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**REVIEW OF LITERATURE & EMPIRICAL RESEARCH
ON CORPORATE GOVERNANCE***

BY

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**KEYWORDS: CORPORATE GOVERNANCE, AGENCY PROBLEMS,
FIRM VALUE, BOARD OF DIRECTORS**

ABSTRACT

Corporate Governance is about putting in place the structure, processes and mechanisms by which business and affairs of the company or firm are directed and managed, in order to enhance long term shareholder value through accountability of managers and enhancing firm performance. In other words, through such structure, processes and mechanisms, the well-known agency problem - the separation of ownership (by shareholders) and control (by managers) which gives rise to conflict of interests within a firm may be addressed such that the interest of the managers are more aligned with that of shareholders.

In recent years, the corporate scandals, some of which are still unfolding, involving high incidence of improper activities of managers expropriating the resources of a firm at the ultimate expense of shareholders prompt the intense re-examination and scrutiny of some of the existing corporate governance practices and also considerable interest in empirical research on the effectiveness of various corporate governance institutions and mechanisms.

This paper makes an attempt to review extensively the literature and empirical research addressing corporate governance and corporate performance, and the roles and effectiveness of various governance institutions and mechanisms, in particular the board of directors.

EXECUTIVE SUMMARY

Below is a summary of the literature, and findings or results of empirical research on various corporate governance institutions, mechanisms and practices.

Board of directors

(1) Functions/roles of boards

Researchers categorized three main roles, namely control, service and resource dependence roles. In Asian context, resource dependence role (i.e. board members providing resources and information to management) is more pronounced than the other two roles. This is interesting as it reflects that top management may be selecting board members to help develop business rather than to perform more of the role of monitoring and controlling the management.

Most researchers observed that CEO has significant influence on board appointments and setting board agenda.

(2) Board size

Recent thinking has leaned towards smaller boards as supported by empirical research, as too big a board is less effective, harder to coordinate and discuss and process problems.

(3) Outside directors / board independence

Empirical research results are mixed. Some argue for more outside directors and yet others against it. Perhaps, one sensible approach is to assess the firm profile and the roles expected of the directors first before deciding on the issue of outside directors. For example, a research found that for certain board committees tasked to address issues such as finance and strategy, firms performed better when they have more inside directors. This could explain why NYSE has very recently adopted two-board structure whereby board of directors consisting of purely outsiders to look after corporate governance and regulatory compliance issues, while board of executives consisting of industry representatives to look after business issues.

(4) Board leadership / CEO-chairperson duality

Researchers found mixed evidence on the issue of whether CEO and chairman positions should be held by one person. One researcher argues that no "one hat fits all" and board leadership structure should depend on individual firm characteristics such as organizational complexity (leading to the issue of whether CEO needs to make shift decisions), availability of alternate governance mechanisms, and CEO reputation and power.

(5) Interlocking directorates

Interlocking directorate occurs when senior managers or directors of two companies simultaneously serve on each other's boards. There are two motivations for this. One is for these directors to network to protect their interests as a social elite class, and the other is for reason of resource dependence (mentioned above) to reduce environmental uncertainty faced by firms so as to enhance firm performance.

(6) Multiple board appointments

This topic attracts considerable debate. Some shareholder activists criticize it because directors who hold multiple appointments are ineffective in discharging their function to monitor and control managers. Empirical research to date however found no or weak evidence that multiple directors shirk their responsibilities and that multiple directorships and poor regulatory compliance in firms are related.

(7) Frequency of board meetings

Some empirical evidence showed that meeting frequency is an important dimension of an effective board.

(8) Board diversity

With globalization bringing about diversity in clients, operations and market competitions, board diversity in terms of gender, races, nationality (local or foreign) of directors and their expertise and experience have recently attracted increasing interest in research. Some initial empirical research found that board diversity is positively correlated with firm value.

Board and executive compensation

Most recent research found stronger relationship between firm performance and performance-based compensation for board of directors and/or executives, but are not clear what an optimal pay-for-performance trade-off should be.

Director and managerial ownership

Ownership refers to shareholding in a firm. Empirical research found that below certain level, managerial ownership is good because it incentivise the top managers to enhance firm value ("incentive" effects). However, beyond certain level, top managers' control of the firm is getting strong and "entrenched" and they may not always act in the interest of other minority shareholders, e.g. they may try to block value-enhancing takeovers ("entrenchment" effects). Getting directors to own a stake in a firm also

helps align the interest of directors with that of shareholders, especially the minority shareholders.

Large shareholders or blockholders (apart from managerial ownership)

This often refers to institutional investors like pension funds (e.g. CULPERS), fund managers and mutual trusts etc. As their holding is relatively large, they have incentives to monitor and exercise influence over managers of firms they invest in. They may even launch proxy contests against incumbent management. Research found that such investors did help discipline the firms and increase share value. However, some such investors may have political or social agenda.

Stock markets

Research found that where investor protection and investor activism are weak, an effective stock market could increase the cost of capital and hence asserts some pain on controlling shareholder -manager.

Market for corporate control: proxy contests, hostile takeovers and leveraged buyouts

A great deal of theory and empirical evidence supports the idea that market for corporate control addresses governance problems of inefficient firms. However, apart from U.S. and to less extent U.K., these largely external governance mechanisms are almost non-existing, let alone common in Asia. There is also suggestion that takeovers are usually expensive from bidders' perspective.

