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CORPORATE GOVERNANCE AND FIRM PERFORMANCE IN THE OIL AND GAS INDUSTRY OF RUSSIA

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ABSTRACT

This study explores corporate governance practices in Russian oil and gas companies over the 2009-2012 periods and examines the relationship between accounting performance measures and corporate governance mechanisms. Our findings suggest that managerial ownership and foreign ownership are positively associated with firm performance. Similarly, the results on government ownership also support our initial hypothesis and indicate that government ownership positively affects accounting performance. However, our findings suggest that board size and independent directors on the board do not appear to affect firm performance. This study demonstrates that corporate governance practices implemented in developed markets have some relevance and synergies to transition economies such as Russia.

1. INTRODUCTION

In recent years, corporate governance issues have received increased attention among scholars, practitioners and regulators worldwide (Jackling and Johl, 2009; Sami et al., 2011; Bozec and Bozec, 2011). For example, Brown et al (2011) report that their electronic search through Google Scholar provided approximately 287,000 results using 'corporate governance' as keywords in 2010. Hannifa and Hudaib (2006), Bhagat and Bolton (2008), Brown et al. (2011) also note that a wide range of accounting and finance studies have contributed to governance literature examining the relation between corporate governance and firm performance. Most prior studies document that effective corporate governance practices positively affect firm performance (Kiel and Nicholson, 2003; Haniffa and Hudaib, 2006; Jackling and Johl, 2009). However, another strand of governance literature concludes that corporate governance is negatively associated with performance (Yermak, 1996; Hutchinson and Gul, 2003; Mashayekhi and Bazaz, 2008). Interestingly, another strand of literature reports no association between corporate governance and firm performance (Bhagat and Black, 2008). Based on the existing research problem, this study focuses on the Russian market analyzing the relation between corporate governance practices of oil and gas companies and their operating performance. Therefore, the

objective of this study is to explore corporate governance practices in Russia and investigate the association between governance structures and firm performance in oil and gas industry.

Russia has significantly improved its performance in recent years (KPMG, 2011). The country has reached the best results in different sectors of economy. Primarily this applies to the mining industry. Specifically, the oil and gas sector plays an important role in the economic growth of Russia. Furthermore, a large number of oil and gas companies such as Gazprom and Lukoil are located in Russia. This study attempts to contribute to the existing literature by exploring governance practices in the oil and gas industry of Russia, and examining the association between corporate governance and firm performance. In particular, we focus on the effects of individual corporate governance variables, namely board of directors, independent directors, management, foreign and government ownership characteristics, and auditing company.

The remainder of the paper is divided into six sections. The next section discusses the development of corporate governance and the Code of Corporate Governance in Russia. Section 3 reviews the relevant literature and also sets out the hypotheses for testing. Section 4 describes the data, variables and the research methodology, which is followed by a discussion of the results in the next section. Finally, the summary and conclusions are presented in Section 6.

2. CORPORATE GOVERNANCE IN RUSSIA

Russia for the first time has faced with the concept of corporate governance at the end of the twentieth century. The main reasons of its development were increased interest to the corporate governance in USA and others countries in 1980's and the world financial crisis of 1997-1998 and corporate problems in emerging countries (Румянцев, 2010).
The first step toward improving corporate governance in Russia was the adoption of the Principles of Corporate Governance in 1999 by the organization for economic cooperation and development (Румянцев, 2010). By that time, these principles were the first set of standards and guidelines in the fields of corporate governance. Later, this document was replaced by the Code of Corporate Governance. The Code of Corporate Governance (hereinafter Code) is a set of the rules, which are designed for securities market participants. In the Russian Federation, Code of corporate governance has been recommended by Federal Financial Markets Service (formerly the Federal Commission for Securities Markets) with the participation and support of the representatives of the Western business community, domestic issuers and professional participants of the securities market on April 4, 2002 (http://www.ecgi.org). Earlier, in November 2001, the Code was approved at a meeting of the Russian Government. Before the economic crisis of 2008, Russian system of corporate governance was flexible and not completely formed (KPMG, 2011). Because of this, the system has undergone a lot of changes. Before the 2008, many companies mostly formally complied with the basic requirements of the law and other corporate governance standards dictated by the existing codes, and other requirements of regulators, stock exchanges, and etc. In a sense, there was a mechanical adherence to the rules, which was to ensure the effective management of the company in

terms of application mechanisms of corporate governance. This confidence among companies was supported by the investment attractiveness factor, expressed in the growth rate of shares of public companies. During the crisis, the corporate governance has ceased to be a tool of external investment attractiveness and companies shifted focus towards the development of corporate governance systems. Because of the economic crisis, owners of most public companies realized the necessity of improving the internal efficiency of their business processes (KPMG, 2011).

