1997) argue that corporate governance is a means or mechanism used to convince the owners of capital that investment obtains appropriate yields. Shareholders' interests can be protected in the long term when his attention was also devoted to the interests of other stakeholders.

Aspects of transparency, accountability, responsibility, independence, fairness and equality are needed to achieve business continuity (sustainability) as well as a good indicator of poor management of the business. Support information system that can be accessed by interested parties has long believed to be able to encourage the creation of good corporate governance (GCG). Transparency, as an illustration, are less optimal implemented when the access to all parties (concerned stakeholders) are limited (Hartono *et al.*, 2013).

2. Modified IBCG Rating

Various models of corporate governance quality measurement in the form of the index had been widely used by researchers over several dimensions. For example, governance index that has been used by Bauer *et al.* (2004) for the euro area; Germany (Drobertz *et al.*, 2004); several developing countries

(Klapper and Love, 2004); Russia (Black, 2001); Korea (Black *et al.*, 2006); USA (Gompers *et al.*, 2003) and Bauer *et al.* (2008) in Japan.

Further developments, implementation of governance quality measurement using the governance index that has been built in European countries, Korea, USA and some emerging markets are getting responses (criticism) from information technology experts. Grzybkowski and Wojcik (2006) mentioned that the rating methodology that used by agency rating on the governance quality is far from transparent. Grzybkowski and Wojcik (2006) then proposed a model for measuring the governance implementation quality calls the IBCG (Internet Based of Corporate Governance) rating based on the OECD Principles of Corporate Governance. IBCG rating is an interaction between corporate governance with internet technology. The model consists of 120 criterias divided into five major components, namely: shareholders, transparency, board of directors, executive management, and technical accessibility.

We assess that the significance of transparency can work well if it is supported by the use of information technology. The quality of governance is proxied by IBCG Rating that has been tested by Hartono *et al.* (2013) and shows that its effect on the firm value and also give recommendation to add resource development planning, especially human resources, disclosure regarding whistleblowing system, and threats of litigation adapting to the conditions of each country.

3. Corporate Governance Quality and Firm Value

Some researchers (Black, 2001; Gompers *et al.*, 2003; Drobertz *et al.*, 2004; Bauer *et al.*, 2008) argue that the governance quality in a company can increase the value of the company. Gompers *et al.* (2003) find that firms with strong shareholder rights (termed Democracies) exhibit better operating performance than firms with weak shareholder rights.Black Bernard *et al.* (2008) confirm the association between governance and value using panel data on Korean public companies over 1998-2004. Firms with higher scores on an overall Korean corporate governance index (KCGI) have higher Tobin's Q. These corporate governance components and a composite variable of these components representing the overall corporate governance of firms are found to be positively associated with the level of uncertainty arising from the incomplete governance arrangements of finance contracts (Rahman, 2002).

Leal and Da Silva (2005) using construct a corporate governance practices index (CGI) from a set of 24questions and show that The CGI maintains a positive, significant, and robust relationship with corporate value. Black *et al.* (2006) in Russia find an economically important and statistically strong correlation between governance and market value. In Brazil, Da Silveira *et al.* (2007) suggest obtained in all econometric approaches show a positive and significant influence of corporate governance quality on firm's market value. OLS results with market value variables Tobin's Q and PBV multiple suggest that, ceteris paribus, a worst-to-best change in governance quality would result in a market capitalization increase of around 85% and 100% in Brazil.

Balasubramanian *et al.* (2010) also find cross-sectional evidence of a positive relationship for an overall governance index and a subindex covering shareholder rights. The association is stronger for more profitable firms and firms with stronger growth opportunities. Eberhart (2012) presents evidence that the adoption by Japanese firms of a shareholder-oriented, more transparent, system of corporate governance creates greater corporate value in comparison to the traditional system of statutory auditors. The effect is not only significant, it is important in magnitude. Data analysis shows a significant increase in firm valuation, as measured by Tobin's Q.

Kallunki *et al.* (2009) investigated the effectiveness of two main corporate governance mechanisms, namely the board of directors and auditing. Overall, the empirical results suggest that both boards with equity incentives and higher quality auditors may act as effective governance mechanisms with positive valuation implications. Hermalin (2008) builds a model that explains the empirical findings, but which doesn't suffer from this money-on-the-table critique. He find that strong governance and performance are positively correlated. Gu and Hackbarth (2012) examines how accounting transparency and corporate governance interact. Firms with better governance are associated with higher abnormal returns, but even more so if they also have higher transparency.