Legal system and investor protection

Recent research suggest that the extent of legal protection for investors in a country is an important determinant in developing financial markets. There is empirical evidence that the quality of minority shareholder rights and legal enforcement help reduce corporate earning management (to mask firm performance) by insiders, and that firm value is positively correlated with protection of minority shareholders. Better investor protection also means higher liquidity (in terms of bid-ask spread and trading volume) of stocks.

Leverage and debt

Research found that contractual terms of a debt contract especially the financial ratio covenants and shorter maturity can assert positive disciplinary effects on managers to manage a firm's cash flows properly and make better investment decisions.

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1. INTRODUCTION

1. Of late, organizations have been paying more attention to corporate governance. We also note the increasing intensity in research on this subject, particularly in the last two decades.

2. However till these days, the well-known agency problems resulting from the separation of ownership from control (Berle & Means 1932; Jensen & Meckling 1976) still prevail in firms worldwide. Recent research (Core et al. 1999) suggests that firms with weaker governance structure have greater agency problems; that firms with greater agency problems allow managers to extract greater private benefits; and that firms with greater agency problems perform worse. Specifically in Asia, it has been shown that both before (Joh 2003) and after (Mitton 2002) the Asian financial crisis in 1997, firms that paid heed to good corporate governance practices fared better and provided greater protection to shareholders, especially the minority shareholders. In corporate America, agency problems have been well publicized by the recent corporate scandals and high incidence of improper activities by managers.

3. But, agency problems are the necessary evils of “*efficient form of economic organization*” called firms (Fama 1980) where the various resource owners are pooled together in order to produce goods or services demanded by customers at the lowest cost. Therefore, firms must be convinced of the importance of grappling with and managing corporate governance for their long-term survival and growth. More importantly, a good balance must be found between ownership and control, or more broadly speaking, among the interest of all stakeholders of a firm.

4. In this literature review, apart from the fundamental aspects of corporate governance, I also focus on how corporate governance affects corporate performance and firm value. If all stakeholders of a firm see value in corporate governance, a positive and helpful attitude by all stakeholders can then be cultivated. If available and appropriate, I also relate more to research works in Asia where the institutional environments and culture are not necessarily similar to that of the Western world, where most of the concepts and theoretical frameworks of corporate governance originated.

2 MAIN BODY OF LITERATURE REVIEW

2.1 THE CONCEPT OF THE FIRM

5. Traditional economists view a firm as a production function (Coase 1937). This view lends itself to theorizing that leads to the structure of corporations we see today, i.e. capital and managerial effort are merely factors of production, without reference to property rights. Thus, managers allocate resources as they see fit without proper accountability for their decisions. This classical production function does not include the influence of public policy, family dynamics, and network exigencies common in some emerging economies such as Asian corporations. Simply put, this view says little about the contractual relationship between stakeholders, boards, and managers.

6. Neo-classical economists see a firm as a nexus of contracts (Alchian & Demsetz 1972; Jensen & Meckling 1976; Fama 1980). Through the firm, the various resource owners increase productivity through cooperative specialization. The relationship between the owner of the firm (i.e. residual claimant) and team members such as employees and suppliers is simply a “*quid pro quo*” contract. They stress that property rights are shaping economic behaviors. For example, the rights attached to securities give investors the power to extract from managers the returns on their investment. Shareholders can vote out the directors if they do not take care of shareholders’ interest. Bondholders can bankrupt the firm if they are not paid interest and principal. Without these rights, firms would find it harder to raise external finance and hence no investment or production activities can be carried out (La Porta & Lopez-De-Silanes 1998). Whoever owns the assets and therefore bears the risks and retains the right to the residual rewards from production is important because it is this person(s) that fundamentally determines the allocation of scarce resources. The issue of property rights brings into relief the theoretical underpinnings for future research in corporate governance (Aghion & Tirole 1997).

2.2 AGENCY PROBLEM AND CORPORATE GOVERNANCE THEORIES

2.2.1 Separation of ownership and control – origin of Agency Theory

7. Theoretical underpinnings for the extant research in corporate governance come from the classic thesis, “*The Modern Corporation and Private Property*” by Berle & Means (1932). The thesis describes a fundamental agency problem in modern firms where there is a separation of ownership and control. Such separation has been clearly expressed by the authors’ own statements: -

“It has often been said that the owner of a horse is responsible. If the horse lives he must feed it. If the horse dies he must bury it. No such responsibility attaches to a share of stock. The owner is practically powerless through his own efforts to affect the underlying property. The spiritual values that formerly went with ownership have been separated from it...the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control.”

8. Adam Smith (Smith 1937) makes a caustic remark about the agency problem:-

“The directors of such companies, however, being the managers of other people’s money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over them...Negligence and profusion, therefore, must always prevail more or less, in the management of the affairs of such a company.”

9. Jensen & Meckling (1976) further define agency relationship and identify agency costs. Agency relationship is a contract under which “one or more persons (principal) engage another person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent”. Conflict of interests between managers or controlling shareholder, and outside or minority shareholders refer to the tendency that the former may extract “perquisites” (or perks) out of a firm’s resources and less interested to pursue new profitable ventures. Agency costs include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent. The share price that shareholders (principal) pay reflects such agency costs. To increase firm value, one must therefore reduce agency costs. This is one way to view the linkage between corporate governance and corporate performance. Fama (1980) aptly comments that separation of ownership and control can be explained as a result of “efficient form of economic organization”.

10. In summary, with its root in industrial and organizational economics, Agency Theory assumes that human behavior is opportunistic and self-serving. Therefore, the theory prescribes strong director and shareholder control. It advocates fundamental function of the board of directors is to control managerial behavior and ensure that managers act in the interests of shareholders.