Economic and financial crisis has contributed to self-determination of the Russian model of corporate governance, which should not be imposed by legislation, but should be formed based on the experience of companies and then secured at the legislative level. Development and compliance with corporate governance standards in most of top Russian companies are assigned to a single person or a structure, and not distributed over various company departments within their direct action (Lazareva et al., 2007). Often this function is performed by the board of directors, directors of corporate governance and corporate secretaries.

After economic crisis of 2008, the Russian business community realized the importance of effective of corporate governance practices in achieving good results in strategic planning and risk management. One of the advantages of corporate governance in Russia is an appearance of independent directors on the board that is considered like a sign of a formal compliance with generally accepted standards. Analysis of corporate governance practices shows that one of its major problems is the contradiction between fixed procedures and actual decision-making processes. Management decisions are often not accepted in a comprehensive basis and implemented without the use of modern management techniques. The next significant weaknesses, which are noted by Румянцев (2010), are lack of transparency and low efficiency of monitoring over senior management activities.

3. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

3.1 Board size and firm performance

According to the resource dependency theory, a board of directors is an important governance mechanism that affects firm performance positively. Larger boards are more productive in the decision making process (Dalton et al., 1998), have more knowledge and skills (Van den Berghe and Levrau, 2004) and diversified (Pearce and Zahra, 1992; and Goodstein et al., 1994). Similarly, Henry (2008) reports statistically significant and positive relationship between board size and the Q-ratio. However, Haniffa and Hudaib (2006) conclude that large board is seen as less effective and could also be costly for companies. Based on the results of the majority of prior studies and the resource dependency theory, it is hypothesized that:

H1*: There is a positive relationship between board size and firm performance.*

3.2 Board composition and firm performance

Agency theory states that the majority of independent directors on the board of directors leads to the agency cost reduction because it is easier to control managers' actions (Fama and Jensen, 1983). Weir et al. (2002), Ho and Williams (2003), and Gupta and Fields (2009) provide evidence that firms with high percentage of independent directors deliver higher performance. However, other studies argue that the percentage of independent directors is not associated with firm performance (e.g., Fosberg, 1989; Klein, 1998; Bhagat and Black, 2002). Based on the agency theory and the findings of most prior studies, it is hypothesized that:

H2: *There is no relationship between the proportion of independent directors on the board and firm performance.*

3.3 Managerial ownership and firm performance

There are two views on the management ownership issue. According to the agency theory, prevailing managerial ownership can be very risky, and it is not beneficial for a company (Beatty and Zajac, 1994). In contrast, if managers are also shareholders of the company, the majority of their actions tend to support company interests. Douma et al. (2006) find a positive relationship between performance and management ownership. Hence, our next hypothesis is:

H3: *There is a positive relationship between the management ownership and firm performance.*

3.4 Foreign ownership and firm performance

Barbosa and Louri (2005) conclude that foreign ownership has a positive impact on firm performance due to many reasons such as geographical expansion, product differentiation, and economies of scale. Foreign ownership also improves firm performance because it requires more corporate disclosure and transparency in financial reporting system of a company (Patibandla, 2006). To examine this relationship, our fourth hypothesis is:

H4**:** *There is a positive relationship between the presence of the foreign shareholders and firm performance.*

3.5 Government ownership and firm performance

Government ownership is another common feature of Russian business environment. State is interested in the economic growth; therefore here is a positive relation between government ownership and firm performance (Hart et al., 1997). Ang and Ding (2006) conclude that government linked companies show higher market valuation than non–government linked companies. Hence, our next hypothesis is:

H5: *There is a positive relationship between the presence of the government and firm performance.*

3.6 External auditors and firm performance

External auditors play a significant role in corporate governance of a firm. Large audit firms are bigger targets for litigation, and hence, they attempt to be more conservative and more diligent, thereby meaning there is a greater association between higher audit quality and larger audit firms. The financial audit provides shareholders with transparent information on the current performance of the company. According to Ojo (2009), an improvement of corporate governance in Europe, in the aftermath of Enron, would require the involvement of intermediaries such as external auditors. Therefore, it is hypothesized:

H6: *There is a positive relationship between the auditing company size and firm performance.*

4. DATA AND METHODOLOGY

4.1 Sample Selection

The sample of this study includes 20 the biggest Russian companies in the oil and gas industry. The study focuses on the post crisis period between 2009 and 2012. The data for two companies are not available for 2009 and 2012 respectively; therefore, the full sample includes 78 observations for four years. Data research variables are mainly extracted from the annual reports and other recourses, which provide information on financial data and corporate governance variables.

