

## CORPORATE GOVERNANCE AND CAPITAL MARKETS: A CONCEPTUAL FRAMEWORK

Faizul Haque\*, Thankom Arun\*, Colin Kirkpatrick\*

### Abstract

This paper outlines a conceptual framework of the relationship between corporate governance and two important determinants of capital market development namely, a firm's access to finance, and its financial performance. The framework assumes that a firm's corporate governance is simultaneously determined by a group of related governance components and other firm characteristics. Whilst the capital markets play a crucial role in enhancing corporate governance standards, the effectiveness and credibility of such effort might be constrained by poor firm-level corporate governance. Moreover, the cause and effect relationship can work in the opposite direction e.g. firm-level corporate governance quality can enhance both the firm's ability to gain access to finance and its financial performance, which eventually lead to capital market development. The framework is primarily based on the economic approaches to corporate governance, although it recognises part of the assumptions of the stakeholder theory and the political economy aspects of corporate governance.

**Keywords:** Corporate Governance, Capital Markets, Conceptual Framework

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\* Faizul Haque is a Lecturer in Finance at the Heriot-Watt University, UK, Thankom Arun is a Reader in International Finance at the Lancashire Business School, UK and Colin Kirkpatrick is a Professor at the University of Manchester, UK. Address for Correspondence: Dr. Faizul Haque, Heriot-Watt University Dubai Campus, Dubai Academic City, P.O. Box: 294345, Dubai, UAE. E-mail: F.Haque@hw.ac.uk

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### 1. Introduction

The capital market<sup>9</sup> of a country can exert considerable influence on the firm by imposing certain rules and regulations relating to the firm's governance practices. Whilst the legal and regulatory structures are essential, the capital market, with adequate transparency and accountability in place, can ultimately reward or punish firms for their governance practices<sup>10</sup> (Drobetz *et al.* 2004). The capital market can wield its governance role in mitigating the agency problems through disciplining the management and improving the firm's overall governance. Gugler *et al.* (2003) argue that the strength of a country's external capital market determines the degree of a firm's investment performance regardless of how closely managers' and owners' interests match<sup>11</sup>.

However, the corporate governance role of the capital is less likely to be effective in a developing economy. As Iskander and Chamlou (2000) observe, the capital markets in developing countries provide little incentive for better corporate governance (either in the real sector or in the financial sector), primarily because of the dominance of a few large firms, low trading volumes and liquidity, absence of long-term debt instruments and inactivity of institutional

shareholders. Moreover, the cause and effect relationship can work in the opposite direction e.g. the state of country as well as firm level corporate governance might have a significant influence on the development of the capital market. Shleifer and Vishny (1997) argue that a firm is likely to get external finance not only because of the reputation of the capital market and excessive investor optimism, but also due to assurances provided by the corporate governance system.

This paper presents a conceptual framework of the linkage between corporate governance and capital markets. It is based on a review of the theoretical and empirical literature on the influence of corporate governance on two important issues of capital market development: a firm's access to finance and financial performance. The paper is structured as follows: section 2 provides a conceptual framework of the theoretical linkage between corporate governance and capital markets. Section 3 reviews the institutional and firm-level corporate governance issues. Section 4 explains the relationship between corporate governance and the firm's access to finance. Section 5 reviews the literature on corporate governance and financial performance. Finally, section 6 concludes the paper.

### 2. A Conceptual Framework

This section develops a conceptual framework in relation to the influence of corporate governance on a firm's access to finance and financial performance,

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<sup>9</sup> The terms capital market, equity market or stock market are used interchangeably in this paper.

<sup>10</sup> Gompers *et al.* (2003) also make a similar observation.

<sup>11</sup> It is, however, mentioned that the investment performance is likely to be constrained by the critical issues of transparency and disclosures.

and thus on capital market development. Figure 1 shows that a firm's corporate governance quality is largely dependent on the institutional mechanisms of a country including the political economy factors, the legal and regulatory standards and the markets. The framework however, recognises that the firm's legal compliance as well as voluntary activism in corporate governance matters, can reduce the expropriation costs in the governance process and partly compensate for the inefficiency in the institutional arrangements in a developing economy<sup>12</sup>.

According to the economic approaches to corporate governance<sup>13</sup>, better firm-level corporate governance not only reduces the agency costs<sup>14</sup>, but also enhances the investors' optimism in the firm's future cash-flow and growth prospects<sup>15</sup>. This in turn, reduces the rate of return expected by the investors, leading to low cost of equity capital to the firm. Likewise, a reduction in the agency costs is likely to cause improved operating and investment performance of the better governed firms. The reduced cost of equity and the improved operating performance eventually enhance both the firm's ability to access equity finance, and the firm value. This eventually enhances the process of capital market development<sup>16</sup>.

### 3. Institutional and Firm-Level Issues of Corporate Governance

This section discusses the relevance of the legal, regulatory and other institutions to the development of a corporate governance system. It also explains the firm-specific issues of corporate governance.