2.2.2 Stewardship Theory

11. Although Agency Theory is the dominant perspective in corporate governance studies, it has been criticized in recent years (Hoskisson et al. 2000; Blair 1995; Perrow 1986) because of its limited ability to explain sociological and psychological mechanisms inherent of the principal-agent interactions (Davis & Thompson 1994; Davis et al. 1997). For example, outside directors as emphasized by Agency Theory, with only legal power, may not possess sufficient expertise and seldom have close social ties with top managers. Stewardship theory is proposed as an alternative perspective to Agency Theory. Stewardship theorists assume that managers are good *stewards* of the firms. They are trustworthy and work diligently to attain high corporate profit and shareholders’ returns (Donaldson & Davis 1994). These *stewards* can co-operate and work closely with the principal to achieve a “goal alignment” (Davis et al. 1997). In an empirical study by Tian and Lau (2001) among Chinese shareholding

companies to contrast Agency and Stewardship Theories, they find that the stewardship hypothesis received stronger support. At the methodological level, Tian and Lau (2001) use two different board composition measures, i.e. independent directors and affiliated directors, to highlight their differences in motivation, firm-specific knowledge, information advantage, interpersonal relationship and mutual trust with the managers, along which dimensions that agency and stewardship theories diverge from each other. CEO duality (i.e. the roles of Chairman of the board and CEO is held by one person) is also seen as a supporting attribute to the stewardship theory and used in the test by Tian and Lau (2001). Phan (2001) suggests that whether the assumptions of Agency Theory can be generalized to emerging markets, with their different sociological, economic, and developmental fundamentals, remains an important research question.

2.2.3 Complex issue of “control” or rather “ultimate control”

12. Recent research also adds complexity to the issue on separation of ownership and control. La Porta et al. (1999) investigate the issue of “ultimate control” of firms in 27 wealthy economies and find that relatively few firms are widely held and that owners enhance their control of firms through the use of pyramiding and management appointments, as well as through cross-ownership and the use of shares that have more votes. Voting rights of these owners consequently exceed their formal cash flow rights (right to receive dividend). This appears to have expanded the concept of control, which Berle & Means (1932) highlight as a type of rapidly moving third force, quite apart from ownership and management. Claessens et al. (2000) also note that control by single shareholder is a common sight in firms in Asia. As previous studies have mostly looked at immediate ownership and not ultimate control, a re-examination of the relation between ownership structure and corporate performance is needed.

13. In the present context, agency problem can be described as a problem involving an agent - the CEO of a firm, the shareholders, and many other stakeholders such as creditors, suppliers, clients and employees, and other parties with whom the CEO engages in business on behalf of the firm. Boards and external auditors act as intermediaries or representatives of these different constituencies (Becht et al. 2002; Bernheim & Whinston 1986).

2.3 DEFINITION OF CORPORATE GOVERNANCE

14. After the above review on firm and agency problems, a look at some definitions of corporate governance is in order before we proceed to the following sections.

15. The Code of Corporate Governance produced by The Committee on Corporate Governance or CGC and adopted by the Ministry of Finance, Singapore (CGC 2001) defines corporate governance as *“the processes and structure by which the business and affairs of the company are directed and managed, in order to enhance*

long term shareholder value through enhancing corporate performance and accountability, whilst taking into account the interests of other stakeholders. Good corporate governance therefore embodies both enterprise (performance) and accountability (conformance)."

16. La Porta et al. (2000) view corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders, i.e. the managers and controlling shareholders. They then give specific examples of the different forms of expropriation. The insiders may simply steal the profits; sell the output, the assets or securities in the firm they control to another firm they own at below market prices; divert corporate opportunities from firms; put unqualified family members in managerial positions; or overpay managers. This expropriation is central to the agency problem described by Jensen and Meckling (1976).

2.4 WHY HAS CORPORATE GOVERNANCE BECOME SO PROMINENT TODAY?

17. Becht et al. (2002) identify several reasons for this. There are the world-wide wave of privatization of the past two decades, the pension fund reform and the growth of private savings, the takeover wave of the 1980s, the deregulation and integration of capital markets, the 1997 East Asia Crisis, and the series of recent corporate scandals in the U.S. and elsewhere.

18. Yoshikawa & Phan (2001) note intensifying global competition and rapid technological changes result in lower price/cost margins which in turn force firms to focus on maximizing asset efficiency and shareholder value if they want to access funds to fuel growth opportunities. Also technological advances reduce transaction costs and the costs of information research, rendering global capital markets more accessible to investors. This has fueled global competition between capital markets and the evolution of corporate governance around the world.

19. In Asia, the prevalence of family ownership, government interference, relationship-based transactions and generally weak legal systems and law enforcement result in agency problems such as large deviations between control and cash flow rights and low degree of minority rights protection. Conventional corporate governance mechanisms such as takeovers and boards of directors are not strong enough to relieve agency problems. The group business and cross-holding structure further complicate agency problems. These agency problems and weak corporate governance, not only lead to poor firm performance and risky financing patterns, but are also conducive to macroeconomic crises (Claessens et al. 2002b), like the 1997 East Asia crisis. Therefore, agency problems and corporate governance in Asia warrant urgent attention

2.5 GOVERNANCE MECHANISMS AND FIRM PERFORMANCE

2.5.1 Internal Mechanisms

(1) **Board of Directors**

20. The board of directors is an important institution in the governance of modern corporations. Fama & Jensen (1983) view the board as "*the apex of internal decision control systems of organizations.*" To date, the often-researched mechanism has been the board of directors (Dalton et al. 1998; Zahra & Pearce 1989). In particular, studies on board composition and board leadership structure have accounted for the bulk of research on boards of directors.