4.2 Description of Variables

The dependent variable is a firm performance which represents accounting performance variables include including equity to assets ratio (proxy for capital adequacy measurement), asset growth (proxy for asset management measurement), sales to asset ratio (proxy for management measurement), return on assets and return on equity ratios (proxies for earnings measurement), current ratio and quick ratio (proxies for liquidity measurement). The independent variables consist of six corporate governance variables. They are board size, number of independent directors on the board, management ownership, foreign ownership, government ownership, and auditing company. Size and age are control variables. Description and measurement of research variables are presented in Table 1. To analyze the relationship between the firm performance and individual corporate governance mechanisms, the following model is used:

$$PERFORMANCE = \alpha 0 + \beta 1BSIZE + \beta 2INDIR + \beta 3MANOWN + \beta 4FOROWN + \beta 5GOVOWN + \beta 6AUDIT + \beta 7SIZElog + \beta 8AGE + \varepsilon,$$

where:

PERFORMANCE - one of the alternative operating performance measures, BSIZE - board size, INDIR – the number of independent directors, MANOWN – managerial ownership, FOROWN - foreign ownership, GOVOWN - state ownership, AUDIT – the type of auditing company, AGE – company age, and SIZE - company size.

Table 1: Research Variables Definition/Measurement

Variables	*Acronym*	*Operationalization*
Dependent variables		
Accounting performance		
Capital Adequacy	CAPAD	Equity to Assets ratio. This ratio is a proxy for accounting measure of financial strength and stability.
Asset Growth	GROWTH	Asset growth is a proxy for firm growth. Total Assets of the current year minus Total Assets of the previous year divided by Total Assets of the previous year.
Management	MNGT	Sales to Asset ratio (also known as Asset Turnover ratio). It shows the amount of sales generated per dollar of assets.
Return on Asset	ROA	Net Income divided by Total Assets
Return on Equity	ROE	Net Income divided by Equity
Current Assets Ratio	CA	Current Assets divided by Current Liabilities.
Quick Ratio	QA	Current Assets minus Inventory divided by Current Liabilities.
Independent variables		
Board size	BSIZE	Total number of directors on the board of the company.
Independent directors	INDIR	Total number of the independent directors on the board of the company.
Management ownership (%)	MANOWN	The proportion of the shares owned by the managers of the company.
Foreign ownership (%)	FOROWN	The proportion of the shares owned by the foreign shareholders of the company.
Government ownership (%)	GOVOWN	The proportion of the shares owned by the government.
Auditing company	AUDIT	Dichotomous with 1 if auditing company that tests the observed company is one of the Big Four and 0 otherwise.
Control variables		
Company size	SIZE log	Natural log of total Assets of the company.
Company age	AGE	Number of years since foundation of the company.

5. FINDINGS AND ANALYSIS

Table 2 presents the summary statistics of the dependent, independent, and control variables based on 78 observations. Several observed companies had a negative growth during some years, therefore the minimum value for GROWTH is -13%. The mean values for ROA and ROE are 10.49% and 38.11% respectively. In terms of liquidity, the mean values of CA and QA are 5.88 and 5.63 times respectively.

Table 2: Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
CAPAD (%)	0.11	97.87	58.15	25.478
GROWTH (%)	-13.10	1448.11	46.31	174.51
MGMT	.00	7.01	.8319	1.05994
ROA (%)	-2.15	71.21	10.49	9.816
ROE (%)	-12.01	983.11	38.11	117.16
CA (times)	.45	225.73	5.8863	25.56747
QA (times)	.34	225.48	5.6369	25.54811
BSIZE	.00	15.00	7.9103	3.76307
IND	.00	7.00	2.2051	2.25837
MANOWN	.00	1.75	.0899	.32382
FOROWN	.00	100.00	7.5762	22.79623
GOVOWN	.00	100.00	23.3670	36.31862
AUDIT	.00	1.00	.6923	.46453
SIZElog	1.50	13.00	8.7244	2.43722
AGE	1.00	21.00	15.2436	4.31604

Table 3. Pearson correlation. Up scripts * and ** indicate two-tailed significance levels of 0.05 and 0.01 respectively.

