CORPORATE GOVERNANCE, OWNERSHIP AND FIRM PERFORMANCE: A REVIEW OF IMPACT OF FINANCIAL GLOBALIZATION

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ABSTRACT

Corporate governance is a natural consequence of globalization, which has led to financial globalization and globalization of municipal laws. Major changes have taken place in codification of rules regarding composition of board of directors and their duties. Disclosure norms both in final account statements and shareholding pattern have now become far more stringent in last two decades Foreign investments gradually led to adoption of corporate governance norms across the world. Relationship of firm valuation with enhanced corporate governance norms & foreign investment has been established in various studies; however relationship between corporate governance and firm performance has not been confirmed.

Keywords: Corporate Governance, Ownership, Firm Performance

INTRODUCTION

Corporate governance has been the subject of research with emphasis on ownership pattern & structure and firm performance over the last two decades. Studies on ownership structure have focused more on board characteristics and independent directors' roles; whereas studies on ownership pattern have focused have focused on disclosures, market pricing and earnings payout. Academic work on developments in corporate governance closely mirrored financial globalization process.

This paper is a review of various studies done on corporate governance with specific reference to ownership structure & patterns and firm performance. In ownership structure, emphasis is on the role of foreign investors, especially institutional. It is assumed that readers are familiar with following words Foreign Direct Investment (FDI), Foreign Portfolio/Institutional Investment (FPI/FII) and Corporate Governance. The paper is divided in to three parts, wherein corporate governance and its relationship with foreign investments, corporate board structure, disclosure practices and firm value have been discussed. In the end, impact of corporate governance in emerging markets has been discussed. All discussions are based on reviews of literature and conclusions based thereon.

CORPORATE GOVERNANCE AND FOREIGN INVESTMENT

Firms observing good governance standards were found to exhibit lower information asymmetry (visa-vies minority shareholders) and ensured timely and correct financial disclosures. It was also observed that such firms ensured lower expropriation risk of capital (Shleifer and Vishny (1997), (OECD 2004), Licht 2003,(Doidge et al 2004). Initial studies focused on foreign listing or foreign portfolio investment in tackling the problem of information asymmetry. Brennan and Coa (1997) reasoned that US based portfolio investors suffer from an information handicap with regard to their investments in developed foreign capital markets and the only incentive for investment were higher returns. This can explain a part of the investment strategy of FPIs; which is corroborated within the study. Study done by Fama and Jensen (1983) shows that increased ownership concentration decreases financial performance because it raises cost of capital of firm which leads to decreased market liquidity and other decreased diversification opportunities

Shleifer and Vishny (1997) in a survey of corporate governance observed that organizations with dispersed ownership, dependency on non-equity financing, lower information asymmetry and transparent disclosure policies reduce lower expropriation risk. It also ensures that problems persisting after implementation of agency model. The literature surveyed in this paper concentrated more on corporate governance from the individual nation perspective rather than foreign investment. Globalization of this particular aspect among business law(s) had not taken place at that time to present levels. (Doidge et al 2004) observed that cross listing on US exchanges led to transparent disclosure, lowering of information asymmetry between domestic shareholders, minority shareholders & foreign shareholders, lowering of the capital cost and reduction of expropriation risk by managers/dominant shareholders. Research on FPIs by Choe et al (2005) and Nieuwerburgh & Veldkamp (2009) of Korean and Indonesian holdings confirmed existence of information asymmetry and higher acquisition information cost. In case of Korean system, it was observed that, FDI from good governance countries had a comparative advantage visa-vis FPI as they become “owners”. Study period 1998-2004, was post East Asian currency crises and presented a study in contrast, with changing ownership structures happening at that time in South Korean corporate sector.

Ahearne et al (2004), Covrig et al (2006) and Ferreria & Matos (2008) observed that foreign investors showed preference for large firms which are cross listed on US stock exchanges and/or firms with low insider/dominant ownership (promoter shareholding high)or had higher holdings by FPIs. Also, lowered cost of raising future capital was observed to be one of the secondary reasons for cross listing in US stock exchanges. Even in the case of an advanced economy like Sweden, Dahlquist et al (2003) observed that it was the free float available to global investors (mainly US investors), which was ranked higher than market capitalization.

Stulz (1999) observed that foreign investors play an important role in corporate monitoring in the presence of dominant shareholders (mostly promoters) as they influence management to acquire special benefits in their favor. As “non promoters,” foreign investors are able to perform arm’s-length monitoring, act as proxy for minority shareholders and increase firm value.