21. Functions of boards

In a comprehensive review of the literature on boards of directors, Johnson et al. (1996) outline three widely recognized functions of boards of directors, namely the control, service and resource dependence roles. Most literature on the control function of the board draws on Agency Theory, which emphasizes the separation of ownership (shareholders) and control (professional managers) inherent in modern corporations. From an Agency Theory perspective, boards represent the primary internal mechanism for controlling managers' opportunistic behavior, thus helping to align shareholders' and managers' interests (Jensen 1993). Service role entails directors giving expert views and strategic advice to the CEO (Dalton & Daily 1999; Lorsch 1995; Westphal 1999). Finally, the resource dependence perspective (Dalton & Daily 1999; Aldrich 1979; Pfeffer & Salancik 1978) views board as an instrument for sourcing critical resources (e.g. financing) and information (e.g. on competitors and industry) to create sustainable competitive advantage (Conner & Prahalad 1996). In addition, a prestigious board may add legitimacy to newly established firms (Au et al. 2000).

22. In Asia, Young et al. (2001) find that the resource dependence function of the boards of overseas Chinese firms in Hong Kong and Taiwan is more pronounced than control and service functions, which they attribute to the social norms and institutional environments facing these firms. Further empirical research to contrast the impact on firm performance of the different functions of the boards will be interesting.

23. Board size

There is a view that larger boards are better for corporate performance because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. However, recent thinking has leaned towards smaller boards. Jensen (1993) and Lipton & Lorsch (1992) argue that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to co-ordinate and process problems. Smaller boards also reduce the possibility of free riding by, and increase the accountability of, individual directors. Empirical research supports this. For example, Yermack (1996) documents that for large U.S. industrial corporations, the market values firms with smaller boards more highly. Eisenberg et al. (1998) also find negative correlation between board size and

profitability when using sample of small and midsize Finnish firms, which suggests that board-size effects can exist even when there is less separation of ownership and control in these smaller firms. Mak and Yuanto (2003) echo the above findings in firms listed in Singapore and Malaysia when they found that firm valuation is highest when board has five directors, a number considered relatively small in those markets.

24. There is also evidence that board size, together with other features of a board, is endogenously determined by other variables, such as firm size and performance, ownership structure, and CEO's preferences and bargaining power (Hermalin & Weisbach 2001).

25. Outside directors/board independence

Though the issue of whether directors should be employees of or affiliated with the firm (inside directors) or outsiders has been well researched, no clear conclusion is reached. On the one hand, inside directors are more familiar with the firm's activities and they can act as monitors to top management if they perceive the opportunity to advance into positions held by incompetent executives. On the other hand, outside directors may act as "professional referees" to ensure that competition among insiders stimulates actions consistent with shareholder value maximization (Fama 1980).

26. Fields & Keys (2003) conduct an extensive review of empirical research on outside directors and find overwhelming support from researchers (Brickley & James 1987; Weisbach 1988; Byrd & Hickman 1992; Brickley et al. 1994) who support the beneficial monitoring and advisory functions to firm shareholders. However, there appears no evidence that insider/outsider ratio is correlated with firm performance (Hermalin & Weisbach 2001) and that firms with more independent directors achieved improved firm profitability (Bhagat & Black 2002; Bhagat & Black 1999). Baysinger & Butler (1985) advocate a mix of insiders and outsiders on the board and find empirical support that this approach enhances firm performance. Agrawal & Knoeber (1996) suggest that boards expanded for political reasons often result in too many outsiders on the board, which does not help performance. Carter et al. (2003) find evidence that the proportion of women and minorities on boards decreases when the number of inside directors on boards increases.

27. Perhaps, one sensible approach is to assess the firm profile and the roles expected of the directors before deciding on the issue of outsider directors. Deli & Gillan (2000) find that firms with lower managerial ownership (of shares) and fewer growth opportunities are more likely to have independent and active audit committees. Klein (1998) examines board committees by classifying committees according to the two primary roles of directors: monitoring and decision-making (advising managers). She finds that firms increasing insider representation on committees associated with decision making e.g. finance and strategy committees have higher contemporaneous stock returns and return on investment.

28. Like board size, empirical studies on outside directors is complicated by the endogeneity problem (Hermalin & Weisbach 2001). For example, Hermalin & Weisbach (1988) find that outside directors are more likely to join a firm after poor performance, when firms leave product markets, or when a new CEO is chosen. Mak & Li (2001) find evidence that the proportion of outside directors of Singapore listed companies is negatively related to managerial ownership, government ownership and board size.

29. It is felt that more research focusing on internal agency problems and inner working of the board will shed further insights on the use of outsider directors.

30. Board leadership and CEO-chairperson duality

Financial economists have paid considerable attention to the role of boards in monitoring managers and in removing non-performing CEOs. Jensen (1993) voices his concern that a lack of independent leadership makes it difficult for boards to respond to failure in top management team. Fama & Jensen (1983) also argue that concentration of decision management and decision control in one individual reduces board's effectiveness in monitoring top management.

31. Relating CEO duality more specifically to firm performance, researchers however find mixed evidence. Daily & Dalton (1992) find no relationship between CEO duality and performance in entrepreneurial firms. Brickley et al. (1997) also show that CEO duality is not associated with inferior performance. Rechner & Dalton (1991), however, report that a sample of Fortune 500 companies with CEO duality have stronger financial performance relative to other companies. Goyal & Park (2002) examine a sample of U.S. companies and find that the sensitivity of CEO turnover to firm performance is lower for companies without CEO duality.

