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Relationship between Good Corporate Governance and Financial Performance: Evidence from Mongolia

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Abstract

Good corporate governance has multiple impacts on stakeholders, the environment, and society. There are many ways to define good corporate governance. In this study, we try to define good corporate governance in Mongolian-listed companies and find that companies with good governance led to good financial performance. An empirical analysis is made based on the 2016-2020 audited reports regarding some of the corporate governance and financial performance indicators of the first and second-classification joint stock companies of the Mongolian Stock Exchange. The result of this study concludes that good corporate governance has a positive effect on financial performance.

Keywords

Corporate Governance of Mongolia, Panel Regression, Corporate Governance Indicators, Financial Performance, Joint-Stock Companies

1. Introduction

The global political, economic, technological, and social environment is changing rapidly, and companies are facing unprecedented challenges in how to survive, work more efficiently, and manage their impact on society, the economy, and the environment. Companies are becoming more open to shareholding rather than sole ownership or traditional family businesses. They have been directed towards a form and system where any organization and individual can be the owners and directors. The benefits of open companies are limitless in terms of shared knowledge, skills, assets, and resources. At the same time, it is difficult to balance and manage their stakeholders' conflicts of interest. Therefore, good corporate governance becomes imperative. On the other hand, companies are becoming large-scale, sophisticated systemic and capital-financed which has a strong impact on society, the economy, technology, and the environment, both positively and negatively.

Mongolian companies cannot stay away from these new trends and challenges, and in a rapidly changing world, we can develop companies with good governance by improving the best practices of corporate governance in accordance with Mongolia's characteristics. Therefore, there is a need to study the concepts, methodology and best practices of corporate governance, how to determine the quality of corporate governance and its importance. Thus, studying how the performance of companies with good governance differs from the others is essential to this paper. Which factors of good governance have a greater impact on financial performance for Mongolian companies are the main questions of this study. In order to do that, we consider some factors of corporate governance of top listed companies, and it is determined how these affect the financial performance of those companies.

This paper consists of the following section: Section 2 explains a good corporate governance approach. Section 3 shows a relationship model between corporate governance and performance. Section 4 discusses empirical results. Finally, we provide a conclusion.

2. Literature Review

Academics and major institutions have been trying to define and explain corporate governance from various perspectives. For instance, corporate governance is the system by which companies are directed and controlled[1]. Corporate governance involves a set of relationships between a company's management, board, shareholders, and other stakeholders[2].

Institutions and academics have done a number of general studies on corporate governance, but they have not yet come to a clear and common understanding of how to define good corporate governance and what its most important components are. Cheffins (2012) identified that the Cadbury Report in 1992 marked the first major step in the next phase of corporate governance development. Since the Cadbury Report, there has been an increased interest in the study of corporate governance by scholars. Since then, the society, those who owns shares began to focus more on the management of their companies in order to control them. As a result, issues of the quality of corporate governance and good corporate governance practices, have been discussed. Not only of scholars and researchers but also policymakers followed public demand in these attraction (Chan et al., 2014; Hugill & Siegel, 2014; Zaman et al., 2011).

There are even fewer studies on how to measure corporate governance (Bebchuk et al., 2005; Cremers & Nair, 2005; Gompers et al., 2003). Daines et al. (2010) and Schnyder (2012) have identified that these studies show conflicting

[1]Cadbury Committee, 1992.

[2]OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris.

findings or very little correlation. Raelin and Bondy (2013) explained that it is typical for researchers to look at the quality of corporate governance in terms of its economic efficiency. However, scholars do not agree on the best way to measure a company's financial performance (Bebchuk et al., 2005), which creates the problem of finding a "perfect" measure of corporate governance quality. So the question of how to measure the quality of universally accepted corporate governance is controversial. But there have been similar principles of corporate governance such as transparency, accountability, responsibility and fairness in the concept, and those are important for good governance, and taken together, corporate governance "best practices" have been used by a number of scholars and policymakers. It determines indicators of good governance through the implementation of shareholders' rights, the responsibilities of stakeholders, and the board of directors.

3. Model

We set up our model to evaluate whether corporate governance is related to financial performance results as follows:

$$\begin{aligned} \mathrm{FP}_{it} = {} & \beta_0 + \beta_1 \mathrm{MS}_{it} + \beta_2 \mathrm{NOS}_{it} + \beta_3 \mathrm{NSM}_{it} + \beta_4 \mathrm{DD}_{it} + \beta_5 \mathrm{FS}_{it} \\ & + \beta_6 \mathrm{NBM}_{it} + \beta_7 \mathrm{NIB}_{it} + \varepsilon_{it} \end{aligned} \tag{1}$$

where FP_{it} is the financial performance indicators of the i-th company in the t-th period under Table 1. The explanatory variables (corporate governance indicators) are denoted by MS, NOS, NSM, DD, FS, NBM, and NIB in Table 2.

4. Results and Discussion

4.1. Data

In order to study the relationship between financial performance and corporate governance, we selected 23 joint-stock companies with registration of Mongolian

Table 1. Financial performance indicators.