Garay and González (2008) show that an increase of 1 per cent in the CGI results in an average increase of 11.3 per cent in dividend payouts, 9.9 per cent in price-to-book, and 2.7 per cent in Tobin's Q. Ntim *et al.* (2009) investigates the relationship between a broad corporate governance (CG) index and firm value (Tobin's *Q)* using a sample of 169 South African (SA) listed firms between 2002 and 2006. Consistent with the results of prior studies, they find a statistically significant and positive association between good CG practices and firm value. De Toledo (2010) assesses the relationship between the quality of governance and the market value of Spanish publicly traded firms. The results show an overall positive impact of governance on firm value. Garay *et al.* (2013) examine the relationship between an Internet-based corporate disclosure index and firm value in the seven largest stock markets of Latin America. They find, after controlling for firms' characteristics, industry and country of origin, that an increase in 1% in the Internet-Based Corporate Disclosure Index causes an increase of 0.1592% in the Tobin's Q and an increase of 0.0119% in the firm's ROA.

Based on a newly assembled firm-level data set on corporate governance and firm performance, Chong and Lopez-De-Silanes (2006) show that better firm-level corporate governance practices are linked to higher valuations, better performance and more dividends disbursed to investors. Using a sample of 169 post-Apartheid SA firms from 2002 to 2007, (Ntim *et al.*, 2010) find a significant positive association between a broad CG index and firm value. Choi Yoon and Han Seung (2011) explore these events to examine the effect of bank governance. Their results are consistent with the argument that recent Japanese restructuring reduces information asymmetries and agency problems, thus improving the efficiency of internal capital markets and firm value.

Other research results indicate that the implementation of governance has no effect on the value of the company or does not increase the maximum value of the company (Bhagat and Black, 1999; Black, 2001). Kang *et al.* (2002) find that downsizing (diversifying expansionary) actions during the crisis have a positive (negative) effect on the value of chaebol firms. they results suggest that change in firm value during such a crisis is a function of firm-level differences in corporate governance measures and owner-manager incentives. Griffin *et al.* (2015) examine why corporate governance varies widely across countries and across firms, and why such variation matters. Using a new database from Governance Metrics International on corporate governance practices across a large number of countries and firms for 2006-2011, and find that Within countries, there is a positive association between firm-level corporate governance practices and firm value; however, across countries, the association is negative or zero.

Seog (2007) show that good (strict) governance may reduce firm value. While good governance prevents managers (entrepreneurs, or controlling shareholders) from expropriating firm value for their private interests, it also reduces the incentives for them to increase firm value in the first place. Other main findings include: Firms may produce more under weaker governance. Whether it look at the effects of governance on long-horizon stock returns, firm value, or operating performance, Giroud and Mueller Holger (2008) consistently find the same pattern: The effect is monotonic in the degree of competition, it is small and insignificant in competitive industries, and it is large and significant in non-competitive industries. Gupta *et al.* (2009) examine the association between the composite or sub-category corporate governance scores and various measures of firm value in Canada. Using data for 2002 through 2005 on the Report on Business rankings and various financial and market measures, Overall, these research does not find an association between the composite or sub-category corporate governance scores and the various measures of firm value. Bae *et al.* (2011) find that during the 1997 Asian financial crisis, Asian firms with weaker corporate governance experience a larger drop in their share values, but during the post-crisis recovery period, such firms experience a larger rebound in their share values

Based on the differences in the results of the study, we conduct studies assessing the need for governance of the relationship between corporate governance and firm value.

4. The Hypothetical Propositions

The contribution of this paper is focus on methodological development. From the methodological point of view, this paper introduces Internet Based Corporate Governance (IBCG) rating modified with adapted to the conditions of each country- a system for the evaluation of the use of Internet in the governance of companies.

The propositions of this research include: 1) there is no difference between the IBCG Rating and the Modified IBCG Rating; and 2) there is positive influence of modified IBCG Rating on firm value. The first proposition can be measured by Chow test. Second proposition can be examined using a variety of measurements of the firm value.

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