32. Faleye (2003) perhaps presents an interesting proposition. He argues that no "one hat fits all" and board leadership structure depends entirely on individual firm characteristics such as organizational complexity, availability of other controls over CEO authority and CEO reputation and power. Using a sample of 2,166 U.S. companies, he finds that companies with complex operations (implying need for CEO to make swift actions), alternative control mechanisms and sound CEO reputation are more likely to have CEO duality.

33. Due to recent corporate scandals in U. S. and high incidence of improper insider activities, more regulatory agencies appear to lean towards the opposition of CEO duality, e.g. NYSE's recent split of CEO and Chairman roles. However, as the above research show, more theoretical work perhaps needs to be done first in order to better understand the advantages and disadvantages of different board leadership structure in different environments.

34. Interlocking directorates

Interlocking directorate occurs when a person from one organization sits on the board of directors of another company and in the most stringent definition, when current senior managers and/or directors of two companies simultaneously serve on each other's boards. Interlocking directorates exist for class integration, defined as the mutual protection of the interests of a social class by its members (Koenig & Gogel 1981). For example, Useem's (1982) interviews with 1,307 U.S. and British executives and directors uncover an elite network of directors in various organizations loosely held together by the common goal of preserving their individual and collective positions in society. Another theory that holds interlocking directorates is resource dependence whereby directors could exchange resources, e.g. capital, industry information, and market access, to buffer the effects of environmental uncertainty (Pfeffer & Salancik 1978). These two different motivations have very different performance implications. Interlocks designed to protect a managerial class have no *a priori* implication for firm performance while those designed to reduce environmental uncertainty could potentially increase the efficient deployment of resource and hence enhance firm performance. Evidence for the latter case has been provided by recent empirical case study in Singapore (Phan et al. 2003) whereby positive relationship between interlocks and firm performance was found for inter-industry (implying resource dependence perspective) but not for intra- and regulatory- interlocks.

35. Multiple board appointments

The issue of multiple board appointments attracts considerable debate. Some shareholder activists criticize multiple board appointments because directors who hold such appointments are ineffective in discharging their function to monitor managers. Several institutions in U.S. such as The Council of Institutional Investors and National Association of Corporate Directors generally advocate that directors with full-time jobs should not serve on more than two or three other boards. The Business Roundtable in Washington, DC, by contrast, believes that limits on the number of directors are ill advised. Ferris et al. (2003) find no evidence that multiple directors shirk their responsibilities to serve on board committees and no significant evidence of a relation between multiple directorships and the likelihood that the firm will be named in a securities fraud lawsuit. Cook (2002), who retired as Chairman and CEO of Deloitte & Touche LLP in 1999 and has taken board seats at five major American companies as a professional director, commented that "there is considerable value in being on multiple boards... and the experience across boards can be of real value to the governance process".

36. Frequency of board meetings

Vafeas (1999) finds that the annual number of board meeting increases following share price declines and operating performance of firms improves following years of increased board meetings. This suggests meeting frequency is an important dimension of an effective board. Lipton & Lorsch (1992) find that the most widely shared

problem directors face is lack of time to carry out their duties, and that (Conger et al. 1998) board meeting time is an important resource in improving the effectiveness of a board.

37. Yet, an opposing view is that board meetings are not necessarily useful because the limited time the outside directors spend together is not used for the meaningful exchange of ideas among themselves or with management (Jensen, 1993), a problem that is a byproduct of the fact that CEOs almost always set the agenda for board meetings.

38. Board Diversity

In very recent times, researchers began to look at how board diversity might enhance corporate governance and firm performance (Fields & Keys 2003).

In probably the first research of its kind, Carter et al.(2003), in a study of *Fortune*1,000 firms, find significant evidence of a positive relationship between board diversity, proxied by the percentage of women and/or minority races on boards of directors, and firm value, measured by Tobin's Q (Chung & Pruitt 1994). They also find that firms making commitment to increasing the number of women on boards also have more minorities on their boards and vice versa, and that the fraction of women and minority directors increases with firm size but decreases as the number of inside directors increases. Adams & Ferreira (2002), in using U.S. data, find that gender diversity of corporate boards provides directors with more pay-for-performance incentives and that the boards meet more frequently. Though not directly looking at board diversity, Keys et al. (2003) present empirical evidence supporting a relationship between diversity promoting activities of firms and expected future cash flows. Specifically they find filing of discrimination of lawsuits produce a negative and significant stock price reaction. In a study on Indian firms, Ramaswamy and Li (2001) find evidence that greater foreign directorship appears to be able to influence firms by discouraging unrelated diversification.

39. Notwithstanding above, empirical studies on the relationship between board diversity and firm performance remain sparse to date. One explanation is insufficient development of testable theory. Hermalin and Weisbach (2001) comment that board-specific phenomena are not quite explained by principal-agent models and note that current theoretical framework including agency theory does not provide clear-cut prediction concerning the link between board diversity and firm value. On the other hand, firms have in recent years been increasingly pressured by institutional investors and shareholder activists to appoint directors with different backgrounds and expertise, under the assumption that greater diversity of the boards of directors should lead to less insular decision making processes and greater openness to change (Westphal & Milton 2000). There are also strong conceptual and business propositions for diversity. A diverse workforce and diverse leadership within the firm can increase its competitiveness as a great variety of ideas and viewpoints are available for decision-making, attract a larger base of shareholders and employees, and help retain existing as well as potentially gain new minority consumers (Cox 1993). Cox & Blake (1991)

show how managing cultural diversity can create a competitive advantage for firms in six areas. There are cost, resource acquisition, marketing, creativity, problem-solving, and organizational flexibility. Robinson & Dechant (1997) also present three business reasons for diversity. There are cost savings, winning competition and driving business growth. According to Robinson and Dechant (1997), in today's fast-paced global market, diversity tends to encompass differences in gender, ethnicity, age, physical abilities, qualities, and sexual orientation, as well as differences in attitudes, perspectives and background.