#### 3.1. Institutional Issues of Corporate Governance

##### The Legal System

Whilst firms rely on external finance (e.g. equity or debt) in meeting their investment needs, the pattern of

relationship between the firm as a distinct legal entity and the shareholders or creditors, tends to be determined by a complex contractual arrangement, which in turn is influenced by the legal system within which the firm operates. The legal system of a country determines the corporate governance structure in relation to the rules regarding the ownership and board structures, mergers and liquidations and shareholders' rights (Gugler *et al.* 2003; Shleifer and Vishny 1997). Similarly, debt contracts help creditors to protect and exercise their rights through liquidation or bankruptcy process (Shleifer and Vishny 1997).

Nevertheless, unlike developed economies, the legal protection of the firm's external financiers (shareholders or creditors) in many developing economies tends to be very low because of the differences in interpretation in the legal systems and poor legal enforcement (Shleifer and Vishny 1997).

##### The Political Economy Issues

In response to the economic interests of the different stakeholders of a society, the political process creates or changes laws, and thus acts as a link between legal rules and economic outcomes (Pagano and Volpin 2005; Bebchuk and Neeman 2005). Pagano and Volpin (2005) put forward a political economy model of corporate governance based on cross-country data on political determinants of investor and employment protection. The model assumes that the political process determines the motives as well as the timing of changes in corporate laws by formalising the behaviour of voters. Bebchuk and Neeman (2005) propose a similar model to analyse how political interplay of the three different interest groups (e.g. corporate insiders, institutional shareholders and entrepreneurs) affects the level of investor protection or private benefits of control. Turnbull (1997) regards the political model as a macro framework of political, legal or regulatory systems, within which an allocation of corporate power, privileges and profits (among owners, managers and other stakeholders) takes place at a micro level.

##### Markets and Competition

Aside from working as a source of financing investment (Samuel 1996), a capital market tends to have both direct and indirect influence on the governance practices of the listed firms (Singh 2003). The direct governance measures include: tightening listing requirements, controlling insider dealing arrangements, imposing disclosure and accounting rules, ensuring protection of minority shareholders and attracting reputational agents (Claessens 2003; Singh *et al.* 2002). Conversely, a capital market can exert indirect influence through pricing mechanisms, which include both allocative and disciplinary measures and the takeover mechanisms (Singh 2003; Samuel 1996).

<sup>12</sup> Klapper and Love (2004), however, argue that better firm level governance mechanisms can improve the investors' protection to a certain degree, but firms alone cannot fully compensate for the absence of a strong legal system.

<sup>13</sup> See also, Drobetz *et al.* (2004); LLSV (2002); Gompers *et al.* (2003); Claessens (2003)

<sup>14</sup> Better governance quality reduces the agency costs to the external providers of funds in relation to their monitoring and auditing costs, and other forms of controlling shareholders' and insiders' expropriations.

<sup>15</sup> With better investor protection and lower expropriation by controlling shareholders, outsider investors intend to invest more or pay higher share prices in the hope that more of the firm's profits would come back to them as interest or dividends (LLSV 2002).

<sup>16</sup> Claessens (2003) identifies several channels, through which corporate governance frameworks affect the growth and development of economies, financial markets and firms. These include, greater access to financing, lower cost of capital, better firm performance, reducing risks of financial distress and financial crisis, and more favourable treatment of all stakeholders.

