THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FIRM PERFORMANCE: MODERATING ROLE OF CORPORATE SOCIAL RESPONSIBILITY

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THESIS SUBMITTED IN FULFILLMENT FOR THE DEGREE OF MASTER OF ACCOUNTING

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DECLARATION

I hereby declare that the materials in this study is my own except for quotation, equations, summaries and references, which have been duly acknowledged.

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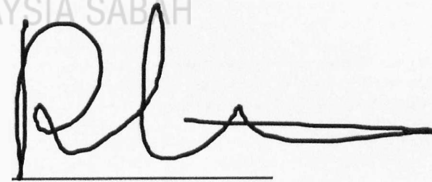

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ABSTRACT

Under the complex and changeable global market in the 21st century, continuous performance is a key driver of a firm especially in coping with a growing number of challenges arising from unforeseen events in business landscape. As a matter of fact, the rapid growth in capital market in Asia especially China has brought the importance of the corporate governance in portraying firm's future performance. More importantly, combined the in-depth development of economic globalization with the Chinese rapid economic development, Corporate Social Responsibility (CSR) has attracted great attention in China. Given the importance of both corporate governance and CSR, this study examined the moderating role of CSR on the relationship between corporate governance and firm performance based on Listed firms in China. To examine their relationship, this study employed panel data regression techniques using stock data to represent the aggregate composition of the Shanghai Stock Exchange 180 Index (SSE 180 index) from 2010 to 2019. All the data collected from database were analyzed through E-VIEWS and STATA software. After controlling the possible endogeneity problems and robustness check, the empirical results are as follows: board size, CEO duality and CEO compensation could improve firm performance. There is a significant negative relationship between debt and firm performance. CSR could moderate (reduce) the positive relationship between board independence and firm performance as well as the positive relationship between CEO compensation and firm performance. In conclusion, the result showed that not all so-called good corporate governance can produce better firm performance based on unique Chinese capital market and although CSR is considered as a useful business strategy, it still has a lot of room for improvement in China. Therefore, companies should constantly improve corporate governance structure and CSR level to achieve the purpose of improving firm performance.

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ABSTRAK

HUBUNGAN ANTARA TADBIR URUS KORPORAT DAN PRESTASI FIRMA: PERANAN MODERASI TANGGUNGJAWAB SOSIAL KORPORAT

Dalam pasaran global yang kompleks dan sentiasa berubah di abad ke-21, prestasi berterusan adalah pemacu utama firma terutama dalam mengharungi pelbagai cabaran yang tidak diduga kewujudannya dalam landskap perniagaan. Seperti yang kita maklum, pertumbuhan pesat dalam pasaran modal di Asia khususnya China telah membawa kepada kepentingan tadbir urus korporat yang menggambarkan prestasi firma di masa hadapan. Lebih penting lagi ialah perkembangan globalisasi ekonomi yang mendalam dengan perkembangan ekonomi China yang pesat, Tanggungjawab Sosial Korporat (CSR) telah menarik perhatian ramai di China. Memandangkan kepentingan kedua-dua tadbir urus korporat dan CSR, kajian ini meneliti peranan CSR dalam memoderasikan hubungan antara tadbir urus korporat dan prestasi perusahaan firma tersenarai di China. kajian ini menggunakan teknik regresi panel data dengan menggunakan data saham yang diwakili oleh komposisi agregat Indeks Bursa Saham Shanghai 180 (indeks SSE 180) dari tahun 2010 hingga 2019. Semua data yang dikumpul dari pangkalan data dianalisis melalui perisian E-VIEWS dan STATA. Setelah mengawal kebarangkalian masalah endogeni dan penelitian ketahanan (robustness), hasil empirik adalah seperti berikut: Saiz lembaga, keduaan CEO dan pampasan CEO dapat meningkatkan prestasi syarikat. Kajian juga mendapati wujud hubungan negatif yang signifikan antara hutang dan prestasi firma. CSR dapat memoderasikan (mengurangkan) hubungan positif antara kebebasan lembaga dan prestasi syarikat serta hubungan antara pampasan CEO dan prestasi firma. Sebagai kesimpulan, hasil menunjukkan bahawa tidak semua tadbir urus korporat yang baik boleh meningkatkan prestasi yang kukuh walaupun CSR dianggap sebagai strategi perniagaan yang bermanafaat. Oleh yang demikian, firma harus sentiasa memperbaiki struktur tabir urus korporat dan tahap CSR bagi meningkatkan prestasi firma.

