# THE IMPACT OF CORPORATE GOVERNANCE ON SELECTED AREAS OF FINANCIAL DECISION MAKING

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***Abstract:*** *The purpose of this paper is to examine the relation between corporate governance and financial decision making process in the area of dividend policy and the indebtedness. The paper uses a correlation analysis to examine the association between corporate governance, the debt companies and the amount of dividends paid to shareholders. We measured the level of corporate governance by corporate governance index, which contains information about a disclosure of annual report, corporate governance information in an annual report, content of corporate governance statement, boards of companies, remuneration of board members, risk management, audit, remuneration and nomination committee characteristics. We have compiled the first corporate governance index in Slovakia and we found inspiration in foreign studies with respect to the specifics Slovak financial market. The most important contribution of this paper is the finding that the application of the principles of corporate governance affects financial decisions of companies. There is a correlation between the responsible application of corporate governance principles and the total debt of companies. And also, there is correlation between responsible application of corporate governance principles and the amount of dividends paid to shareholders.*

***Keywords:*** *corporate governance, dividend policy, debts, Bratislava Stock Exchange*

***JEL Classification:*** *G30, G32, G34*

## 1. INTRODUCTION

The statements of the European Commission and the OECD in the context of the economic crisis are consistent and as the main problem they see that the managements of companies failed to apply the principles of corporate governance. In the context of the financial and economic crisis, representatives of world institutions are looking for a global solution which could help to create effective and sustainable management systems. The principles of corporate governance can help to make this happen and these principles are one of the means to reduce the harmful short-term and excessive risk taking. Nowadays, corporate governance is one of the key elements in building people's trust.

We point out the importance and impact of responsible application of corporate governance principles for the companies based on the available empirical studies and the results of our research.

## 2. CONCEPT OF CORPORATE GOVERNANCE

The term corporate governance and its everyday usage is a new phenomenon that appeared in the last twenty years or so. The basic theories that influenced the development of corporate governance include a variety of areas including finance, economics, accounting, law and management.

Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Schleifer, Vishny, 1997). A definition from the OECD clearly captures the essence of corporate governance "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions in corporate affairs" (OECD, 2004). Corporate governance is governance and management of the principles of openness, honesty and responsibility of the management to the shareholders, employees, suppliers, customers, banks, regulators, immediate surroundings and the environment (Lazárová, 2008).

Some authors define corporate governance from the perspective of the agency cost or stakeholder theory. Corporate governance is understood as a response to the agency problems that arise from the separation of ownership and control in a corporation (Boubaki, 2005 in Elbadry, 2010). In the case of separation of ownership from management there is a set of mechanisms that affect the decision making of managers. Through corporate governance we can influence managers acting in their own interest to implement decisions that maximize the value of owners (Elbadry, 2010). From the perspective of the stakeholder theory, corporate governance is defined as ways in which all parties interested in the well-being of the firm (the stakeholders) attempt to ensure that managers and other insiders take measures or adopt mechanisms that safeguard the interests of all stakeholders, not just shareholders but also creditors, employees, customers, suppliers and so on (Elbadry, 2010).

## 3. THE IMPACT OF CORPORATE GOVERNANCE ON DEBT AND DIVIDEND POLICY OF MONITORED COMPANIES

The authors of several studies have researched the direct relationship between corporate governance and the debt of companies. Chen et al. (2010, p. 234) found the overall impact of external financing needs on corporate governance. Their results demonstrate the important implications that corporate governance practices have for those firms with a particularly strong need for external equity, and the fact that external financing needs provide incentives for firms to seek out ways of making improvements to the overall quality of their corporate governance practices. In this case, good corporate governance gives a signal to investors that firms are likely to have fewer potential problems of information asymmetry and conflict of interest between managers and shareholders, and thus, creates greater shareholder wealth and firm value. The results of a study made by Funchal et al. (2008) show that the higher the corporate governance score on the Brazilian Corporate Governance Index, the lower the cost of debt. The Brazilian Corporate Governance Index considers disclosure, ownership structure, board composition and shareholder rights in its computation. Next, they found that better corporate governance arrangements relate to firms with higher debt amounts. Based on the results of these studies, we set the following hypothesis.