40. In a report by The Conference Board, U.S. (Martino 1999) written with anecdotal evidence from some large corporations such as IBM, Ford Motor, Nortel, Lucent, Sara Lee, Texaco, and DuPont, diversity has been cited as an imperative for business success. The report cites the shift in labor market demographics, turnover rates, and the productivity gains of heterogeneous teams as primary drivers for diversity. The report also suggests that the truly diverse company is one that has minorities and women at every level of the workforce including the board of directors.

41. With globalization bringing about diversity in clients, operations and market competition, it will be interesting to see how firms can respond to the challenge and more research on board diversity is needed in understanding how to establish a more effective and robust board.

42. Quality of board meetings

The contents and quality of board meetings, is the other important if not the most important dimension of an effective board. However, this area remains largely under-researched, probably due to the absence of reliable data.

(2) *Director and executive compensation*

43. An often-suggested internal solution to the problem of inefficient or self-serving management is the development of compensation plans that tie management compensation directly to firm performance, e.g. through stock price performance. This pay-for-performance plan generally helps to reduce agency problems in the firm (Morgan & Poulsen 2001), as the votes approving the plan are positively related to firms that have high investment or high growth opportunities. On the other hand, votes approving the plan are inversely related to negative features in some of the plans such as dilution of shareholder stakes. Research also shows that the use of incentive or equity-based compensation for CEOs (Harvey and Shrieves 2001) and for managers (Mehran 1995) is greater in firms with a higher percentage of outside directors on the board.

44. However, Core et al. (1999) demonstrate that firms with weaker board (e.g. ineffective outside directors) and ownership (e.g. no blockholder) structures allow CEOs

to obtain excessive compensation, which results in poorer subsequent firm performance. Yeo et al. (1999) find no significant evidence for the incentive effect of executive share option plans (ESOP) on stock price and operating performance of Singapore listed firms.

45. Corporate governance reformers and institutional investors have recently argued that firms can increase the monitoring of management by providing directors with a financial stake in the performance of the firm. Perry (1999) finds evidence that incentive-based compensation for directors influence the level of monitoring by the board and through such compensation, firms can align the interest of directors and shareholders. Perry also finds that the likelihood of a firm adopting a stock-based incentive plan for directors is positively related to the fraction of independent directors on the board. Hermalin and Weisbach (1998) also suggest that incentive-based pay for directors can increase the monitoring efforts performed by the board. Shivdasani (1993) provides evidence that ownership by unaffiliated outside directors is negatively related to the probability that a firm will be subject to a hostile takeover attempt.

46. When choosing the type of compensation, researchers also report that firms have to be sensitive to their own firm characteristics. Lambert & Larcker (1987), for example, report that greater stock-based compensation is used when accounting measures are noisy and when a firm is in early stages of investment with rapid growth in assets and sales. Yermack (1995) reports pay is more sensitive to stock value in companies with noisy accounting data or in companies facing cash constraints and less sensitive in companies that are regulated.

47. While recent research finds a much stronger relationship between firm performance and executive compensation (Hall & Liebman 1998), most researchers however note it is not clear what the optimal pay-performance tradeoff should be. Some researchers found that managers can and do sometimes design compensation plans at the expense of shareholders (Core et al. 1999; Campell & Wasley 1999).

48. In short, the structure and level of pay-for-performance for managers and directors has been and will continue to be a topic of considerable controversy.

(3) Board and managerial ownership

49. The cost of large shareholdings and entrenchment are formalized in the model of (Stulz 1988), which predicts a concave relationship between managerial ownership and firm value. In the model, as managerial ownership and control increase, the negative effect on firm value associated with the entrenchment of manager-owners starts to exceed the incentive benefits of managerial ownership. The entrenchment costs of manager ownership relate to a managers' ability to block value-enhancing takeovers. McConnell & Servaes (1990) provide empirical support for this relationship among U.S. firms.

50. In Asian economies, control by single shareholder is a common sight in firms (Claessens et al. 2000). Claessens et al. (2002b) find that firm value increases with the cash-flow ownership (right to receive dividends) of the largest and controlling shareholder, consistent with “incentive” effects. But when the control rights (arising from pyramid structure, cross-holding and dual-class shares) of the controlling shareholder exceed its cash-flow rights, firm value falls, which is consistent with “entrenchment” effects. La Porta et al. (2002), using samples in 27 wealthy countries, find evidence in firms with higher cash flow ownership by controlling shareholder improves firm valuation, especially in countries with poor legal investor protection. Baek et al. (2004) find evidence that Korean listed firms with concentrated ownership by controlling family shareholders experienced a larger drop in stock value during the 1997 financial crisis. Using listed firms in eight East Asian economies to study the effect of ownership structure on firm value during the 1997 Asian crisis, Lemmon and Lins (2003) also find evidence that stock returns of firms in which ownership is concentrated in top managers and their family members were significantly lower than those of other firms.