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LIST OF ABBREVIATIONS

CSR	-	Corporate Social Responsibility
CG	-	Corporate Governance
FP	-	Firm Performance
OECD	-	The Organization for Economic Co-operation & Development
SOEs	-	State-owned Enterprises
SSE	-	Shanghai Stock Exchange
GICS	-	Global Industry Classification Standard
VIF	-	Variance Inflation Factors
OLS	-	Ordinary Least Squares
IV method	-	Instrumental Variable method
2SLS	-	Two-Stage Least Square
LM	-	Lagrange Multiplier

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CHAPTER 1

INTRODUCTION

1.1 Introduction

This chapter outlines the background of the study, problem statement that represents the gaps in the literature, scope of study, significance of study, definition of important terms and organization for the rest of the chapters available in the study.

1.2 Background of the study

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The world market of the 21st century has been undergoing complex and profound changes in tandem with the acceleration of world economic globalization. This may result in instability and uncertainty in the business environment in this new century. In relation to that, complex and changeable market environment has forced firms to face many challenges and even cruel market competition. Under this situation, firms have opportunities to occupy a larger market, yet will be eliminated by the market forces because of failures to compete. Hence, continuous stable performance is a key driver of a firm especially in dealing with the increasing challenges posed by the unforeseen events in a dynamic business landscape. Only through performance can a firm have opportunity to achieve sustainable development and make rapid progress, so most firms are trying to find all possible ways to improve their performance (Taouab, 2019).

However, with the strong economic growth in China, Chinese capital market had always experienced many problems like weak corporate governance, unnecessary interference in business decisions from government and lack of effective executive restraint mechanisms. As a result, some scholars (Liu et al., 2015;

Yu, 2013) argued that China's capital market is unique in that a distinct ownership structure (highly concentrated state-owned shares), an inefficient environment within its institution (poor protection for investors and rampant insider trading) as well as quite weak law enforcement. The above issues have hindered the growth of firm performance in China. Therefore, it is meaningful to explore the factors that can influence firm performance based on Chinese capital market.

Firm performance, as refer in this study, is focused on a firm's financial performance. It is normally measured through its net income and cash from their daily operations. According to Yu (2013), financial performance refers to the capability of a firm to create new resources through its daily business activities within a certain period of time. In fact, firm performance is not measured solely based on financial performance. Some non-financial indicators are also used to measure firm performance, such as quality, customer and employee satisfaction, innovations, market share and so on. These indicators not only reflect the economic position of a firm, but also portray the future financial performance results. As a matter of fact, the non-financial performance may be a closer link to company's long-term strategies. However, there is no uniform method to classify, measure and evaluate them (Kotane & Kuzmina-Merlino, 2012), which causes difficulties to guarantee the reliability of data and display information through non-financial indicators. Therefore, firm financial performance is an important manifestation of a modern company's business objectives. Although firm performance could be measured by numerous indicators, this study attempted to execute the measurement in connection with corporate governance.

There was consensus amongst scholars about the importance of firm performance, hence investigations on its determinants by several empirical studies have been carried out. Corporate governance, as one of its determinants, facilitates effective and prudent management that could deliver the long-term success of firms and hence becoming a key driver for improving firm performance. According to Shleifer & Vishny (1997), corporate governance was considered as a mechanism that can guide the actions of managers to maximize the interests of financiers so that their financial investment could be returned. This means that a better-governed firm should have better performance to ensure investors in corporations get the best

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interests. Al-Matari et al. (2014) argued that an effective corporate governance could prevent possible financial crisis and attract more investment for firms to maximize its capital and reinforce its pillars, thereby promoting the growth of firm performance. Furthermore, a strong corporate governance will not only improve firm performance, but also promote the capital market operation and long-term sustainable development of both capital markets and firms (Sabbaghi, 2016). Therefore, the understanding of corporate governance and its substantial impacts on firm have led to this being a popular research topic.