H1: *We assume that there is a correlation between the level of corporate governance in companies listed on the Bratislava Stock Exchange and their indebtedness.*

The subject of our research was companies whose securities are listed on the Bratislava Stock Exchange. The reference period was the year 2012. We obtained the information from the documents which are available in the Central Register of Regulated Information and on the websites of companies. In this paper, we measured the level of corporate governance through corporate governance index. Corporate governance index takes into account the criteria for evaluation in various areas, whose level was evaluated by ordinal characters (see Appendix). Weighting of each criterion in the index is as follows.

$$\text{GC index} = 1{,}2 \times (1) + (2) + 2 \times (3) + (4) + (5) + (6) + (7a) + (7b) + (7c) \quad (1)$$

We evaluated the level of debt through debt ratio (Jindřichovská, 2013):

$$\text{Total debt} = \text{external sources of finance} / \text{total assets}. \quad (2)$$

After an intensive data mining for each surveyed company we evaluated the data in the statistical program SPSS 18 through the Spearman´s rank correlation coefficient.

Based on the value of the Spearman´s rank correlation coefficient, it is evident that there is a correlation between the level of corporate governance and the indebtedness. We can conclude that intensity dependence is weak and it is at the level of 0,328.

Chang and Dutta (2012) examined the dividend policy of a set of Canadian firms over a period of 1997-2004. They found that firms with large board favour higher dividend payments. It is confirmed that a larger number of board members is directly related to the low level of corporate governance, because a larger number of members in the board is considered ineffective. The authors found support for the ‘substitution model’, which means that firms with weaker corporate governance practices favor higher dividend payments. In another study, the authors Pinkowitz, Stulz and Williamson (2006) also confirmed the existence of an indirect correlation between the level of corporate governance and the volume of dividends paid to minority shareholders. Francis, Hasan, John and Song (2011) examined this issue on a sample of American companies from NYSE, NASDAQ and AMEX. Their results confirm a strong correlation between the level of corporate governance and dividend policy. Companies with low levels of shareholder rights tend to pay higher dividends to attempt to establish a good reputation in the market (Jiraporn, Ning, 2003). In general, generous dividends compensate weak shareholder rights. The relationship between corporate governance and dividend policy has been researched by Klock, Mansi and Maxwell (2005); Allen, Gottesman, Saunders and Tang (2012), and O'Connor (2013). Based on the results of these studies, we set the following hypothesis.

H2: We assume that there is a correlation between the level of corporate governance in companies listed on the Bratislava Stock Exchange and the amount of dividends paid to shareholders.

As in the previous case, we measured the level of corporate governance through corporate governance index. We obtained information about the amount of dividends paid to shareholders from the annual reports of companies for the period of 2012.

**Table 1** Correlation between GC index and debt

| | | | CG index | Debt |
|---|---|---|---|---|
| Spearman's rho | CG index | Correlation Coefficient | 1,000 | ,328** |
| | | Sig. (2-tailed) | . | ,001 |
| | | N | 94 | 94 |
| | Debt | Correlation Coefficient | ,328** | 1,000 |
| | | Sig. (2-tailed) | ,001 | . |
| | | N | 94 | 94 |

**. Correlation is significant at the 0.01 level (2-tailed). Source: Authors

**Table 2** Correlation between GC index and the amount of dividends

| | | | **CG index** | **Dividend** |
|---|---|---|---|---|
| **Spearman's rho** | CG index | Correlation Coefficient | 1,000 | ,386** |
| | | Sig. (2-tailed) | . | ,000 |
| | | N | 94 | 94 |
| | Dividend | Correlation Coefficient | ,386** | 1,000 |
| | | Sig. (2-tailed) | ,000 | . |
| | | N | 94 | 94 |

**. Correlation is significant at the 0.01 level (2-tailed). Source: Authors

Based on the value of the Spearman´s rank correlation coefficient, it is evident that there is a correlation between the level of corporate governance and the amount of dividends paid to shareholders. We can conclude that intensity dependence is also weak and it is at the level of 0,386. In comparison with the previous case, the correlation between the level of corporate governance and the amount of dividends paid to shareholders is stronger.