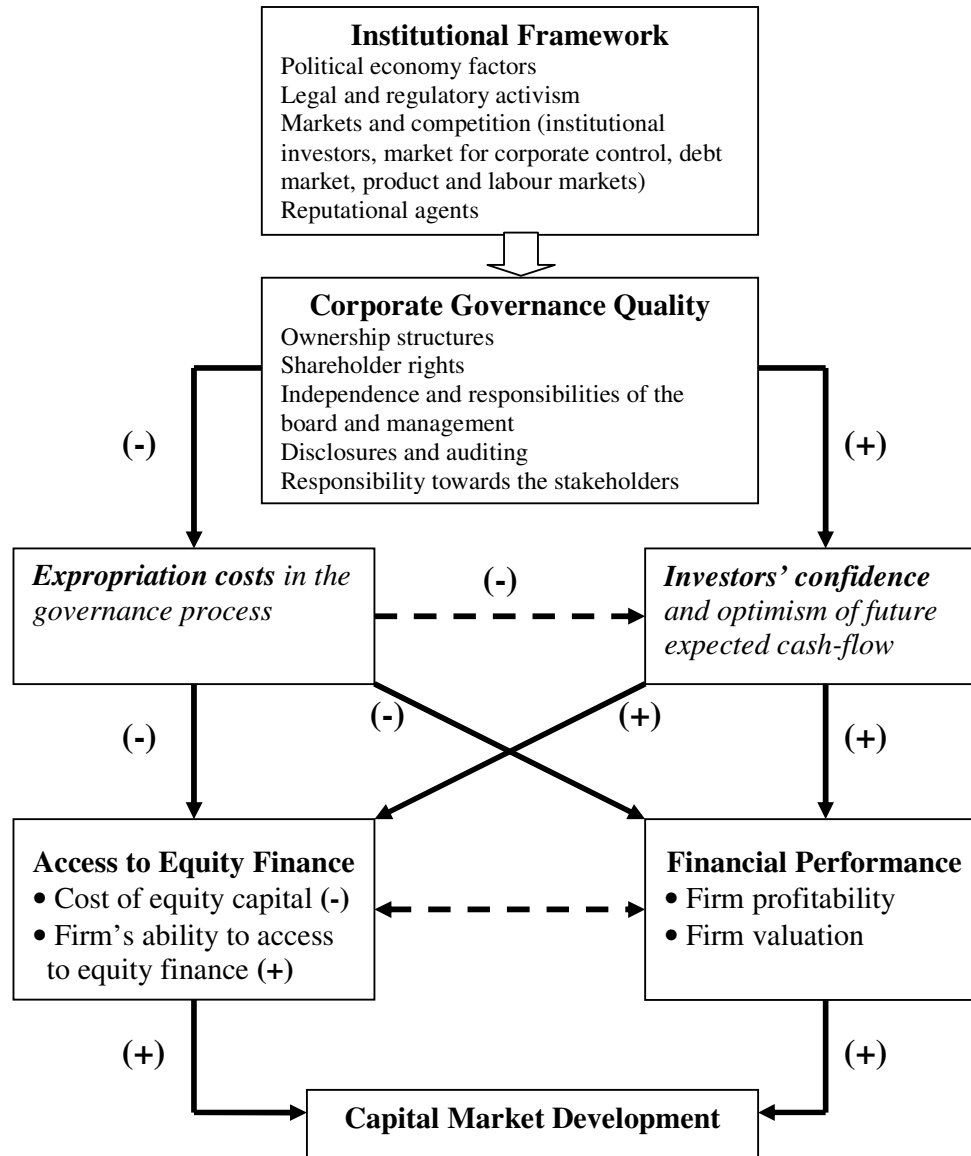


Figure 1. Corporate Governance, Access to Finance and Financial Performance: A Conceptual Framework

Tobin (1984), cited in Singh (2003), distinguishes between the two concepts of share price efficiency of the stock market namely, information arbitrage efficiency through which all currently available market information is incorporated into the share price, and fundamental valuation efficiency, where share prices accurately reflect the future discounted earnings of the firm. Singh (2003) also mentions that the stock market, with the help of the market for corporate control<sup>17</sup>, can improve the efficiency and performance of a firm by replacing inefficient managers and transferring the firm assets to those who can manage it more efficiently.

However, several studies<sup>18</sup> observe that the effectiveness of the pricing (e.g. both allocative and takeover) mechanisms in a developing economy tends to remain rudimentary because of poor corporate governance associated with transparency and disclosures<sup>19</sup>. Alba *et al.* (1998) argue that the

<sup>17</sup> The market for corporate control includes hostile takeovers, management buy-outs, and leveraged buy-outs (Prowse 1994).

<sup>18</sup> For example, Claessens (2003); Morck *et al.* (2000); Singh (2003); Demirag and Serter (2003)

<sup>19</sup> Singh (2003) and Prowse (1994) criticise the takeovers mechanism as being an inherently flawed and expensive method of solving corporate governance problems. Claessens (2003) states that, in a capital market with a weak property rights environment, insider investors including the analysts, might be involved in the trading of private information available to them before it is disclosed to the public. Iskander and Chamlou (2000) also state that the signalling measure is likely to be diluted if the capital market is not transparent, investments are costly to exit and

governance role of a developing economy capital market is being constrained by an absolute family dominance, weak incentives to improve disclosure and governance, poor protection of minority shareholders, and weak accounting standards and practices. Demirag and Serter (2003) also mention that the majority of family-based business groups in developing countries appear to own and control banks (through pyramidal or complex shareholding) that act as a substitute for external capital market. Likewise, Prowse (1994) argues that the managers of firms with less reliance on external finance are unlikely to be disciplined by the capital market.

The institutional investors<sup>20</sup>, being an important part of the capital market, tend to influence the process of corporate governance. For example, Samuel (1996) argues that institutional investors tend to be more efficient than individual investors in collecting, analysing and acting on objective, firm-specific fundamental information, and thus influence a firm's investment and other financial decisions. The Institutional Shareholders' Committee (ISC), the FRC (2003) and Mallin (2004), outline several governance roles of the institutional investors in solving the agency problems, which include (Mallin 2004): (i) engaging in dialogue with the firm based on mutual understanding of objectives, (ii) evaluating overall governance disclosures with particular emphasis on board structure and composition, (iii) evaluating and monitoring the performance relating to shareholder value and shareholder activism, (iv) exercising voting power (either direct or proxy voting) on all major corporate decisions, and (v) intervening whenever necessary, particularly in the issues like corporate and operational strategies, investment decisions, acquisition or disposal strategy, internal control mechanism, and board and management contracts.