Corporate governance became a preferable topic in academic discussions during the Asian financial crisis in 1997 as well as some landmark events, such as the well-known corporate scandals of Enron and WorldCom in Europe and many others (li et al., 2012). Since the mid-1980s, the Organization for Economic Co-operation & Development (OECD) countries have undergone complex and profound changes regarding to their economies and politics, which have intensified the use of the term "corporate governance" (Marie L'Huillier, 2014). For OECD countries, transparency, integrity and reliability with a set of rules, policies and resolutions are crucial for good governance. According to OECD (2004), good corporate governance involves an effective board whereupon majority of directors must be independent, employing different person as chairperson and Chief Executive Officer (CEO), as well as a two-tier board (Supervisory Board and Board of Directors). However, most of OECD members are developed countries. Therefore, although all parties generally agree on the view that "good corporate governance" can have a positive effect on firm performance. It is still a great controversy about whether the listed companies have really improved firm performance after adopting those considered as good corporate governance mechanisms in the emerging countries like China.

Based on Chinese capital market, Chen et al., (2011) examined whether the major problem of controlling-shareholder expropriation prevalent in developing countries could be mitigated through the adoption of good governance practice stipulated by OECD countries. They found the OECD-prescribed practices cannot alleviate the negative effect of controlling-shareholder expropriation on firm performance. Most of them are mainly aimed at resolving conflicts between shareholders and managers not between controlling and minority shareholders. In

emerging economies like China, controlling shareholders may undermine minority shareholders' interests as well as firm performance in some inappropriate ways, such as appointing unqualified friends or family members as executives, engaging in self-serving transactions, and advancing personal, familial, and political agendas (Chen et al., 2011; Li & Qian, 2013). Some scholars (Chen et al., 2011; Hu et al., 2010; Jiang & Kim, 2015; Jiang & Peng, 2011; Sabbaghi, 2016; Su et al., 2008; Young et al., 2008) described this phenomenon as Principle-Principle conflicts, which is characteristics of many emerging economies. However, compared with developing countries, the problem of controlling shareholders expropriation in developed countries can be offset to a large extent through tough legal measures and mature market mechanisms.

Likewise, Dian (2014) furthermore argued that the so-called good governance practices that come from the West (such as the independent director system) are often divorced from the actual situation in the host country (OECD countries). Dian (2014) believed that the so-called good governance practices are the results constructed by the various complex social forces and interest groups in specific social, political and cultural institutions. How 'optimal' corporate governance works largely depends on whether it is suitable for the institutional environment it is embedded; such as the link between independent directors and firm performance is not clear in China. The reason for this phenomenon is the difference in the role of independent directors between China and the Western countries. In the Western countries, independent directors are believed to effectively alleviate agency costs between internal managers and external shareholders. But in China, major shareholders or controlling shareholders may plunder wealth from small shareholders. As a result, independent directors in emerging economies often do not play their role, and supervisors often have low status and weak power in companies, which have highlighted in several previous studies (Jiang & Kim, 2015; Liu et al., 2015). Therefore, not all so-called good governance practices are beneficial to every country.

Additionally, some corporate governance practices are judged as undesirable by Agency Theory, may contribute to the improvement of firm performance in emerging economies. Typically, state ownership can exhibit certain benefits for firms

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in China. Liu & Yang (2012) found that Chinese State-owned Enterprises (SOEs) performed poorly before the 2008 financial crisis, while improved during the crisis because Chinese state-owned banks provided them with bailout loans during this period to help them get out of their difficulties. Based on the ideas given by Yu (2013), it made clear that under the unique environment in which have a concentrated ownership structure, reliance on the banking system, poor investors protection and weak law enforcement, the state as the large shareholder could provide financial and resource support for firms. In contrast to China, most of studies have frequently found the adverse effect of high state ownership on firm performance based on a Western perspective. In Western countries, the ownership structure is not concentrated, while minority shareholders' rights could be protected by a sound legal infrastructure, well-managed labor market as well as active takeover markets. Therefore, it is necessary to explore more about corporate governance based on the Chinese unique background.