	CAPAD	GROWTH	MGMT	ROA	ROE	CA	QA	BSIZE	INDIR	MANOWN	FOROWN	GOVOWN	AUDIT	SIZElog	AGE
CAPAD	1	-.282*	-.470**	.233*	-.396**	.270*	.265*	.108	.183	.135	-.336**	.395**	-.174	.162	.477**
GROWTH	-.282*	1	.536**	.068	.273*	-.030	-.029	-.157	-.176	-.023	.643**	-.041	-.246*	-.378**	-.525**
MGMT	-.470**	.536**	1	-.049	.554**	-.093	-.092	-.118	-.200	-.100	.722**	-.211	-.093	-.246*	-.510**
ROA	.233*	.068	-.049	1	.018	.146	.145	-.037	-.045	.102	-.131	.421**	-.237*	-.201	.082
ROE	-.396**	.273*	.554**	.018	1	-.032	-.030	-.166	-.171	-.041	.563**	-.078	-.043	-.234*	-.380**
CA	.270*	-.030	-.093	.146	-.032	1	1.000**	-.064	-.041	-.038	-.059	.309**	-.248*	-.074	.053
QA	.265*	-.029	-.092	.145	-.030	1.000**	1	-.064	-.042	-.038	-.058	.308**	-.247*	-.075	.052
BSIZE	.108	-.157	-.118	-.037	-.166	-.064	-.064	1	.431**	.081	-.096	.076	.385**	.612**	.316**
INDIR	.183	-.176	-.200	-.045	-.171	-.041	-.042	.431**	1	.441**	-.208	.177	.110	.627**	.322**
MANOWN	.135	-.023	-.100	.102	-.041	-.038	-.038	.081	.441**	1	-.093	-.181	.030	.101	.229*
FOROWN	-.336**	.643**	.722**	-.131	.563**	-.059	-.058	-.096	-.208	-.093	1	-.132	-.145	-.294**	-.635**
GOVOWN	.395**	-.041	-.211	.421**	-.078	.309**	.308**	.076	.177	-.181	-.132	1	-.184	.107	.157
AUDIT	-.174	-.246*	-.093	-.237*	-.043	-.248*	-.247*	.385**	.110	.030	-.145	-.184	1	.517**	.252*
SIZElog	.162	-.378**	-.246*	-.201	-.234*	-.074	-.075	.612**	.627**	.101	-.294**	.107	.517**	1	.544**
AGE	.477**	-.525**	-.510**	.082	-.380**	.053	.052	.316**	.322**	.229*	-.635**	.157	.252*	.544**	1

Table 3 shows Pearson's correlation results for variables used in this research. Significant correlations among independent and control variables may potentially lead to multicollinearity problems. To test for presence of multicollinearity, we have checked variance inflation factors (VIF) for all variables in all the regression models and identified that maximum number is 2.297 (Age variable) which is far below of 5.00, thereby suggesting that no multicollinearity is present. The finding signals better performance with the presence of the government as a shareholder. As expected, auditing company is negatively associated with firm performance indicating more conservative reporting for companies audited by Big 4. The negative correlation of SIZE log with ROA supports the study of Weir et al. (2002), suggesting that smaller companies are better performers.

Table 4 shows the regression results for the effects of operating performance on governance practices and the control variables. Contrary to Hypotheses H_1 and H_2, BSIZE and INDIR are not associated with any of operating performance variables. Consistent with H_3, management ownership has a significant and positive relationship with ROA. This

result is contrary to Beatty and Zajac (1994), but supports Douma et al. (2006) that management ownership positively affects the company's earnings. The regression results for FOROWN indicate that there is a positive relationship between the presence of the foreign shareholders and operating performance. This is consistent with the findings of Barbosa and Louri (2005) and Patibandla (2006). With regard to government ownership, the empirical results show that there is a positive and significant association between GOVOWN and performance variables including CAPAD, ROA, CA, and QA. Finally, AUDIT is negatively associated with CAPAD, CA, and QA. This indicates that companies audited by Big 4 disclose more conservative financial reports which result in much more conservative operating performance indicators. Overall, the empirical findings indicate that corporate governance practices including managerial ownership, foreign ownership, and government ownership had a positive impact on operating performance variables in the post-crisis period.