Increased institutionalisation seems to improve the efficiency of the governance role of the capital market with which the firms are valued and governed. Samuel (1996) argues that the monitoring and disciplinary activities of institutional investors may act as a viable alternative to debt finance as well as the market for corporate control<sup>21</sup>. This is particularly

important for developing country firms, because they appear to rely more on debt than equity. However, as Iskander and Chamlou (2000) and Samuel (1996) argue, institutional investors in developing economies generally represent only a small part of a diversified portfolio and also may not be strong enough to impose fairness, efficiency, and transparency. Therefore, the institutional investors are less likely to play a strong governance role in a developing economy.

Stiglitz (1985, cited in Prowse 1994) and Gul and Tsui (1998), argue that the debt market can mitigate the agency problem by providing the debt holders with the incentives and power to monitor and control insiders' expropriation. Shleifer and Vishny (1997) also state that the concentration of debt in the hands of few creditors tends to help the latter exercise significant cash flow as well as control rights<sup>22</sup>, and thus reduce the firm's agency costs (by preventing the managers from investing in unworthy investment projects or extracting private benefits). It is further commented that creditors can liquidate a firm (if it is unable to run efficiently or pay its debts), acquire the assets used as collateral, and participate in the voting process on major corporate decisions<sup>23</sup> (e.g. reorganisation of the firm or removal of the managers). Nonetheless, irrespective of the nature of creditor rights, the effectiveness of the country's legal system seems to remain crucial.

Friedman (1953, cited in Singh *et al.*, 2002) says that perfect competition in product markets solves the associated problems of corporate governance in modern corporations including the problems of separation of ownership and control. Because competitive market would ensure natural selection through which profit maximising firms with optimal ownership patterns and corporate governance structures would survive. Gillan (2006) refers to the theoretical perspectives on the link between product market competition and different aspects of corporate governance, including compensation structure and CEO turnover. However, different researchers suggest that competition alone can not eliminate the above mentioned problems. In the real world both capital and product markets suffer from fundamental market imperfections and therefore it is easier for larger profitable firm to take over a small profitable firm than the other way around (Singh *et al.*, 2002). It is also mentioned that the probability of survival for a large unprofitable firms are relatively higher than

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institutional investors are poorly governed. Others (e.g. Keynes 1936; Singh 2003) also suggest that the pricing mechanism is often dominated by speculation, herding, myopia and fad, that all weaken the capacity of the stock market to ensure the allocation of resources in a more efficient way. The real world stock prices tend to be simulated by the information arbitrage efficiency, as Keynes (1936, cited in Singh 2003) argues that successful investors anticipate the likely movements of other stock market participants rather than appreciating the fundamental values of the firm.

<sup>20</sup> Such as, insurance companies, pension funds, non-pension bank trusts and mutual funds

<sup>21</sup> However, Samuel (1996) does not find any evidence of the impact of institutional ownership on investment performance. Sarker and Sarker (2000), cited in Claessens and Fan (2002), also find no evidence that institutional

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investors are active in corporate governance.

<sup>22</sup> The relative power and domination of creditors are much higher for multiple creditors, because each of the individual creditors can take legal action against the firm, and it is reasonably difficult for the firm to renegotiate with several creditors rather than a single one (Shleifer and Vishny 1997).

<sup>23</sup> Creditors can use short term lending and take the equity ownership of the firm in order to be involved in the investment and other corporate decisions (Shleifer and Vishny 1997).

those for a smaller, relatively profitable firm. Likewise, Shleifer and Vishny (1997) and Kar (2000) argue that product market competition is probably the most powerful force towards economic efficiency in the world but this doesn't deny the place for the mechanisms for corporate governance.

Available literature also refers to the influence of the labour markets (for the board members, CEOs and others executives) on the firm's corporate governance. Jensen and Meckling (1976) argue that labour market forces and reputation concerns have a disciplining effect on both managers and board members. Gillan (2006) also mentions that the governance and organisational structure are associated with the employment relationship and the labor market for executives.

The reputational agents<sup>24</sup> can play important roles in enhancing better corporate governance. Iskander and Chamlou (2000) mention that the reputational agents can exert pressure on companies as well as government to disclose relevant information, improve human capital, recognise the interests of the outsiders, and otherwise behave as good corporate citizens.

### 3.2. Firm-level Corporate Governance Issues

This sub-section explains the components of firm level corporate governance, which include structure of ownership and control, shareholder rights, board and management diversity, disclosures and auditing, and responsibility towards the stakeholders.