Due to those issues highlighted in previous studies, it is essential to further explore the contribution of corporate governance dimensions on firm performance. Furthermore, combined the in-depth development of economic globalization with the Chinese rapid economic development, people's awareness of social responsibility is gradually enhanced. Corporate Social Responsibility (CSR) which is originated from the West, has attracted great attention in China. An important reason why CSR has attracted much attention is that the commercial value it brings is increasingly reflected (Feng et al., 2017). The commercial value brought by CSR includes (1) attracting, retaining, and motivating employees; (2) continuing to meet consumer's needs; (3) reducing costs by energy conservation and cutting down other unnecessary inputs; (4) developing new products and services to help solve social issues and promoting firm innovation. Many studies showed that CSR, as a useful business strategy, could promote firms' sustainable development (Cheng et al., 2016; Feng et al., 2017; Liu & Zhang, 2016). Therefore, corporate undertaking social responsibility should become an indispensable part of the corporate management system.

In addition to that, as a tool for connecting with external environment, CSR is conducive to enhancing communication with external stakeholders and promoting

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the active participation of various stakeholders. Firstly, CSR can help firms to establish a responsible brand image, increase the firm financial stability and reduce operational risks. More importantly, firms with higher level of CSR are more likely to attract more investors to bring additional social capital for them, which may increase competitiveness of firms and improve their performance. Therefore, increasingly more firms realized that CSR is beneficial for their long-term and sustainable development. In order to be recognized by the government, investors and the public, many firms in China are actively trying to practice CSR and disclosure CSR reports.

Given the importance of both corporate governance and CSR, Jo & Harjoto (2011) argued that the influence of both them on firm performance has attracted great interest from shareholders, practitioners and government regulators. However, there is limited empirical evidence to analyze their relationship. In addition to that, given that the unique background of China with its economic transformation, it is not sure the applicability of foreign research results in China are valid or not (Liu & Zhang, 2016). Thus, in the context of social institutional changes, it is necessary to investigate the relationship among corporate governance, CSR and firm performance integrated with China's institutional environment.

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1.2.1 China's unique background for this study

a. China's Firm Performance

Every firm regards maintaining high and stable performance as its primary goal. For Chinese Listed Companies, the Split Share Structure Reform implemented by China from 2005 to 2006 converted all non-tradable shares into tradable shares, which resulted in that all non-tradable shareholders had the same aim with tradable shareholders. Thus, any shareholder in a company strived to find effective ways to improve firm performance. However, with the strong economic growth in China, Chinese capital market had always experienced many problems like weak corporate governance, unnecessary interference in business decisions from government as well as lack of effective executive restraint mechanisms. These factors are constraints on firm performance. There were two important problems that resulted in the neglect of firm performance of Chinese listed firms.

On the one hand, China used to be a planned economy for a long time until the establishment of Chinese capital market in 1990. At that time, firms just need to finish the production task assigned by the nation and this resulted in that firm performance was neglected and China's economy lagged behind some countries. Under this background, pre-reform SOEs were the prototype organizations in a planned economy. They merely focused on some insider affairs like achieving production levels, while rarely paid more attention to external factors (Mutlu et al., 2018). Therefore, it was known that the main purpose of these companies was not to maximize profits.