## 4. CONCLUSION

The importance of corporate governance is gathering today, largely due to the positive impact on the economy as a whole. In spite of a relatively short history of the Slovak financial market, we were able to confirm both hypotheses. The authors of studies are divided into two opinion groups in indebtedness in the context of corporate governance. The authors of the first group (Chen et al., 2010; Funchal et al., 2008) claim that better corporate governance arrangements relate to firms with higher debt amounts. Good corporate governance can increase access to external sources of financing for the company. The second group of authors (Jiraporn et al., 2003; Wen et al. 2002; Mande et al., 2012) says that a higher level of corporate governance has an impact on lower debt of companies. In this paper, we confirmed the hypothesis of a direct correlation between corporate governance and debt companies in the Slovak capital market. We also confirmed the second hypothesis that there is a correlation between the level of corporate governance and the amount of dividends paid to shareholders.

Our ambition for future research is to extend corporate governance index to be able to objectively assess the level of corporate governance in companies in the Slovak capital market. We will have more possibilities for deeper regression analysis with the new corporate governance index.

## APPENDIX

Appendix A Evaluation 1st, 2nd, 3rd 4th and 5th criterion and results of the survey

| Criteria | Description | Ordinal scale | Results – numbers of companies |
|---|---|---|---|
| **1. Disclosure of Annual Report** | Availability of information to shareholders and potential investors, such as annual financial report, annual report, a statement on corporate governance and other information that goes beyond legal obligations. | „0“ = annual report for the period 2012 is not disclosed | 10 |
| | | „1“ = annual report is published in the CERI* or on the company's website | 8 |
| | | „2“ = annual report is published in the CERI and also on the company's website | 76 |
| **2. Annual Report** | The scope and clarity of the information about corporate governance. | „0“ = annual report does not contain information about corporate governance | 22 |
| | | „1“ = annual report contains partial information about corporate governance | 65 |
| | | „2“ = annual report contains partial information about corporate governance and deviations from the Code | 7 |
| **3. Corporate governance statement** | The scope, clarity and quality of information. | „0“ = no specific information about corporate governance | 44 |
| | | „1“ = includes a brief explanation of each point of the statement | 29 |
| | | „2“ = contains explanations of each point of the statement and reasons for deviations from the Code | 21 |
| **4. Boards of companies** | Disclosure of information about board members, such as names, experience, responsibility and functions. | „0“ – no information | 15 |
| | | „1“ – only the names of board members | 65 |
| | | „2“ - published the names of board members, together with the qualifications, roles and responsibilities and management functions | 14 |
| **5. Remuneration of board members** | Information about the structure and amount of remuneration for individual members of the board. | „0“ = no information | 46 |
| | | „1“ = only cumulative information about remuneration | 43 |
| | | „2“ = information about the amount of remuneration of individual board members | 5 |

* Central Register of Regulated Information

Source: Authors

Appendix B Evaluation 6th and 7th (7a, 7b, 7c) criterion and results of the survey

| Criteria | Description | Ordinal scale | Results – numbers of companies |
|---|---|---|---|
| **6. Risk management** | Information about risk management, defined predictable risks and risk quantification. | „0“ = no specific information | 67 |
| | | „1“ = basic information about risk management and defined predictable risks | 11 |
| | | „2“ = comprehensive information about risk management and risk quantification | 16 |
| **7. Audit Committee/ Remuneration Committee/ Nomination Committee** | Information about the establishment or failure to establish committees and their activities. | „0“ = no information | 38/71/78 |
| | | „1“ = information about the establishment or failure to establish committee | 44/21/16 |
| | | „2“ = in the case of establishing of the committees there is an information about the activities and results of the committees | 12/2/0 |

Source: Authors

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