#### Structure of Ownership and Control

The structure of ownership defines the nature of the principal-agent problems, e.g. the extent to which a manager's goals are closely aligned with those of the owners of a firm (Gugler *et al.* 2001; Claessens 2003). The agency problems can be mitigated through large or concentrated shareholding, because this gives investors the incentives and abilities to acquire information on the firm's operations and to monitor and control opportunistic behaviour of the manager at the expense of the firm's long term value creation activities (Shleifer and Vishny 1997; Claessens 2003). The ownership of a firm can be concentrated in the hands of different shareholders such as, family, individual or a group of individuals, foreign investors or institutions like banks, non-bank financial institutions, and the state (Shleifer and Vishny 1997). The types of shareholding tend to have different governance implications<sup>25</sup>, since different controlling shareholders

might possess different incentives, skills and abilities to monitor the activities of management and board (Prowse 1994). For example, management ownership is a popular device to reduce the agency costs since managers, as owners, are likely to act in the best interest of the firm (Tsui and Gul 2000).

#### Shareholder Rights and Equitable Treatment

Shleifer and Vishny (1997) mention that shareholders can exercise their basic rights by being involved in the voting process of a firm, especially on several important corporate decisions such as, election of the board of directors, and mergers and liquidations. However, the inefficiency in the legal system in many developing economies seems to cause the poor state of minority shareholder rights in relation to their participation in the governance process or receiving dividends. The presence of multiple classes of shares also causes discriminatory practices among different types of shareholders (e.g. some shareholders can exercise more voting rights than their cash-flow rights in the firm) (Claessens *et al.* 2000). Moreover, the opportunistic behaviour of the controlling board, coupled with the informational asymmetries between managers and minority shareholders, makes it difficult for the latter to exercise their rights (Caprio and Levine 2002). In spite of the possibility that a large group of small shareholders can concentrate their voting rights, it does not seem to be financially and practically feasible because of the free rider problem, where most individual shareholders are small and dispersed and are unlikely to have the motivation to organise themselves (Shleifer and Vishny 1997). In this connection, the OECD (2004) mention that a well-structured corporate governance framework and the codes of good governance might help in protecting shareholder rights and ensuring equitable treatment.

#### Board and Management Diversity

The board of directors and executive management are two important components of a firm's governance process. Several closely related governance issues of the board and management include the responsibility, structure and independence of the board, and the management contract.

The board seems to be an important internal mechanism for resolving the agency problems, since it is primarily responsible for recruiting and monitoring the executive management to protect the interests of the shareholders and other stakeholders. Mallin (2004) mentions that the board makes a bridge between managers and investors by taking a leadership role<sup>26</sup>. Mallin also suggests that an

<sup>24</sup> Among others, the reputational agents include, accounting and auditing professionals, lawyers, investment bankers and analysts, credit rating agencies, consumer activists, environmentalists, and the media in monitoring the performance of the firms in the process of corporate governance.

<sup>25</sup> Nonetheless, a country's legal structures tend to determine the power and scope of the governance role

played by different types of shareholders.

<sup>26</sup> Available literature (e.g. Mallin 2004, McColgan 2001; Solomon *et al.* 2003) also emphasises the presence of board sub-committees such as remuneration committee, audit

evaluation of the board (or board sub-committees) can help establish performance criteria that can be used to achieve the corporate objective and to align the performance of the directors with the interest of the shareholders. A related literature also refers to board structure and independence as important governance components. Denis and McConnell (2003) regard a smaller board as an important determinant of corporate governance and firm performance. Solomon *et al.* (2003) and Tsui and Gul (2000) opine that the outside or non-executive directors play an important governance role in relation to the welfare of the investors, especially non-controlling shareholders. The presence of outside directors improves the degree of corporate accountability and creates a balance of power between the CEO and the board<sup>27</sup> (Denis and McConnell 2003; Ricart *et al.* 1999). Likewise, the OECD (2003) observes that independent non-executive directors can exercise impartial judgement in relation to the conflicts of interest among different stakeholders. This presence of independent non-executive directors seems to have an important implication in family-based governance, as Solomon *et al.* (2003) consider founding family dominance as a negative aspect of corporate governance<sup>28</sup>.

The issue of CEO duality (the CEO and board chairperson being the same individual) appears to constrain board independence, because there is a possibility of conflict of interests. Daily and Dalton (1997) and Kesner and Dalton (1986) mention that separate board structure can enhance board independence and shareholder value. However, a separate board does not necessarily ensure better governance, as Daily and Dalton (1997) argue, the chairperson in a separate board structure might possess his/her own interest in the firm's governance<sup>29</sup>. Corporate interlocking<sup>30</sup> is another inter-organisational strategy for managing the resource interdependencies such as, strategic alliances, mergers and acquisitions (Ong *et al.* 2003). Whilst the presence of the same individual on the boards of several firms can create firm value, it can yield a negative influence on the firm's governance

because of the potential for conflicts of interests between firms. Aside from monitoring the executive management, the board is also responsible for designing the management contract that minimises the degree of agency conflicts. Several studies (e.g. Prowse 1994; Becht *et al.* 2002; McColgan 2001) mention that a management contract aligns personal interest of the managers with that of the shareholders and provides managers with the incentives to maximise firm value. It is suggested that a value-enhancing management contract should include: basic salary components, performance-based cash bonuses and profit-based salary revisions, stock participation plan<sup>31</sup> (e.g. stock options), outright ownership of the firm's equity, pension rights, performance-based dismissal provisions, and long-term incentive plans.

