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The Impact of Governance on the Performance of Lebanese Firms

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***Abstract*— This study discusses the concept of the performance of Lebanese companies in particular the role that governance plays on this performance. A good performance is a target in the eyes of management, shareholders and even employees. The study aims to analyze the performance measures, compare the results found in the literature to validate or challenge assumptions of the study.**

***Index Terms*— Corporate Governance, Financial Performance, Lebanese Family Business, Board of Directors.**

I. Introduction

Corporate governance is the set of rules that describe how companies are directed and controlled. It defines the rights, responsibilities and obligations of members, implements formal and informal rules and values governing the general sphere of human dynamism. In recent decades, many companies have faint because of malfunctioning governance mechanisms. Thus research to find effective governance mechanisms have become imperative for better business performance. Prior to the above, one should really understand the relationship between governance and performance.

This research attempts to explain the relationship between corporate governance and financial performance of managerial entities in the Middle East region, particularly in Lebanon. The issue is part of the relationship between the board mechanism and the training of Lebanese companies. The objective of this research is to find how governance ensures the survival and sustainability of the business. The next part will consist of a literature review. Following that the problem and the theoretical study will be reformulated. At a later stage the research methodology will be developed based on a broad sample of Lebanese companies. The development of the research question and the treatment of the subject will be on the quantitative approach. In the last sections we will present the results and analyze them before concluding the research.

II. RESEARCH ISSUES

Corporate governance is mainly the control of managers by shareholders and management laws. Good corporate governance seeks to maintain a balance of forces within the company to ensure good control. This study aims to investigate the relationship between the many administrative mechanisms and performance of local firms. The problem addressed is the following: What is the impact of the governance structure of Lebanese companies on their financial performance? This issue will allow us to find the changes that governance must undergo when performance degrades.

The need to treat this issue is necessary with the increasing size of companies, the influx of foreign capital, and the appearance of collective capitalism. The aforementioned factors have caused many abuses by the leaders of managerial power, and in extreme cases caused frauds. For that purpose we must understand the concept of governance as a strategy and decision making.

Most Lebanese companies are of medium and small sizes. Moreover, they are mostly family businesses, in which the control takes the form of dynastic pyramid where the family holds the majority of shares. In these businesses it is often found that the manager escapes all internal and external control mechanisms, since the majority of shares, even in large enterprises, remain with the family [1].

III. HYPOTHESIS

There is no universal model of corporate governance as it depends on the legal and institutional systems. In this framework, several hypotheses are formulated and tested such as the presence of external directors. The presence of external directors is important in the context of independence, particularly in an institution where the board is mostly a family. The introduction of independent external directors enhances the company's value. In addition, the external members add a layer of transparency because they are intended to protect their own interests, not those of the shareholders.

Another hypothesis is the positive role that the presence of feminine administrators can play. The role of women is becoming increasingly important in Lebanese family businesses. Women bring new ideas, new methods of management and mostly play a very important role in communication.

Two other hypotheses are tested: the functions and size of the board. Some believe it is best to avoid duplication of functions, and therefore must choose a structure that separates the functions, mainly the management and audit. As for the size of the board, opinions are divided. Some like Andrew P. and E. Schiehll find that efficiency increases with the size of the board in oppose to others like S. Bahagat and Black who believe the opposite. How can the size be linked to the performance? Is there an optimum number of members to serve on the board?

IV. LITERATURE REVIEW

Theoretically, there are a number of reasons which prove that good governance practices amplify the company's value. Thus, many researchers have examined this theme. For example, Chen and Steiner (1999) examined the relationship

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between managerial ownership, debt, dividends and risk. They found that the managerial ownership reduces conflicts between managers and shareholders, while creating problems between shareholders and creditors.

A. The company size

To understand the effect of size on the performance of the company, we must understand the criteria for measuring the size. The size is defined by the employee workforce. Small businesses have between 10 and 49 employees, while medium-sized enterprises employ 50 to 499 employees. Another criterion which must be combined with the number of employees is the turnover. The latter measures the value of sales annually, calculated by multiplying the quantity sold by the unit price. The last criterion of size measurement is the equity of the company, being the capital from savings or capital invested by the partners[2].