One the other hand, Chinese economic reforms started in the late 1980s with the privatization of many SOEs. Although for the past 30 years China has transitioned into a market-based economy from a centrally planned economy, Chinese capital market is still influenced by weak law enforcement and inefficient environment within its institutions. This inefficiency has resulted in the lack of protection for investors and minority shareholders. There were not enough incentives for top management; issues like rampant inside trading and low levels of disclosure and transparency were common (Li et al., 2015). Meanwhile, the government still controlled tightly many firms especially listed firms and these firms still retained substantial state-owned shares. Combining the above factors, managers in those firms with a high level of state ownership did not take the initiative to maximize the profitability of firms without sufficient incentives (Dian, 2014). From what has been discussed, it is important to find an effective way to improve performance of firms.

b. China's Corporate Governance

China started corporate governance reform accompanying by the establishment of China's capital market in 1990. Due to the growing capital need from Chinese firms, the Shanghai and Shenzhen stock Exchanges were established on December 19, 1990, and July 3, 1991, respectively. The opening of these exchanges had played a significant role in the process of Chinese market-oriented reform and firms privatization (Jiang & Kim, 2015). However, unlike most developed countries whose stock exchanges were set up to reallocate capital, the Chinese main motivation for establishing stock exchanges was to allow SOEs to raise capital as well as to improve their operating performance. Therefore, the uniqueness of Chinese capital market

lies in its unique ownership structure-a high degree of state ownership. In addition, China, is similar to many other emerging countries, has a centralized ownership structure, a fragile institutional environment characterized by weak investor protection and rampant insider self-trading (Liu et al., 2015) and quite weak law enforcement (Yu, 2013). Therefore, the immature capital market is an essential factor in advancing China's corporate governance reform (Sabbaghi, 2016).

Additionally, in order to better manage companies, many changes have taken place over the past two decades to improve the functions of corporate governance, including many regulatory changes and introductions of new rules that could affect corporate governance (Jiang & Kim, 2015). In particularly, there were two significant corporate governance reforms that took place in China. The first one was to regulate the board of directors of listed firms, which passed on August 2001. It required that all domestic listed companies' boards of directors must include at least one-third directors who are independent by June 2003. After the board reform, significant changes have taken place in board size and the number of independent directors of Chinese listed companies increased. The second one was the Split Share Structure Reform implemented by China during 2005-2006, which converted all non-tradable shares into tradable shares. As a result, the proportion of tradable shares has increased dramatically and the ownership concentration has decreased (Li et al., 2015). Therefore, China provides a good research context to investigate whether the corporate governance practices are applicable for Chinese public listed companies.

c. Corporate Social Responsibility (CSR) in China.

Corporate Social Responsibility (CSR) is a relevant management concept that guides companies to incorporate economic, social and environmental issues into their business operations and their interactions with stakeholders. Combined the in-depth development of economic globalization with the Chinese rapid economic development, Chinese firms have shown great interests in CSR that originated from the West.

China's CSR practice was introduced from the West with the China's reform and open-door policy. For the past two decades, the rapid development of China's economy has led to a series of problems such as child labor, food safety and

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environmental pollution, which have aroused people's great attention to the practice of CSR in China (Cheng et al., 2016). The term 'social responsibility' first appeared in the Company Law of the People's Republic of China (revised in 2005), which required "When undertaking business operations, a firm shall comply with the laws and administrative regulations, social morality and business morality. It shall act in good faith, accept the supervision of the government the general public, and bear social responsibilities." Since then, CSR practice in China has entered a stage of accelerated development. In order to be recognized by the government, investors and the public, many companies are actively trying to practice CSR and disclose CSR reports.

Although China's CSR had a late start compared to the Western countries, it has developed rapidly. Cheng et al. (2016) furthermore pointed out that the Chinese government has played a vital role in promoting the compilation and disclosure of CSR reports. The Chinese government and relevant departments have introduced a series of measures to encourage companies to fulfil their social responsibilities and issue CSR reports. For example, in 2008, in order to push SOEs to be responsible for both their stakeholders and the environment, the Shanghai Stock Exchange regulator issued notice to guide these companies to actively engage in CSR. In 2012, Chinese government established a CSR guiding committee to further promote the better fulfilment of social responsibilities. Chinese companies, especially state-level companies, were required to assume more social responsibilities, including no layoffs or pay cuts during the economic difficulties (Yeh et al., 2019).