Leuz et al (2009) were of the opinion, that investment decision of a foreign investor gets adversely affected by information asymmetry. For Foreign Investors, difficulty in determining the true value and risk of investment in firms due to information asymmetry leads to investment in firms with lower information acquisition cost. In companies with information asymmetry, foreign investors face problems in monitoring costs and therefore prefer to invest in firms with high governance standards to avoid information acquisition & monitoring costs. This study was conducted on the aggregate foreign holding of US investors in firms across 29 countries and it was observed that US investors avoid firms with high insider ownership(promoter) on account of likely governance problem. In this study insider ownership (promoter holding) was taken as proxy for corporate governance. An important observation was that, US institutional investors were demand led rather than supply led in these matters; emphasizing the fact that demand for quality scrip’s was always there.

Bushee et al (2014) also studied US institutional investor preferences w.r.t. specific ownership structure forms for corporate governance mechanisms. They considered board characteristics and shareholder rights as attributes of corporate governance and obtained results similar to that of Leuz et al (2009). For this study a corporate governance index was constructed based on five attributes related to board size & its independence and also used the index parameters created by Gompers et al (2003) for studying shareholder rights. An important conclusion drawn by Bushee et al (2014) is pertinent because it deduced a relationship between sensitivity of large institutional investors' preference for growth stocks of firms with high level of corporate governance. Other conclusions regarding quantum of portfolio investment and governance were in line with that of Leuz et al (2009) and Gompers et al (2003). Indices used in these studies do not represent major corporate governance mechanism in a firm and also insider/dominant ownership pattern may not be comparable among countries as it is not uniform across the countries selected in these studies.

Carrying on the work carried out by earlier authors, Das (2014) studied investment decisions made by foreign investors by taking data of foreign equity holding of mutual funds from 37 countries. Foreign investors display preferences for those aspects of governance that reduce informational disadvantages. Study showed that fund managers give more portfolio weight to better governed firms. Investments were directed in firms having strong independent board characteristics & auditors; both these characteristics affect the decision of investment while particulars of shareholder rights were observed to play smaller role in investment decisions. Mutual funds were found to prefer better governed firms so as to save cost of monitoring. The study also provided evidence that firm level governance and country level governance are complementary to each other. However Leuz et al (2009) were of the opinion that country level and firm level governance attributes are substitutes of each other. Differences in results of two studies may due to the fact that data sources used by both studies were different.
Aggrawal et al (2011) studied impact of institutional investors on corporate governance in companies from 23 countries for the period 2003– 2008 and found firm-level governance to be positively associated with FPIs. Any change in institutional ownership over time was found to affect changes in firm-level governance positively but only unidirectional. FPIs from countries with strong shareholder protection were observed to play significant role in improving governance practices of firms located outside U.S. Firms which had a high institutional ownership penalize non performing management. FPIs not only prefer better governed firms, but also improve governance practices of firms and undertake shareholder activism which is not possible for individual investors. Finally, it was observed that monitoring and activism by institutions transcended country borders. *Caveat*- countries studied were developed countries.
With regard to FDI, Globerman & Shapiro (2002) observed that good governance had a positive effect on both inflows and outflows; although the latter was observed to be significant only for developed and large economies.

Admati & Pfleiderer (2000) argued that a firm can have the benefit of overseas listing and "voluntarily" adopting foreign standards of reporting standards and regulations, as FDI inflows provide benefits to the host country. Positive relationship between FDI inward performance and corporate governance or transparency level of host countries was observed in this research.

Kim (2011) studied relationship between FDI and corporate governance (transparency) of 28 countries for the time period 1990-2002 by delving in to FDI performance and corporate governance variables. It was observed that countries having strong rules for board directors' showed higher FDIs. Another finding was that corporate governance (transparency levels) had positive effects on FDI inflows. Farooque et al (2009) in their study of 173 countries came up with an observation that adoption of IFRS had significant positive influence on governance and thereby having an indirect effect on FDI through its impact on governance. Alsubaie (2012) found the impact of FDI to be more pervasive than previously studied. It was observed that not only do FDI increases firm specific corporate governance practices but also it had a spillover effect on firms competing for FDI inflow and suppliers to firms having FDI ownership.