51. Firms are governed by a network of relation representing by contracts for financing, capital structure, and managerial compensation, among others. Himmelberg et al. (1999) show that managerial ownership is explained by variables describing the contracting environment and they can’t conclude that changes in managerial ownership affect firm performance.

2.5.2 External Mechanisms

(1) *Large shareholders or blockholders*

52. Investors with large ownership stakes have strong incentives to maximize their firms’ value and are able to collect information and oversee managers, and so can help overcome one of the principal-agent problems in the modern corporation – that of conflicts of interest between shareholders and managers (Jensen & Meckling 1976). Large shareholders also have strong incentives to put pressure on managers or even to oust them through a proxy fight or a takeover. Shleifer & Vishny (1997) point out that “Large shareholders thus address the agency problem in that they have both a general interest in profit maximization, and enough control over the assets of the firm to have their interest respected.”

53. Other research (Holderness & Sheehan 1985; Barclay & Holderness 1991; Bethel et al. 1998) find that block purchases are followed by increases in share value and abnormally high rates of top management turnover. Consistent with the view that market for partial corporate control identifies and rectifies problems of poor corporate performance, Bethel et al. (1998) find that activist investors typically target poorly performing and diversified firms for block share purchases, and thereby assert disciplinary effect on target companies’ plans in mergers and acquisitions.

54. However, Shleifer & Vishny (1997) caution that “Large investors may represent their own interest, which need not coincide with the interest of other investors in the firms, or with the interests of employees and managers.” Woitke (2002) also cautions that not all institutional monitorings are positively related to firm value, as some institutional investors such as administrators of public pension funds (as opposed to private pension funds) may focus on political or social issues other than firm performance. Thus, not all shareholders may benefit from the managerial monitoring by institutional investors.

(2) *Market for corporate control: proxy contests, hostile takeovers and leveraged buyouts*

55. A great deal of theory and evidence supports the idea that the market for corporate control addresses governance problems (Manne 1965; Jensen 1988). Market for corporate control gives investors power and protection in corporate affairs if there is no workable control relationship between shareholders and managers, and ensures competitive efficiency among corporate managers. (Jensen 1986; Jensen 1988) argues that takeovers can solve the free cash flow problems, since they usually lead to distribution of the firm’s profits to investors over time.

56. While there is evidence that the hostile takeovers and leveraged buyouts of the 1980s in U.S. were typically followed by improved operating efficiency and shareholder value (Bhagat et al. 1990; Kaplan 1989), the effectiveness of takeovers and leveraged buyouts as a corporate governance mechanism remains questionable. First, takeovers and leveraged buyouts can be expensive. As Grossman & Hart (1980) point out, the bidder may have to pay the expected increase in profits under his management to target firm’s shareholders who otherwise may not give up the shares. Acquisitions may also increase agency costs when bidders overpay for acquisitions that bring them private benefits of control (Shleifer & Vishny 1993; Jensen 1993). Jensen (1993) shows that disciplinary hostile takeovers were only a small fraction of takeover activity in the 1980s in the U.S.

57. Dodd & Warner (1983) define proxy contests as “dissidents” attempt to obtain seats on a firm’s boards currently in the hands of “incumbents” or “management”. Minority shareholders with substantial holdings usually bring proxy fights. Manne (1965), and Alchian and Demsetz (1972) depict the proxy contests as an integral component of the control devices disciplining management.

58. Relating proxy contest to firm value, Dodd and Warner (1983) find share price performance around the time of the contests is positively associated with proxy contests whether or not “incumbents” are ousted. Mulherin & Poulsen (1998), in a study of shareholder wealth effects of proxy contests in U.S. between 1979 and 1994, find that proxy contests create value, that bulk of the shareholder wealth gains arise from firms that are acquired in the period surrounding the contest, and that for firms that are not acquired, the occurrence of management turnover has a significant, positive effect on

shareholder wealth because firms replacing management are more likely to restructure following the contests.

59. Claessens & Fan (2002a) find evidence that in Asian countries where investor protection and investor activism are weak, stock markets are increasing the cost of capital for firms and the controlling shareholders and managers ultimately bear some of the agency costs. Phan and Yoshikawa (2000) find support for the usefulness of agency theory to Japanese companies when they accessed global equity markets, in that the rules of capital market discipline do affect managerial strategic behavior.

(3) *Legal system and investor/creditor protection*

60. In different jurisdictions, rules protecting investors/creditors come from different sources, including company, security, bankruptcy, takeover, and competition laws, accounting standards, and also regulations and disclosure requirements from stock exchanges.

61. Recent research suggests that the extent of legal protection of investors in a country is an important determinant of the development of financial markets. For example, La Porta et al. (2000) explain that the protection of shareholders and creditors by the legal system is not only crucial to preventing expropriation by managers or controlling shareholders, it is also central to understanding the diversity in ownership structure, corporate governance, breadth and depth of capital markets, and the efficiency of investment allocation. La Porta et al. (2000) however admit that reforming or improving such legal protection is a difficult task as the legal structure of a country is deeply rooted and in view of the existing entrenched economic interests. Leuz et al. (2003) also find empirical evidence in a study of 31 countries that corporate earnings management (to mask firm performance) by insiders is negatively associated with the quality of minority shareholder rights and legal enforcement.