### Transparency and Accountability

Transparency and accountability<sup>32</sup> are two closely related issues that are crucial, not only in enhancing the disclosure and auditing standards of a firm, but also in developing the regulatory organ's capacity to monitor and discipline the firm's governance practices. Therefore, it is imperative for a firm to make its financial and non-financial information available and easily accessible to outsiders in order that everyone can make informed decisions. Effective disclosures enable existing as well as prospective investors, to evaluate the management's past performance, forecast the firm's future cash flow (Gilson 2000), and to decide whether the risk profile of a firm is within an acceptable level (Fok 2000). As Mallin (2002:253) notes, "... information to shareholders is one of the most important aspects of corporate governance, as it reflects the degree of transparency and accountability of the corporations towards its shareholders". The quality of a firm's disclosures tends to be determined by the development of the capital market and the standards of accounting and auditing practices of a country. Whilst Claessens and Fan (2002) emphasise the quality auditing and professional integrity of the external auditors, it is commented that weak enforcement of accounting and auditing standards restrains quality auditing.

### Responsibility towards the Stakeholders

As mentioned earlier, an effective corporate governance system enhances corporate transparency and accountability, and maintains a balance between the shareholders' wealth maximisation and the diverse interests of various stakeholders. Kar (2000) observes that a fundamental objective of corporate governance

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committee, nomination committee and risk committee, to oversee specific governance matters and to maintain transparency and accountability.

<sup>27</sup> Ricart *et al.* (1999), however, suggest that the quality rather than the quantity of non-executive directors is important for effective corporate governance.

<sup>28</sup> A non-executive director is said to be independent in his judgement, and is not at all influenced by any financial, family or other form of tie, with the company or its management (Mallin 2004).

<sup>29</sup> For example, the chairperson might be a firm's former CEO, or holds large shares of the firm or have a close relationship with the founding family or executive management.

<sup>30</sup> Ong *et al.* (2003) define board interlocking in two different ways: (i) the total number of firms in which the directors of a firm sit as the board members, and (ii) the number of total directorships held by the directors of a firm.

<sup>31</sup> McColgan (2001) regards the use of an equity-based management compensation plan as an effective measure to mitigate agency problems and maximise shareholder value.

<sup>32</sup> *Transparency* can be defined as a process by which information about existing conditions, decisions and actions is made accessible, visible and understandable, whereas *accountability* refers to the discipline and need to justify and accept responsibility for the decisions taken (Sheng 2000).

is the enhancement of shareholder value, whilst protecting the interests of other stakeholders. Mallin (2004) suggests that a preferential treatment to the shareholders<sup>33</sup>, whilst taking into account the interests of the stakeholders, can enhance both shareholder and stakeholder values. The OECD (2004) outlines several principles of corporate governance that acknowledge the roles and rights of the stakeholders, such as the employees and society as a whole. It is stated that the stakeholders' rights as established by the legal system of the country (or through mutual agreements and co-operation), need to be recognised by a firm for maximising the well-being of its employees, creating wealth and welfare for society, and maintaining sustainability of the enterprises and financial systems. This section has reviewed the concept of corporate governance from the perspective of institutional and firm-level components. The effectiveness of corporate governance mechanisms tends to be dependent on the legal and regulatory framework of a country, variations in the market practices and regulation of the stock exchanges, and differing societal values. An appropriate governance framework requires an optimal mix of these mechanisms that in turn, can resolve corporate governance problems. However, as several studies (e.g. Prowse 1994; Tsui and Gul 2000; Cuervo 2002) suggest, the effectiveness of this optimal mix may vary depending on the institutional development of a country, its corporate governance system and the company in question.

#### 4. Corporate Governance and Access to Finance

A related literature (LLSV 1997, 1998; Gilson 2000; Claessens 2003) observes that corporate governance influences the firm's access to external finance and capital market development through controlling the insiders' and/or controlling shareholders' expropriation, and thus enhancing the investors' confidence<sup>34</sup>. The firm's access to external finance seems to be influenced, among others, by the cost of capital<sup>35</sup> to a firm and the firm's financing (or capital structure) decisions. In this connection, this section reviews how corporate governance is linked with the firm's cost of equity capital and its financing pattern.

<sup>33</sup> It is argued that shareholders, being the recipients of a firm's residual cash-flow, have a vested interest in the proper utilisation of the firm's resources.