Brown and Caylor (2006) in their work (restricted to US markets), expanded corporate governance measure (CG-Index) created initially by Gompers et al (2003). The study expanded the CG-Index from 24 attributes to 51 attributes, taking in to account attributes related to stock option expenses and audit mechanisms for the years 2001 and 2003 (preceding onset of Sarbanes–Oxley Act 2002). Among other variables taken in the study, it was observed that the newly created CG index and Tobin's Q were associated to a reasonable extent.

Removal of information gaps between promoter/dominant shareholder and others including FIs; risk of assets (equity) seizure by host were the initial driving force for corporate governance, which along with desire for reduction in capital costs by corporates resulted in listing or cross listing on American stock exchanges. FPIs had displayed penchant for stocks of companies with dispersed holdings and companies giving importance to higher number independent directors on board. In fact bi-directional causality has been observed between ex-US FPI and corporate governance in invested companies. Also FDI was observed to enhance corporate governance. Influence of FDI was found to be more pervasive than FPI even in matters related to corporate governance.

BOARD STRUCTURE AND CORPORATE GOVERNANCE

Board structure and its impact on corporate governance has been the subject of intense scrutiny both from academics and from regulators. Hence it is worthwhile to review some of the literature.

Presence of outside director is considered to be one of the most important mechanisms of corporate governance both in developed as well as in emerging economies. Kumar & Singh (2012) made an attempt to understand the impact of outside director(s) on firm value. The study included board structure of 157 non-financial Indian companies for the year 2008. Aim of research was to know whether monitoring by grey directors i.e. non-executive non-independent and independent director has any effect on firm performance. The findings of study were that grey directors on board had marginally deteriorating effect and independent directors had insignificant positive effect on firm value. It was also proved that firms which had a certain minimum number of independent directors had relatively higher market valuation.

Rashid et al (2010) studied effect of corporate board composition in the form of representation of independent directors on firms' economic performance in Bangladesh with a sample comprising of 274 firms. Findings of study were that presence of independent directors did not have any impact on firm valuation. The paper surmised that the basic idea of having independent directors on board is to have transparency but the absence of necessary institutional and cultural differences in an underdeveloped economy such as Bangladesh may not produce the desired impact.

In studies done for advanced economies, Agrawal & Knoeber (1996) and Bhagat & Black (2002), observed negative relationship between outside directors and firm performance.

Therefore role of outside directors as governance mechanism is questionable or not clear in the developed countries due to presence of several other external governance mechanisms like mergers & acquisition, market for corporate control etc.

Dahya et al. (2007) in their analysis of 799 firms across 22 countries found significant positive relationship between proportion of independent directors and firm performance with specific reference to presence of dominant shareholders in countries with weak protection of shareholder rights. The study also found negative relationship between higher proportion of independent directors on board and related party transactions. Most likely, presence of independent directors to some extent retains the separate identity of a company

Saravanan (2012) studied impact of corporate governance firm valuation of manufacturing firms in India. The study had a sample size of 1723 listed firm on Bombay Stock Exchange (excluding banking, insurance and financial firms) for the period 2001 to 2010. Significant correlation between firm value and corporate governance variables (board size, board composition etc) was observed.

Ghosh (2006) studied the association between firm performance and board composition of non-financial firms of 127 listed manufacturing firms for the year 2003. It was observed that larger board size had a negative impact on firm's performance, while positive association exists between number of non-Executive Directors and firm's performance. The study also found that CEO remuneration has positive influence on corporate performance. Regarding CEO compensation, the title of CEO is recent in nature in India and is used for non-promoter professional appointees.

Lei and Song (2012) examined the effect of board structure and other internal corporate governance mechanism on the firm valuation using data of Hong Kong firm for the time period 2001 to 2009. Board index was constructed with attributes related to board independence, power and conflict of interest and some Corporate Governance attributes. Results of study indicated that independent board resulted in higher firm value. It also confirmed that among all attributes of corporate governance, the attributes of board plays most important role among internal Corporate Governance mechanisms in determining firm valuation.

Erickson et al. (2005) in Canadian firms observed a negative causation between proportion of outside directors and firm value. Quite likely poor performance results in increase on board dependence.

Presence and number of independent directors on board, has been found to be positively correlated with firm valuation. In case of developed economies, this claim is not solely justified since there are other causal reasons for firm valuation. In emerging economies, role of independent directors, mandated and protected by regulations has played significant role in corporate governance.

