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The impact of governance reform on performance and transparency[☆]

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ABSTRACT

This study examines the influence of Mexico's efforts to improve corporate governance on firm performance and transparency. We utilize compliance data from the *Code of 'Best' Corporate Practices*, disclosed annually by public firms in Mexico, as a measure of corporate governance strength. We document a significant increase in compliance over 2000–2004 indicating Mexican companies view non-compliance as costly. However, we find no association between the governance index and firm performance, nor is there a relation with transparency. Instead, we find firms with greater compliance resort to the more costly mechanism of making dividend payments (higher propensity to pay and greater yield) to reduce agency conflicts. We conclude these associations are the direct result of the institutional features of the Mexican business environment, which is characterized by concentrated ownership of insiders, interlocked boards of directors, a lack of insider trading enforcement, and generally poor protection of minority investors. Our results show that monitoring mechanisms alone are not enough to fundamentally change economic behavior.

1. Introduction

Corporate governance systems are designed to ensure that investors receive a fair return on their investment (Shleifer and Vishny, 1997). Using cross-country analysis, the governance literature has demonstrated that stronger governance systems lead to more efficient allocations of capital resources. This, in turn, spurs economic growth and increases the likelihood of investors receiving a return (see, for example, La Porta, López-de-Silanes, Shleifer, and Vishny, 1997, 1999, 2000). It is unclear how an economy with generally weak governance can bring about change to improve the investment climate and stimulate economic development. To investigate this, we examine the efficacy of mandated changes in corporate governance in Mexico, which is an emerging market economy with a lack of minority investor protection that is dominated by concentrated ownership.

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Mexico offers a rich environment for investigating the influence of improved governance-related disclosures on the behavior and perception of public firms. Governance improvements in a developing economy such as Mexico's can potentially have meaningful and measurable effects in the market. In Mexico, the efficacy of governance is particularly salient for minority investors in contrast to the marginal influence of governance in the US given the strength of the US legal environment and product markets (Shleifer and Vishny, 1997). If a Mexican firm can commit to better governance, it is more likely to invest properly and provide more transparent financial reports, resulting in a higher probability of providing a fair return to investors. In this study, we address whether this commitment is deemed to be credible by examining if greater compliance leads to improved performance and transparency.[3]

Mexican firms are required to report each year their compliance with the *Code of 'Best' Corporate Practices* (hereafter, the *Code*). The purpose of the *Code* is to strengthen corporate governance systems of publicly listed corporations with the intention of increasing corporate transparency and raising investor confidence in Mexico. Compliance with the *Code* has increased significantly over the sample period. In 2000, only 28% of sample firms complied with three-quarters or more of the criteria versus 79% in 2004. This increase stands in direct contrast to studies using US data, in which governance is stable over extended periods of time, making it difficult to draw inferences (Gompers, Ishii, and Metrick, 2003; Core, Guay, and Rusticus, 2006). Further, the dramatic increase in compliance indicates that Mexican companies believe there are benefits of compliance or costs of noncompliance.

The results indicate that compliance is not associated with various measures of firm performance, earnings management, or the return-earnings relation. The lack of significance is likely due to the business environment in Mexico. Over 90% of sample firms exhibit concentrated ownership, and many have significant levels of interlocking boards that satisfy the independence criteria in the *Code* but create concerns about the true independence and the monitoring performed by these boards.

We perform an extensive set of robustness checks to confirm our main analyses. First, we examine whether firms with large changes in compliance have improved performance or transparency, but we find no evidence of this. Second, we examine a number of subdivisions of the *Code* including board and audit committee characteristics. With the exception of audit committee compliance, all inferences remain unchanged. Greater audit committee compliance does result in statistically better operating performance in terms of return on assets and market returns, along with slightly greater transparency. However, the economic significance of these effects is small. The statistically significant results for audit committee compliance does alleviate concerns about the statistical power of the tests because we are able to detect a statistically significant, but economically small effect related to *Code* compliance in Mexico. Overall, the robustness tests reveal that the results are stable across a variety of different methodologies and that we have sufficient statistical power in our tests.

Although the relation between compliance with the *Code* and measures of performance and transparency is minimal, we show that firms with greater compliance have a higher propensity to pay dividends and provide marginally greater dividend yields relative to lower compliance firms that also pay dividends. These results illustrate that Mexican firms that want to commit to better governance must resort to the costly mechanism of paying dividends to reduce agency concerns as opposed to being more transparent via performance and financial reporting. Consistent with La Porta, López-de-Silanes, Shleifer, and Vishny (2000), Rajan and Zingales (2003), and Locke, Qin, and Brause (2007), our results suggest that, without significant changes in the legal environment along with the enforcement of necessary regulations to accommodate the concentrated ownership structure, mandated improvements in governance-related disclosures in developing economies such as Mexico are not likely to result in substantial changes in performance or financial reporting.

The objective of the *Code* is to allow market participants to determine which companies have good governance (López-de-Silanes, 2002), which, in turn, will create market pressures for other companies to follow. We contribute to the growing literature investigating the effects of corporate governance on firm performance and transparency. Our paper is the first to show that this form of market monitoring is not enough to create fundamental economic improvements for countries such as Mexico that are dominated by insider ownership and weak investor protection.

The results have implications for a broad spectrum of global economies. Antoine Van Agtmael, the former deputy director of the International Finance Corporation, estimates that approximately 18%–19% of the world's market capitalization is located in emerging markets as of 2006. Investors in these countries are often posed with similar problems faced by minority investors in Mexico, namely, wealth transfers to majority owners without legal remedy. A recent article in the Wall Street Journal (2005a) indicates the agency conflicts present in many emerging markets can be reduced via stronger corporate governance. Another article in the Wall Street Journal (2006) suggests reforms in Mexico have been successful in this regard. Our results illustrate this is not the case and suggest that alternative mechanisms have to be developed before substantial improvements are seen in Mexico.

This conclusion is consistent with a recent story in the Wall Street Journal (2008), which contrasts the relative rise of the Brazilian stock market to the stagnation and even decline of the Mexican market. The number of publicly listed companies on the Mexican stock exchange

[3] Because of concentrated ownership, the takeover market is virtually nonexistent in Mexico. Similarly, bankruptcies, shareholder lawsuits, mergers and acquisitions, chief executive officer turnover, public offerings and share repurchases are all limited in nature. As a result, we focus on performance, financial reporting, and dividend payments as outcome metrics that are directly related to governance.