<sup>34</sup> LLSV find the quality of investors' legal protection having significant positive effect on the valuation as well as breadth of both debt and equity markets. Claessens (2003) also considers shareholder and creditor rights important in developing the capital markets and the banking sector.

<sup>35</sup> For example, as Pal (2001) suggests, increased cost of capital, lack of investors' confidence and favourable bank lending rates tend to encourage firms to move away from costly equity finance to alternative cheaper sources, which ultimately lead to a decline in the activities of capital market.

#### 4.1. Corporate Governance and Cost of Equity Capital

In a fully integrated world of capital market with no transaction or agency costs, the Capital Asset Pricing Model<sup>36</sup> (CAPM) predicts that the cost of equity capital (or the investors' expected return on equity) only depends on the level of covariance risks of the world market portfolio, and that the country as well as firm-specific corporate governance differences, have no explanatory power (Drobetz *et al.* 2004). However, a recent literature suggests that corporate governance influences the cost of capital because of the potential for the principal-agent problems i.e. the agency costs. As Drobetz *et al.* (2004) argue, apart from the systematic risks embedded in the beta<sup>37</sup>, corporate governance could be treated as an additional risk factor for which investors require an adequate compensation in terms of higher expected returns<sup>38</sup>. Therefore, the classical CAPM approach should be combined with the firm-specific corporate governance issues. Gugler *et al.* (2003) also mention that the effectiveness of the capital market in influencing the rate of return is more likely to be constrained by the critical issue of transparency and disclosures.

The summary of the empirical studies shown in Table 1 reveals that better corporate governance quality reduces a firm's cost of equity capital, which in turn enhances the firm's access to equity finance. Claessens (2003) and LLSV (2000) also support the prediction of the agency theory that better corporate governance helps firms to reduce their cost of equity capital. This is probably because outsiders are likely to provide more finance and expect lower rates of return if they are given greater assurance (through better governance) of a return on their investment. Gompers *et al.* (2003) observe that poor corporate governance provisions cause agency costs to the firms in the form of inefficient investment and other capital expenditure decisions. Singh (2003) also argues that more efficient and dynamic firms can obtain capital from the stock market at a lower cost, whereas firms with less efficiency and dynamism have to acquire capital at a higher cost.

<sup>36</sup> The Capital Assets Pricing Model (CAPM) determines the required rate of return of a firm or a project as the sum of the risk free rate of interest and the market risk premium. The market risk premium is calculated by multiplying the difference between the market return and the risk free rate of interest with the Beta of the project. Beta is the measure of the extent of systematic risk in the project e.g. the higher the beta (or systematic risks) the greater the required rate return (or cost of capital) (Parasuraman 2002).

<sup>37</sup> See, the CAPM approach above.

<sup>38</sup> Lombardo and Pagano (2002) and Drobetz *et al.* (2004) argue that expected stock returns compensate investors for their expected monitoring and auditing costs, and other forms of expropriations associated with the firm's governance process.

**Table 1.** Summary of the literature on the relationship between corporate governance (CG) and cost of equity capital

| Author(s)                  | Sample (Period)                               | Focus of the Study                         | Key Findings  |
|----------------------------|---|--|---|
| Black et al. (2006)        | 515 Korean firms (2001)                       | CG and firm value                          | * Better governed firms tend to enjoy lower cost of capital   |
| Drobetz et al. (2004)      | 91 German firms (2002)                        | CG and stock returns                       | * CG is negatively related with the expected stock returns  |
| Lombardo and Pagano (2002) | 1,183 firms, 21 developed economies (1997)    | Legal determinants of the return on equity | * Shareholder rights is negatively associated cost of equity capital<br>* Accounting standards are positively linked with excess returns  |
| Ashbaugh et al. (2004)     | 995 non-fin S&P 1500 firms (1996-02)          | CG and cost of equity capital (COE)        | * Firms with better CG have lower COE<br>* Firms with more transparency and more independent audit committee have lower COE<br>* Ownership concentration is positively linked with COE<br>* Board independence and % of board that own stock are negatively linked with COE |
| Chen et al. (2003)         | 545 firm-yr obs., 9 Asian economies (2000-01) | CG and cost of equity capital (COE)        | * Disclosure and non-disclosure CG have negative effect on COE<br>* Strengthening overall CG is more important than adopting better disclosure policy   |