DISCLOSURE PRACTICE, OTHER CORPORATE GOVERNANCE PRACTICES & FIRM VALUE

Lefort and Walker (2005) looked in to the aspect of how corporate governance practices at firm level within a country affect its market valuation (as a measure of firm performance) and payout policy on corporate governance indicators at the firm level. They found that firms having higher regression coefficient between cash and control rights were consistently more valued by the markets.

Motwani & Pandya (2013) studied corporate governance practices of Indian firm in leading sectors for the period 2008 to 2012. The study showed that there was an increase in corporate governance practices & disclosures during the period of five years, and companies were making constant efforts to improve corporate governance practices and disclosures. Companies belonging to the automobile, power and IT sectors excelled in corporate governance & disclosure practices.

Gherghina et al (2014) examined relationship between ratings corporate governance and firm performance, including both as a global measure of corporate governance and four sub-indices corresponding Audit, Board Structure, Shareholder Rights and Compensation. Their research presented a negative relationship between corporate governance global rating and firm performance. The sample consisted of 83 companies (non-financial) of the S&P 100 for the year 2013. Also, negative relationship between corporate governance sub-indices and firm performance, with some exceptions was observed. The paper suggested that investors should take the ratings from third party sources with due precaution

Studies related to Indian corporate sector have been conflicting in this regard. Samontaray (2010) and Mohanty (2003) had reported positive association and causation between corporate governance and firm financial performance parameters. However, a study purporting to the early years of corporate governance (between 2007-08 to 2010-11) by Pandya (2013) showed no impact of observance of corporate governance on either Return on Capital Employed or firm value (as measured by Tobin's Q) on a sample of twenty five companies belonging to five sectors. A possible reason is the difference in constitution of sample. Another plausible reason could be the changed economic environment in India post 2010 (Khan 2014).

Disclosure practice as a part of corporate governance has been a recent phenomenon in developing countries. Its causation with firm performance and valuation has not yet been firmly established. A possible reason could be economic downturn since 2007-08.

EMERGING MARKETS SCENARIO

Cyril (2001) studied impact of corporate governance in China by studying the effect of investments and problems associated with corporatization of industrial sector during 1980s and 1990s. At that time in China, state ownership and control were found to be the main cause of lack of transparency. This in spite of the fact that by 1997, foreign ownership was quite widespread but was as FDI. Schipani and Liu (2002) argued that in order to attract foreign investors in capital markets in China, focus should be made to eliminate excessive control of government on Chinese corporate sector. Li et al (2009) studied 643 non-financial companies listed on the Chinese stock exchanges and found strong & significant negative relation between government shareholding and corporate performance among the more profitable firms. This indicates perhaps a deliberate oversight on the part of major (government) shareholder.

Cheung et al. (2008) found that for the year 2004, Chinese companies listed on various foreign stock exchanges stressed more on the role of stakeholders, disclosure and transparency as compared to Chinese companies listed solely on Chinese exchanges. Most likely at that time emphasis was more on FDI rather than FPI. Wei (2007) studied relation between state-owned shareholding and corporate performance a sample of 276 China-listed companies from the period 1999 to 2002. It was observed that if the proportion of state-owned share was relatively small, there was no negative correlation, but if the proportion exceeded 50 per cent, it produced negative impact on company's performance. It was also found that if non-state-owned shareholdings are relatively small, they have a significantly positive effect on company performance. Other findings of study showed that major corporate governance measures, such as the proportion of independent directors & independent supervisory directors, size of board, managers' incentives and audit committee, had insignificant effect on a firm's performance.

Mishra & Ratti (2011) looked in to corporate governance through the prism of comparison between foreign equity vs. domestic shareholdings in Chinese companies and studied the role of large domestic holdings, foreign cross company holdings and FPIs in Chinese companies. It was observed that corporate governance and ownership pattern had great impact on foreign investments. It was found that foreign ownership relative to free float is negatively impacted by dominant holdings (domestic cross company holdings) and positively related to large FPI holdings. The latter provide a monitoring function which reduces agency problems. Large domestic holdings not only make reduce availability of shares for foreign investors, but discourage further foreign investments. For that particular period, foreign investors prefer not investing in domestic Chinese firms; rather with Chinese firms listed abroad with *large book to market values* (showing strong preference for prospective value buying).