Many researches have invested the effect of firm size on its overall performance. The larger the company is, the greater the risk of ineffective management and loss control is; this causes a decline in performance. However this is not a general rule. Size with other factors may present an advantage or a disadvantage for the company. In a study conducted on French companies, the results confirmed that the company size has a negative effect on the amount of value created. More precisely the factor that turns the size of the company into an advantage remains its economic and fiscal situation [3].The same study found that in contrast to large companies, there are good opportunities the company's value is high. Under favorable conditions and monetary management, the opportunity and the large size of dynamism makes overall growth of the company. Large companies will perform better while smaller companies are marked by fragile growth and productivity and a higher debt risk [3].

Another study connects the company size to the size of its board of Directors, and the effect on its performance. The ownership structure and firm size affect the number of directors [4]. The management strategy and the diversification across industries are pushing big business to expand the size of their board. Sometimes a great council brings together a resource pool, skills and experience. But empirical studies realized in Anglo-Saxon countries have concluded that a large board size is detrimental to the performance. These studies found that it results in a lack of consistency in the opinion of the members of directors. Large companies require a large number of leaders among which the control can be lost. This is not the case of family businesses.

B. Control System

The term internal control represents the measures taken by the Board in order to ensure proper operation of the business. Internal control is a form of assistance to ensure an effective and efficient work environment that respects the laws of society, all this while avoiding errors. It is also among the objectives of the control system to inspect the quality of the overall work. Internal control is one of the objectives of internal audit in large companies. It conducts internal audits on the board for them while operating as an independent entity[5]. An old study by Bajan-Banaszak in France in 1993 that contained more than 800 medium and small enterprises shows that the majority does not have a management tool other than financial accounting [6]

The role of governance surpasses the leadership council interaction and shareholders to find a better way to manage the business. The business of government is a control system that operates on two levels: internally and externally. The board of directors chaired by the CEO supports key decisions internally. External control is usually done by external auditors.The internal control system is carried out along four axes. The first is the reflection on the strategic choices. The second line of control is to define and implement a structure for the organization. The third axis is manifested in improved overall performance. The fourth area of management serves to maintain the consistency and a high level of transparency and integrity [7]

As most of the Lebanese companies are small businesses delegated from father to son, the control is in the hand of the family whom holds the majority of the property titles making control more difficult. The entrepreneur possessed absolute power and escapes the control mechanisms [1].

C. Financial Measures

The measurement of financial performance is made through several indices. Some are accounting ratios; others measure the added value of the company. An important ratio is the ratio of the liability structure that studies the balance of different funding streams. Another ratio is the debt ratio that calculates the degree of compliance to the creditors of the company, which is an indirect measure of the security of the firm. To these is added the ratio of the structure of the assets representing the importance of fixed capital and profitability ratios, such as the ratio of total gross profitability and the profitability ratio of equity. Works addressing the impact of governance mechanisms on corporate financial performance are very rare. Some studies claim that small boards of directors are more effective in terms of financial management [7].

D. Company Strategies

Strategy consists of all the actions that the company uses to achieve its goals. The strategy spreads over the medium or the long term and is mainly the definition of the service or products to offer, markets and customers to target. It also includes the resources to be employed, as well as development areas, such as input in new markets, mergers, etc.... The best business orientation to achieve these goals within the framework of the implemented strategy is imperative to good performance. The strategy is based on a comprehensive analysis of the internal situation of the company in the context of human resources, strengths and weaknesses, and external circumstances such as socio-economic situation of the market. All this work falls under the responsibility of the directors who must have sufficient vision to anticipate risks and the skill to successfully apply the implemented strategies [8].

V. METHODOLOGY ANALYSIS

A. Lebanese family businesses

Since 90% of Lebanese companies are small family businesses, this study will be based on a model of Lebanese family company controlled by the founding family where the concept of management and governance do not actually exist. The study will be based on the size of the family business in

terms of employees, company turnover, the growth rate and profitability. Beyond these economic concepts applicable to all companies, this study will analyze the company's board of directors; specifically their sensitivity to external conditions: the competitiveness, technology, innovation, and their relationship with other stakeholders such as shareholders, directors of the board itself, officers, and employees. This study will check the measures adopted by the board to lead the company. It will also attempts to fragment the board to find the strength of each member to assign accordingly the responsibilities, to be able to detect the company's performance, and to identify who is responsible in the event of poor performance.

As part of the assumptions, we will examine the role of women on the board, and the role of external directors and their effectiveness to affect the overall performance of the company.