Table 4. Regression Analysis. Upscripts *, **, and * indicate significance of 0.10, 0.05, and 0.01 respectively.**

	CAPAD	GROWTH	MGMT	ROA	ROE	CA	QA
(Constant)	.213	1.958	.905	.157	.500	2.723	2.600
	(1.627)*	(2.332)**	(1.902)**	(2.971)***	(.793)	(.174)	(.167)
BSIZE	.004	.021	-.010	.004	-.039	.055	.060
	(.489)	(.407)	(-.342)	(1.291)	(-.990)	(.056)	(.061)
INDIR	-.086	.356	.028	-.059	.097	-19.148	-18.915
	(-.524)	(.340)	(.048)	(-.901)	(.123)	(-.983)	(-.971)
MANOWN	.097	.323	-.162	.075	.077	6.410	6.384
	(1.027)	(.532)	(-.471)	(1.956)**	(.169)	(.569)	(.566)
FOROWN	-.001	.040	.031	-.001	.029	-.043	-.041
	(-.447)	(4.554)***	(6.203)***	(-1.034)	(4.335)***	(-.260)	(-.248)
GOVOWN	.002	.003	-.004	.001	.001	.205	.204
	(2.914)***	(.596)	(-1.352)	(4.306)***	(.332)	(2.353)**	(2.345)**
AUDIT	-.142	-.171	.004	-.015	.336	-13.279	-13.103
	(-2.143)**	(-.400)	(.015)	(-.546)	(1.050)	(-1.674)*	(-1.651)*
SIZE log	.002	-.149	.006	-.013	-.041	.971	.923
	(.083)	(-1.204)	(.088)	(-1.635)*	(-.444)	(.423)	(.402)
AGE	.025	-.048	-.013	.001	.003	.184	.190
	(2.929)***	(-.855)	(-.401)	(.324)	(.068)	(.178)	(.183)
Adj. R-square	33%	41%	48.8%	25.1%	26.4%	5.2%	5.1%
F-stat	5.742	7.701	10.167	4.220	4.444	1.533	1.514

6. CONCLUSION

This study explores corporate governance practices in Russian oil and gas companies in the post-crisis period and examines the relationship between accounting performance measures and corporate governance mechanisms. The results indicate that the board size and independent directors on the board do not appear to affect firm performance. This result supports Fosberg (1989), Bhagat and Black (2002), Klein (1998) who find no linkage between number of independent directors and firm performance. Moreover, our results indicate that management ownership has a positive impact company performance. This implies that managerial ownership increases earnings and therefore improves the performance of oil and gas companies in Russia. The findings on foreign ownership suggest that foreign ownership is positively associated with firm performance. The empirical evidence shows that foreign owners were able to improve asset growth, management quality and liquidity. The results on government ownership also support our initial hypothesis and indicate that better government ownership positively affects accounting performance. One of the features of Russian corporate governance is a government involvement in the business process (Lazareva et al., 2007). The analysis confirmed that the government as a stakeholder is a prosperous mechanism of corporate governance of the Russian companies in the oil and gas industry.

The study indicates that companies audited by Big 4 issue more conservative financial reports which result in much more conservative accounting performance indicators. The control variables like firm size and age have significant relationships with firm performance. For example, size is negatively associated performance thereby suggesting that small companies on average outperform large firms. We acknowledge several limitations of this research that suggest further investigation of the topic. Firstly, only six independent variables were tested in this study. It is possible to consider other variables such as the presence of different committees, CEO duality, CEO education, etc. Secondly, sample size is relatively small due to a small number of companies and only four years included in this study. One of possible directions for future research can be to extend time period and conduct a comparative analysis of the pre-crisis and post-crisis periods. Third, this study considers Oil and Gas industry only. Further and deeper insights can result from a comparative study conducted on inter-industry dataset. And finally, this study tests the correlation of corporate governance indices only with accounting performance variables. Therefore, considering market performance, for example, using Tobin's Q ratio can highlight other aspects of the governance – performance relations.

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