Ratios	Indicators and Abbreviations
Solvency ratio	Current ratio (CUR)
	Quick ratio (QR)
Financial stability ratio	Tangible worth to total assets (TAR)
	Debt to equity ratio (DER)
Profitability analysis	Gross profit margin (GP)
	Return on assets (ROA)
	Return on equity (ROE)
Cash Flow analysis	Cash receipts from operations to sales ratio (CRO)
	Cash paid for operations to cost of sales ratio (CPO)

Source: Ehrhardt and Brigham (2011).

Table 2. Corporate governance indicators.

Abbreviations	Explanations
MS	Major shareholder's share
NOS	Numbers of shareholders
NSM	Numbers of shareholder meetings
DD	Dividend distributed or not
FS	Financial statements submitted within due dates
NBM	Number of board directors
NIB	Number of independent directors

Source: Paniagua et al. (2018).

Stock Exchange. We also included the criteria that these companies be steady and that their shares trade actively. In accordance with the criteria, the related data covered the period of 2016-2020, based on audited financial statements. Table 3 displays the summary statistics.

According to Table 3, the largest shareholder owns a maximum of 97.5%, a minimum of 19.7%, and an average of 47.7%; the number of shareholders is a maximum of 51,881, a minimum of 94, and an average of 3790; the number of board members is a maximum of 11, a minimum of 9, the number of independent directors is a maximum of 5 and a minimum of 2, and an average of 3.

4.2. Panel Regression Analysis

Table 4 shows the result of a Panel Least Square estimation. The solvency ratio outcomes show that dividend distribution (DD) and the number of independent directors (NIB) have a positive effect on the current ratio (CUR) and quick ratio (QR). In other words, if dividends are timely or having more independent directors on the board, it could improve the current and quick ratio. If the number of independent directors on the board is large, it is observed that the solvency ratio comes into good effect.

The financial stability results show that the number of shareholders (NOS) has a positive effect on financial stability. However, the percentage of the largest shareholder (MS) and whether financial statements were reported not on time (FS) had a negative effect. In conclusion, the financial stability of companies with a large number of shareholders is good. In contrast, the largest shareholder's share is high, and companies that do not report their financial statements on time are poor in terms of financial stability.

According to the profitability results, the number of independent directors (NIB) has a positive effect on the company's profitability. In other words, the greater the number of independent directors the better the profitability.

According to the cash flow results, the number of directors (NBM) and the number of board meetings (NSM) have a positive effect on the company's cash flow, while the number of independent directors (NIB) has a negative effect.

Table 3. Summary statistics.

	MS	NOS	DD	NBM	NIB	NSM	FS
Mean	0.4774	3790.078	0.5130	9.2260	3.1652	1.0956	0.9652
Median	0.4490	924.0000	1.0000	9.0000	3.0000	1.0000	1.0000
Max	0.9750	51881.00	1.0000	11.000	5.0000	2.0000	1.0000
Min	0.1970	94.00000	0.0000	9.0000	2.0000	1.0000	0.0000
St D.	0.2026	10527.64	0.5020	0.6360	0.5450	0.2954	0.1840
Observation	115	115	115	115	115	115	115

Source: Mongolian stock exchange (2016-2020).

Table 4. Relationship between corporate governance and financial performance.

Explanatory variables	*MS*	*NOS*	*DD*	*NBM*	*NIB*	*NSM*	*FS*	*Adj. R^2*
CUR			2.621** (1.173)	−2.640** (1.068)	5.277* (1.464)			0.361
QR			2.315* (1.175)	−2.616** (1.069)	5.605* (1.331)			0.372
TAR	−0.421** (0.178)						−0.105* (0.054)	0.924
DER		0.002** (0.001)						0.861
GP					0.179** (0.081)			0.690
ROA			−0.070** (0.035)					0.549
ROE			0.102* (0.047)					0.572
CRO				1.170** (0.335)	−2.586** (0.391)			0.522
CPO						0.775** (0.366)		0.116

Notes: Standard errors clustered at the province level are reported in parentheses. ***, **, and * denote statistical significance at 1%, 5%, and 10%, respectively.

Taken together, the adjusted R-squared of selected corporate governance factors on financial performance indicators is at most 92 percent and at least 12 percent.

4.3. Limitation

The study acknowledges several limitations. The data utilized were derived from audited financial statements covering the years 2016 to 2020. Upon the conclusion of the annual reporting period in 2023, it would be prudent to conduct an analysis encompassing a full eight years of data to more comprehensively examine the relationship between corporate governance and financial performance.

This study considers a total of seven indicators of good corporate governance. Future research could be enhanced by identifying additional measurable indicators aligned with the principles of good corporate governance, including transparency, accountability, fairness, and responsibility.

Notably, this study does not account for indicators of good corporate governance related to executives, who are among the main stakeholders. It is essential for future research to include these indicators to better understand their impact on financial performance.

5. Conclusion

In order to study the relationship between financial performance and corporate governance, we collected 5 years data of top 23 joint stock companies and 9 indicators were used as dependent variables from the financial part. From the governance part, we used 7 factors of corporate governance indicators as explanatory variables. Selected 7 indicators of corporate governance have a different relationship to financial performance. Among the best explanatory indicators are the major shareholder's share, the number of shareholders, the financial statement submitted within due dates, and the number of independent directors. We concluded that not every corporate governance numerical indicator is necessarily correlated with financial performance.

Selected corporate governance indicators have a greater impact on financial stability and profitability than other financial performance. In general, it can be concluded that good corporate governance has a positive effect on financial performance.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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