Dwivedi & Jain (2005) studied relationship between corporate governance and ownership structure & firm value of 340 listed Indian firms for the years 1997-2001 across 24 industry groups. Major governance attributes included in the study were board size, directors' shareholding, institutional & foreign shareholding. It was observed that higher proportion of foreign shareholding is associated with increase in market value, while domestic institutional shareholders association was statistically insignificant. Weak but positive correlation was found to exist between board size and firm value. While directors' shareholding has nonlinear negative relationship with firm value; public shareholding has linear negative association. This indicates a robust link between foreign investors' presence and market performance and also indicates indifference of domestic investors. Sarkar and Sarkar (2000) in their study done observed that Development Financial Investment (DFI's) play passive role in corporate governance system of companies when their holding is less than 25% but when debt holding of DFI's are high they play active role in monitoring performance of board and company. Most likely reason during the period considered for study was that regularity of interest payment to them was under strict observation of government bodies.

Increasing institutional investors in general and foreign in particular have been observed to increase strengthen corporate governance even in developed economies e.g., France. In case of India, most of the rules & guidelines for corporate governance were in place between 1995 and 2003 (Mizuno 2014).

Any improvement in governance must have a positive effect on firm valuation, otherwise adoption of governance norms disincentives its adherence, especially in countries with long history of stock exchanges. Causal relationship from corporate governance to market valuation with particular regard to emerging markets like India, Russia and Korea have been reported in numerous studies in the last few years. Balasubramaniam et al (2010) observed a significant correlation between firm value (normalized Tobin's Q) and a specifically constructed corporate governance index. Dharmapala & Khanna (2013) studied immediate impact of introduction of changes in Listing Agreement Rules of Market Regulator on firm value (Tobin's Q) and observed significant correlation between the two. With particular reference to FPIs, weak but significant cause and effect relationship was observed. Limitation of this study was that it was confided to the period immediately after implementation of the new rule (in 2003). The results of this study complemented an earlier work by one of the authors Black and Khanna (2007). Taking normalized/moderated market valuation of 30 top stocks of 1999, Black (2001) observed a strong relationship (correlation & regression) between market valuation and corporate governance. In continuation of this study, Black et al (2006) expanded the scope of research by undertaking time series study of corporate governance score and firm value (Tobin's Q) for the period 1999 and 2005. A strong relationship was observed between the above two. In their two studies on Korean stock market Black et al (2006a and 2006b). It was observed that corporate governance score and market/firm value are strongly correlated. It was also found that larger firms (asset size) and firms requiring capital at lower cost adopt enhanced corporate governance norms voluntarily.

Perhaps on account of financial globalization, China, which had a much larger inward foreign investment, followed the trajectory of other economies regarding firm performance & valuation and its relationship with corporate governance. FPI has been directed towards firms, which had lower promoter holdings (here state). Also more FPI was directed towards Chinese firms listed outside China. In case of countries like India, South Korea and Russia, it was observed that large corporates adopted corporate governance norms quite rapidly. This had a positive impact on market valuation and reduction in cost of capital.

Dispersed and foreign ownership of firms led to adoption of corporate governance practices prevalent in advanced economies. Foreign ownership also increased market valuation and firm performance. Emerging Markets to attract capital at lower cost had to incorporate corporate governance norms in line with US & UK.

CONCLUSION & SUGGESTION

Corporate governance and its impact on corporates have seen a trajectory defined by needs of investors and corporates. Initial impetus for corporates to adhere to US origin governance norms was to reduce cost of capital by cross listing on US stock exchanges. From the investors' end, desire was for a system with adequate asset protection and reduction in information asymmetry. With passage of time, issues like presence & role of independent directors, director's remuneration and disclosures by management started becoming important parts of governance system. Their relationship with firm valuation is not yet firmly established at global level, perhaps on account of fact that they are *necessary but not sufficient cause*, for firm valuation. In emerging markets, the path traversed between corporate governance, its acceptance and impact on firm valuation & performance has been rapid. Most likely cause was the drive for globalization and the concomitant benefits associated with it.

Typical institutional investor had insisted on disclosure and information symmetry. Desire for reduction in cost of capital led to listing /cross listing in US exchanges which necessitated adoption of corporate governance norms. Over a period of time FPIs/FDIs led to best practices in corporate governance across listed firms in many countries. An important development in recent years has been the change in configuration of board. Presence of independence directors raised firm valuation, better managed companies & corporate governance.

Corporate governance has three basic advantages – establishing separate identity between promoters and company, lowering of cost of capital and increasing disclosure by corporates. Linking of corporate governance with corporate social responsibility could be a future course of action. Corporates can insist on adherence to governance with associated stakeholders like financial institutions, suppliers and even industrial buyers.

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