62. Relating legal protection to corporate valuation, La Porta et al. (2002) find evidence of higher valuation, measured by Tobin's q , of firms in 27 wealthy countries with better protection of minority shareholders. This evidence indirectly supports the negative effects of expropriation of minority shareholders by controlling shareholders in many countries, and for the role of the law in limiting such expropriation. In Asian context, Claessens & Fan (2002) confirm that the lack of protection of minority rights has been the major corporate governance issue and it is priced into the cost of capital to the firms. Similarly, Johnson et al. (2000) find evidence that the protection of minority shareholder rights matters a great deal for the extent of stock market decline during Asian financial crisis.

63. In a vivid comparison of firms from two investor protection environments but both listed on Stock Exchange of Hong Kong, Brockman & Chung (2003) contrast the Hong Kong blue chip stocks which operate in an investor protection environment comparable to that of Western Europe or North America and the China-based red chip

stocks and H-shares which are exposed to China's legal system, they find that Hong Kong-based equities enjoy higher firm liquidity, measured by trading spread and volume, than their China-based counterparts. Such liquidity cost is ultimately reflected in stock valuation.

64. Daines (2001) presents yet another interesting case study on how corporate law can benefit shareholders. He suggests that Delaware law, by which more than 50% of the public firms in U.S. are incorporated, facilitates the sale of public firms, thereby improving firm value. One contributing factor is the relatively clear and mild takeover law and expert courts in Delaware.

(4) *Leverage or debt*

65. Leverage increases are used, apart for other purposes, as part of the target companies' defensive strategies in hostile takeovers. Empirical evidence (Safieddine & Titman 1999) supports that higher leverage ratios deter takeovers because they are associated with performance improvements. In particular, Safieddine & Titman (1999) find that the operating performance of former targets following failed takeover attempts is positively related to the change in the target's leverage ratio. They also document that failed targets that increased leverage the most decrease investment, sell off assets, reduce employment, and increase the focus of their firms, which supports the views expressed by (Jensen 1986) on the positive role of debt in motivating organizational efficiency.

66. Jensen (1986), as a way to reduce agency cost relating to free cash flow, suggested "...debt creation enables managers effectively bond their promise to pay out future cash flows, ...to motivate cuts in expansion programs and the sale of those divisions that are more valuable outside the firms...and not to waste cash flows by investing them in uneconomic projects..." and this control hypothesis is more important in organizations that generate large cash flows but have low growth prospects.

67. The control function of debt was appropriately further explained and expanded by subsequent research. Using a case study on L.A. Gear in U.S., DeAngelo et al. (2002) illustrate that debt covenants and debt maturity can constrain managerial discretion more effectively than does the pressure to meet cash interest obligations emphasized by Jensen (1986). L.A. Gear's highly liquid asset structure enabled it to meet its debt obligations and keep operating for six years despite prolonged losses. DeAngelo et al. therefore conclude "...Excess liquid assets can be used to satisfy a firm's short to intermediate-term cash obligations and buy time without improving operations, whereas accounting-based debt covenants such as minimum earnings and net worth constraints require operating improvements..." In the same vein, debt contracts with shorter maturities give managers less scope to buy time by using liquid assets to meet interest payments and provide more frequent oversight by suppliers of debt capital. Smith (1993) also documents that the possibility of technical default due to breach of accounting-based debt covenants affects among others, the investment policies of the borrower in potentially important way.

2.5.3 Governance index and firm value

68. Instead of looking at individual components, there are some recent attempts to construct index encompassing several corporate governance components and measure corporate performance against the index. For example, in U.S., Gompers et al. (2001) construct a "Governance Index" consisting of provisions related to takeover defenses and shareholder rights, and find that the index is highly correlated with firm value, measured by Tobin's Q.

3. SUMMARY AND CONCLUSION

69. The literature on corporate governance examines the efficacy of alternative structures of ownership and the boards of directors and various other governance structures. While there is increasing evidence of the failure of certain governance structures to control and motivate managers to increase firm performance, the empirical evidence to date is mixed and gives little coherent evidence for the shape of an optimal governance structure. One explanation is that existing theories have not been sufficiently complete to include all major determinants of good corporate governance. Perhaps there will never be one optimal governance structure because no two firms, two markets, two legal regimes or two cultures are exactly the same, resulting in highly complex issue of corporate governance. Ultimately governance structure is determined by a combination of the above factors and their dynamics. A more likely and useful outcome of the on-going debate and research, perhaps, might be the increasing focus on shareholder interest and concerns, and identification of some widely accepted guiding principles, rather than trying to find some specific mechanisms which are universally applicable, for effective corporate governance.

4. SUGGESTIONS FOR FUTURE RESEARCH

70. In general, there is disproportionately large amount of research in U.S. and using U.S. data. Given corporate governance concerns human behaviors and business practices, and the different impact of different institutional environments and culture on corporate governance, there is an urgent need for workable corporate governance model for Asia.

71. In the context of Asia, some areas are worth being further researched into: -

- (a) How unique institutional environments in Asia whereby high blockholder and government ownership, weak legal investor protection and lack of active market for corporate control exist have affected corporate governance structure such as board characteristics; and explore

alternative model where the roles of foreign institutional investors, fund managers, firm reputation, proxy contest and other voluntary mechanisms may be emphasized.

- (b) There are successful family owned or controlled companies in Asia. More in-depth empirical study on the merits and demerits of family ownership structure and how has it impacted firm value. May be the resource dependency theory can better explain the success of these companies. If so, how corporate governance may evolve in these companies and what can be done to better align the interest of controlling family ownership and other shareholders?
- (c) Empirical multi-country study on the differences in legal environments, such as legal investor protection merits and takeover codes and how these differences affect firm liquidity and valuation.

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