1.3 Problem Statement

Nowadays, under the changing business environment, firm performance has attracted ever-increasing attention, especially after the reverberations of the financial crisis of 2007-2009 (Elsayed & Elbardan, 2018). It has become a related concept in strategic management research and frequently used as dependent variable (Santos & Brito, 2012; Taouab, 2019). Firm performance plays a significant role for the long-term sustainability of firms. First of all, continuous performance enables a firm to survive by gaining sufficient profit compared to the risk. Only

through good performance can firms experience development and make progress (Taouab, 2019). Furthermore, firm performance is essential for investors and stakeholders by bringing high and long-term returns since good performance would attract more investment for firms after being evaluated by investors around the world (Al-Matari et al., 2014). A well performing firm plays an important role for society at large by generating more employment opportunities for society and improving the income of individuals (Mirza, 2013; Taouab, 2019). Given the importance of firm performance, it is necessary to explore the factors affecting firm performance.

Corporate governance, as one of influencing factors, is a crucial driver for improving firm performance. Understanding the link between corporate governance and firm performance is essential to formulate effective corporate governance policies and public regulatory policies (Kao et al., 2019). However, although corporate governance reforms in China are gradually bringing improvements to the mechanisms of Chinese capital market, the Chinese capital market is less efficient compared to the developed capital markets, such as those of the US, the UK, Australia, Singapore and Japan. Hence, most of the research were based on the data from developed countries to analyze the relationship between corporate governance and firm performance (Mirza, 2013). Chinese corporate governance practices have its own characteristics like special regulatory issues especially in financial, legal and institutional issues; distinct economic environment (Jiang & Kim, 2015). These unique characteristics help to compare findings of this study with those of mature markets and to study how corporate governance structures influence firm performance based on Chinese background. Furthermore, in view of the increasing importance of China in the current world economy, recent scholars believed that China provides a good background for scholars to study the concept of corporate governance related to firm performance (Mutlu et al., 2018). Therefore, given the significant institutional difference between developed and emerging countries, there is still a wide gap specially in the case of emerging economies like China.

More importantly, one of the gaps in this study is whether CSR disclosure could moderate the relationship between corporate governance mechanisms and firm performance based on Chinese capital market. On the one hand, there is a general consensus that firms with higher level of CSR are likely to increase

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competitiveness of companies and improve their performance (Famiyeh, 2017). CSR, as an effective tool to reduce conflicts between stakeholders, could reduce information asymmetry, reduce agency costs, strengthen firm brand and reputation and bring additional social capital to the firm (Xiao & Xue, 2014). However, according to the standpoint of Barnea & Rubin (2010), when insiders (such as managers and major shareholders) overinvest in CSR or cover up firm's improper behaviors in pursuit of their own interests, CSR may also reduce firm performance. Based on that opinion, CSR practice could increase the cost of companies, which deviates from the goal of maximizing firm profits. From what has been discussed above, CSR can lead to changes in agency costs, which can also influence the relationship between corporate governance and firm performance. According to Agency Theory (Jensen & Meckling, 1976), an appropriate corporate governance could protect shareholder interests, ensure principle-agent interest alignment and minimize agency cost, hence improve firm performance. Based on the noted situation, it is worth considering whether CSR could moderate (increase or reduce) the relationship between corporate governance and firm performance. However, the role of CSR disclosure as a moderator in the relationship between corporate governance and firm performance has rarely been studied. In order to fill this research gap, this study examined the relationship between corporate governance and firm performance under the moderating role of CSR based on Chinese capital market.

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1.4 Research Objectives

The main objective of this study is to investigate the relationship between corporate governance and firm performance. This study further aims to determine whether CSR can moderate the relationship between corporate governance and firm performance. The more specific objectives of this study are as follows:

1. To examine the relationship between Corporate Governance (including board characteristics, ownership structure, CEO compensation and capital structure) and firm performance (FP).
2. To analyze the moderating role of Corporate Social Responsibility (CSR) on the relationship between Corporate Governance (including board characteristics,