B. *Sample and Data Collection*

After consulting historical studies addressing the issue of governance and performance of the business, we will adopteda descriptive approach in this research. This approach uses quantitative research methodology elements. The term Descriptive Search refers to the type of question, the design and analysis of research data that will be applied to a given subject. Descriptive statistics explain the deductive statistics that determine cause and effect.

The chosen company sample was reduced to 30 Lebanese family businesses selected non-randomly, belong to different sectors and are unlisted. The study population consists of supervisors, managers and officials that exist in one of the family businesses in Lebanon. This research will use SPSS to analyze the data collected. The principal research is the questionnaire, developed from previous research and the axis of the study variables. This questionnaire was distributed to managers and supervisors of the companies in the analysis sample. The questionnaire aims to measure the level of governance, based on Likert triple scale.

C. *Description of data*

Knowing that the telecommunication sector has the most companies from the sample, the distribution of target companies is not fair.

A summary of the sample in terms of sectors is listed in the following table:

		Frequency	Percent
Valid	Financial services	5	16.7
	Distribution	6	20.0
	Hotel	4	13.3
	Commercial	4	13.3
	Telecommunication	8	26.7
	Food	3	10.0
	Total	30	100.0

D. *Selection of variables*

As research stands on the impact of governance on performance, a separation will be made at the level of variables. First, the variables of governance will be examined. Later on the variables of performance will be examined. The variables of governance are considered as independent variables. The performance variables are the type of dependent variables.

1) *Governance Variables*

The variables of governance are the variables that greatly affect the performance. The study will focus on three control variables; the company's age (AGE), size (T), and debt (DT)

AGE: the age of the company is considered a major factor affecting the performance:

$$AGE = \log(\text{number of exercise years})$$

T: the size is a factor that can act directly and indirectly, positively and negatively on the business performance and effectiveness of policy enforcement (Kolsi&Ghorbel, 2011). It is calculated using the formula below:

$$T = \log(\textit{book value of total assets})$$

DT: The debt level computes the load borne by the company, and measure as such the effectiveness of the strategies to control debts:

$$DT = \frac{\textit{Book value of debt}}{\textit{Total assets}}$$

E. *Performance Variables*

Whatever the extent of the performance, it remains the endogenous variable on which the other variables act. Financial performance will be measured from two indicators; "Return on Assets" (ROA) and "Return on Equity (ROE)." Both indicators estimate competitiveness and management efficiency. Furthermore the stock market performance, specifically the company's market value will be measured through the "Market-to-Book" indicator (MTB)

ROA: variable which measures the profitability of the net assets and expresses the ability of capital to create earnings using the available resources (Kolsi&Ghorbel, 2011). It is calculated by the following formula:

$$ROA = \frac{\text{Operating profit}}{\text{Total assets}}$$

ROE: variable that measures the return on equity, and expresses the ability of capital brought by shareholders to generate profit (Kolsi&Ghorbel, 2011). It is calculated by the following formula

$$ROE = \frac{\text{Net profit}}{\text{Shareholders' equity}}$$

MTB: variable that measures the company's investment opportunity by expressing the valuation of the company on the financial market (Kolsi&Ghorbel, 2011). It is calculated by the following formula:

$$MTB = \frac{\text{Market Capitalization}}{\text{Shareholders' equity}}$$

F. *Statistical techniques*

A subsequent combination of statistical techniques is adopted to analyze the data and calculate the variables mentioned in the previous section. This will be through multiple regressions between several dependent variables on one hand and independent variables of the other. The chi X2

test will also be used. Comparison tests between two averages will also be used. The discriminant analysis will also be used to study the interactions of variables between one another. As previously mentioned all will be part of a descriptive statistical study. In the next section we will elaborate on the use of each statistical method to clarify the results

VI. RELATIONSHIP BETWEEN GOVERNANCE AND PERFORMANCE OF THE FAMILY BUSINESS

After calculating the ROA, ROE and MTB, we will check for the significance level calculated through the X^2 tests allow us to refute the hypothesis H_0 (the first variable does not affect the second) or disprove the hypothesis H_1 (the first variable affects the second). The significance level "Sig" will be compared to risk α equal to 5%. If the significance level is less than α, then H_1 is validated.

