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Corporate governance, financial management decisions and firm performance: Evidence from the maritime industry

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ABSTRACT

This study investigates the relation between corporate governance with (i) financial management decisions such as earnings management and sub-optimal investment, and (ii) firm performance in maritime firms. The study reveals that important corporate governance measures, such as insider ownership, board size, presence of corporate governance committees, the percentage of directors serving on the boards of other firms and CEO duality, are associated with financial management decisions and firm performance. The associations revealed can potentially assist in mitigating agency problems and improving financial management decisions and performance in maritime firms.

1. Introduction

The globalization of the world economy along with the increased competition and the rapid technological advancements in the freight transportation markets, affected the financing environment of the maritime industry, and led more companies to rely on capital markets to finance investment opportunities (Syriopoulos and Theotokas, 2007; Grammenos and Papapostolou, 2012a). Capital markets, however, appreciate the quality of a corporate governance system because it moderates the extent of the agency problems. Agency problems, arise from either the separation of ownership and management (Jensen and Meckling, 1976) or from conflicts of interest between controlling and non-controlling shareholders (Bebchuk and Weisbach, 2010), and may probe self-interested managers (controlling shareholders) to act against the best interests of shareholders (non-controlling shareholders). Agency theory suggests that shareholders may alleviate agency problems by instilling corporate governance mechanisms (Jensen and Meckling, 1976). Research output on the impact of corporate governance on firm policies and performance has been extremely prolific in the general cross section of industrial firms (see, among others, Gompers et al., 2003; Giroud and Mueller, 2011; Brown et al., 2011). Nonetheless, whether the presence of corporate governance mechanisms are effective in mitigating agency problems in very specialized sectors, such as the maritime industry, remains an open empirical research issue which we investigate in this study.

A strong motivation for this study emanates from the recent trends towards Initial Public Offerings (IPOs) in the maritime industry (e.g. Grammenos and Papapostolou, 2012b) coupled with the inherent uncertainty and volatility of the shipping freight markets. Such an environment, however, exacerbates agency problems and make it easier for managers to engage in (harmful) earnings management practices which could have been, otherwise, mitigated in the presence of a strong cor-

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porate governance system (e.g., Larcker et al., 2004; Klein, 2002; Xie et al., 2003). In addition, the maritime industry is characterized by capital intensity as billions of dollars are invested every year for the building and purchase of ships that are high value assets reaching several hundred million for specialized vessels (e.g. LNG ships). In an era of economic downturn it is crucial for maritime firms to have a good understanding of the mechanisms that will safeguard optimal investment decision-making. On this basis, it is important to understand the relation between corporate governance and investments in the maritime industry since the literature indicates that strong corporate governance can mitigate sub-optimal investments in the cross section of industrial firms (e.g., Masulis et al., 2007; Harford et al., 2008; Richardson, 2006; Bohren et al., 2009). Finally, various other maritime industry unique characteristics, such as rising fuel prices and slowdown in global trade intensify the need for effective decision making and at the same time raise the sensitivity of those decisions to firm performance.

The notable lack of comprehensive evidence as to these relationships in the maritime industry renders it an empirical issue of significance. Therefore, in this study, we focus on the maritime industry to investigate: (i) the impact of corporate governance on financial management decisions such as earnings management and sub-optimal investment decisions, and (ii) the relation between corporate governance and maritime firms' performance.

Previous studies examining corporate governance in maritime firms are not only limited in number, but also leave many questions and empirical issues unanswered, especially when it comes to the nexus of corporate governance practices with financial management decisions pertaining to earnings management, investments and firm performance. In addition, to the best of our knowledge, all previous studies in the context of the maritime industry have chosen a very narrow sample of firms focusing for instance on either Greek shipping companies (e.g. Koufopoulos et al., 2010; Syriopoulos and Tsatsaronis, 2011) or Scandinavian shipping companies (e.g. Randoy et al., 2003). Studies that employ unsatisfactorily small samples, constrained at the same time by short sample periods, may provide results that are qualitatively indicative for some empirical relationships but most of the times may be far from being statistically generalizable even to the geographically constrained population from where the samples have been chosen.

In addition, given the presence of large shareholders in many shipping companies, this industry has a concentrated ownership structure with family owners in many firms as well. Based on theory, blockholders can exert a positive or a negative effect on firm performance; in fact, depending on the percentage ownership and the type of the blockholder, the empirical literature reports alignment (Shleifer and Vishny, 1986) or entrenchment effects (La Porta et al., 1999). Moreover, the family incentive alignment hypothesis argues that family relationships among owners and managers create advantages (Fama and Jensen, 1983) and family controlled firms may operate more efficiently than others (McConaughy et al., 2001). Nevertheless Morck et al. (1988) and Smith and Amoako-Adu (1999) provide evidence of a negative effect of family (insider) ownership on corporate performance. The idiosyncratic nature and characteristics of the maritime industry above provide another motivation and justify further research of the effects of corporate governance.

Despite the voluminous body of general corporate governance literature only a small part deals with industry specific samples and those tend to focus almost exclusively on the banking sector. As argued in Andreou et al. (2012), one benefit of focusing on a single industry is the mitigation of possible inter-industry variations that usually tarnish inferences of studies that span several industries. This study contributes to the field by focusing solely on the maritime industry which is an industry with unduly specialized environmental and operational characteristics. In particular, concentrating on the maritime industry provides the opportunity to examine corporate governance in a unique macroeconomic setting of market uncertainty, volatility and capital intensity found to influence financial management (Drobetz et al., 2012) and concentrated ownership found to influence firm performance (Tsionas et al., 2012).

Apart from the direct relevance of industry-specific results, focusing on the maritime industry also provides the opportunity to directly control for unique industry related factors improving confidence in the validity of the theoretical and practical implications of the study. It is particularly important to focus on the maritime industry as it is characterized by idiosyncratic factors that place added significance to strong corporate governance mechanisms (which may not be apparent when one considers large and general cross sections of firm observations). One issue of concern is the lack of transparency in ship registration and ownership. Anonymity of ownership is a standard industry practice affected through the widespread use of flags of convenience (international ship registers). The establishment of holding firms in international ship registers provides the possibility to adopt lax corporate governance practices. For instance, even a company like Diana Shipping that is listed on NYSE but incorporated in the Marshall Islands has published a statement (available from the company's website) of significant differences in corporate governance practices in relation to those required by NYSE, but exempted from them.[1] On these grounds, we expect that corporate governance in the maritime sector will have different effects to those in the general industry norms and this will be reflected in the firms' corporate practices as well as in the investors' perceptions about those firms.

The paper is organized as follows. Section 2 presents a review of the maritime related literature on corporate governance. Section 3 synthesizes the theoretical literature to develop the conceptual framework for the study. Section 4 presents the dataset and describes the variables deployed in the study. Section 5 analyzes the empirical findings, provides a discussion of the results and assesses their robustness. Finally, Section 6 provides a conclusion that includes implications for further research and practice.

[1] Diana Shipping does not fully comply with the NYSE corporate governance requirements such as, among others, the regular meeting of non-management directors in executive sessions, the establishment of a nominating/corporate governance committee of independent directors and a committee charter specifying the purpose, duties and evaluation procedures of the committee, the establishment of an audit committee with a minimum of three members and the requirement to adopt and disclose corporate governance guidelines.