$$\sum_{i=1}^{J} \frac{(O_i - E_i)^2}{E_i}$$

Where: O_i to the observed values
E_i the estimated values

A. The effect of external directors on the financial performance

In the case of studying the role of dependent or independent external directors, Sig is equal to 0.042, 0.049 and 0.037 respectively. These values are less than 5%, which implies a positive influence on business performance

B. The effect of women directors on financial performance

Concerning the presence of women on the board, the performance variables are above 5%; this confirms the positive impact of women's presence on corporate performance, with an index of significance equal to 0.049 for the ROA and ROE for 0026

C. The cumulative effect of the duties on financial performance

Similar to the above assumptions, the ROA, ROE and MTB will also be used to validate the hypothesis that the accumulation of functions improves business performance.The value of the significance index is less than 5% in all three cases

D. The effect of the size of the board on financial performance

In the end, to test the hypothesis of the effect of the size of the Board on the performance of the family business, the calculated values of ROA, ROE and MTB are respectively 0.028, 0.020, and 0.021, all greater than the risk. This proves that the size of the board improves performance.

E. The effect of age and debt performance

The final analysis is a regression analysis that will study the impact of governance on performance using governance measures regarding the age of the company and debt. The results are tabulated below

Coefficients

Model	Unstandardized Coefficients		T	Sig.
	B	Std. Error		
(Constant)	.004	.008	.515	.612
Date of companycreation	3.097E-005	.000	.133	.895
size of the company	.000	.000	-.823	.420
Turnover	6.170E-012	.000	.069	.043
business debt	-.002	.001	-3.306	.003
The presence of women directors	.005	.003	1.636	.020
The size of the Board	-.001	.002	-.619	.044
Increasing the size of how many board	-.002	.001	-1.052	.001
Increasedfrequency of meetings	.003	.004	.792	.005

Age has a significance index equal to 0.895, higher than 5%, indicating that the age of the company does not influence the performance. The level of debt has a negative coefficient of 2% and a significance index of 3%, proving that the debt level affects the performance since its index is lower than 5%. The fact that the coefficient is negative shows that a high level of debt threatens the company's performance

VII. ANALYSIS AND DISCUSSION OF RESULTS

The results showed that the performance of the Lebanese company is positively affected by the presence of women, especially that diversity on the board provides additional pool of expertise. Several studies have shown that women are generally more organized than men and more attentive to detail. This improves the overall management of the company, especially in the case of small family business where the woman is involved in all forms of management and planning strategies. Also the presence of external directors prevents any kind of misconduct by board members and minimizes corruption.

Combining the functions in small business is an asset to the performance since it ensures transparency and disclosure, even if it's risky in some casesto reduce the control exercised over these functions controlled by a single individual. In the case of small enterprises this factor improves the performance. Finally, when it comes to companies with a small board, this adds to the performance. In Lebanon, the small size ensures more effective monitoring but also a more rigorous schedule. It will also eliminate the control exercised on the leaders as they are usually members of the same family having the same goal of maintaining the profit made by the family. This also eliminates any risk of fraud or financial corruption.

The age of the company was found insignificant to performance. The test results on the debt are expected. Excessive debt can destabilize the reserves of the company and thus affect the implementation of long-term strategies. This is compounded in family businesses since it has no shareholders or any external source of capital. With that being

said, we can conclude that a clear relationship exists between governance and performance. This has been proven by the majority of the study variables.

VIII. CONCLUSION

Finally, this study aimed at proving that link between governance and the company's performance. A sample of thirty Lebanese family businesses was tested via measuring three variables; ROA, which calculates the profitability of net assets, ROE, which measures the return on equity, and the MTB which measures the investment opportunity . A descriptive statistical analysis based on regression, Chi square was able to demonstrate a positive effect of the small size of the company, the independence of outside directors, the presence of women, and accumulation functions have on the overall performance. In addition, other analyzed governance variables were the age and the level of debt. The first was found not significant but the heavier the debt is, the greater the risk of peril of the firm. For better performance of Lebanese companies, leaders must employ more women and especially of outside directors to control expenditure and reduce debt.

The most important study limitation remains that performance is an aggregation of several measurement variables. Only three variables were used in this research and this can cause a bias results. Our empirical results showed the difficulty of building a clear model of the relationship between governance and performance. This research contributes to push the leaders of Lebanese companies to change the composition of their board especially in the case of employment of women in the administrative board and the use of outside directors.

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