Source: Compiled by the authors based on a review of the literature

**Table 2.** Summary of the literature on the relationship between corporate governance (CG) and capital structure

| Author(s)                   | Sample (Period)                                 | Focus of the Study                       | Key Findings   |
|-----------------------------|---|--|--|
| Wen et al. (2002)           | 60 Chinese firms (1996-98)                      | CG and capital structure                 | * CEO tenure and outside directors are negatively linked with leverage<br>* No evidence on the effect of board size and CEO compensation on debt ratio   |
| Suto (2003)                 | 375 non-fin Malaysian firms (1995-99)           | CG and investment behaviour              | * Ownership concentration (OC) and firm size (FS) are negatively linked with the debt ratio  |
| Du and Dai (2005)           | 1,473-1,484 East Asian firms (1994-96)          | Ownership and capital structure          | * Controlling owners with little shareholding choose higher debt<br>* Weak CG and crony capitalism contributes to risky capital structure  |
| Kumar (2005)                | 2,000 Indian firms (1994-00)                    | CG and firm financing                    | * Firms' with dispersed shareholding have higher leverage<br>* Firms' with higher FS and lower institutional shareholding have lower debt<br>* No relationship between directors shareholding and debt |
| Jiraporn and Gleason (2005) | 4,638 firm-yr obs. from IRR (non-fin) (1993-02) | Shareholder rights and capital structure | * Firms with more restricted shareholder rights have higher leverage<br>* Supports the view that leverage helps alleviate agency problems  |
| Alba et al. (1998)          | 357 Thai firms (1994-97)                        | Corporate fin. and CG                    | * OC is positively linked with leverage  |

Source: Compiled by the authors based on a review of the literature

#### 4.2. Corporate Governance and Firm Financing

The seminal works of Fama and Miller (1972) and Jensen and Meckling (1976) are widely credited with forwarding the agency theory-based explanation of capital structure. The definition of corporate governance also relates corporate governance with the firm's financing pattern<sup>39</sup>. Available literature suggests that debt finance can resolve agency problems through increased management shareholding, reduced cash-flow problems and increased probability of bankruptcy risks and job losses<sup>40</sup>.

Several studies empirically examine how capital structure is associated with individual governance issues such as ownership and board structures or shareholder rights. The summary of literature presented in Table 2 shows that firms with higher ownership concentration or weak shareholder rights tend to have a higher level of debt finance (Alba et al. 1998; Jiraporn and Gleason 2005). The literature (e.g. Suto 2003; Du and Dai 2005) also suggests that the controlling shareholders' fear of diluting the shareholding dominance, along with their close links with (or increased reliance on) the banks, causes firms to have risky capital structure (e.g. higher leverage).

<sup>39</sup> Shleifer and Vishny (1997:737) define corporate governance "as the ways in which suppliers of finance to corporations assure themselves in getting a return on their investment".

<sup>40</sup> Increased debt finance and subsequent higher management shareholding appear to mitigate agency conflicts by aligning the interests of the shareholders and managers (Jensen and Meckling 1976); the obligation of paying debt along with its interest reduces free cash flow and thus restrains managers from using the free cash for non-optimal activities (Jensen 1986); debt finance increases the probability of costly bankruptcy and subsequent job losses, and thus encourages managers to work harder, consume fewer perquisites, and make better investment decisions (Grossman and Hart 1982, cited in Harris and Raviv 1991).



**Table 3.** Summary of the literature on the relationship between corporate governance (CG) and financial performance

| Author(s)                     | Sample (Period)                            | Focus of the Study                   | Key Findings  |
|-------------------------------|--|--------------------------------------|---|
| Black <i>et al.</i> (2006)    | 515 firms, Korea (2001)                    | CG and firm value                    | * CG has a positive influence on firm value<br>* Better CG is less likely to predict higher firm profitability  |
| Drobetz <i>et al.</i> (2004)  | 91 firms, Germany (2002)                   | CG and expected stock returns        | * CG is positively associated with firm value and stock returns   |
| Klapper and Love (2004)       | 374 firms, 14 emerging econ. (2000)        | Determinants of CG and performance   | * Better CG is highly correlated with better profitability and firm valuation   |
| Gompers <i>et al.</i> (2003)  | 1,500 large firms (S&P) (1990s)            | CG and equity prices                 | * Firms with stronger shareholder rights have higher firm value, higher profits and higher sales growth   |
| Thompson and Hung (2002)      | 83 firms, Singapore (2001)                 | CG and corporate performance         | * Positive relationship between ownership concentration (OC) and profitability<br>* Both CGI and non-executive chairman are negatively associated with profitability  |
| Gugler <i>et al.</i> (2003)   | 19,010 non-fin S&P firms (1996-01)         | CG and investment returns            | * Firms in countries with strong CG systems, strong accounting standards and strong enforcement have higher returns on investments  |
| Gugler <i>et al.</i> (2001)   | 19,000 firms, 61 economies (1996-01)       | CG and investment returns            | * Managers' shareholding and cross-shareholding are negatively linked with investment performance   |
| LLSV (2002)                   | 539 large firm, 27 wealthy economies       | Investor Protection and Valuation    | * Firms in countries with better minority shareholder protection, and firms with higher cash-flow rights by controlling owners have higher value  |
| Yurtoglu (2000)               | 126 Turkish non-fin firms (1998)           | Ownership, control and performance   | * OC and pyramidal shareholding (PS) are negatively linked with profitability and firm value  |
| Lemmon and Lins (2003)        | 800 non-fin firms, East-Asian (1997)       | CG and firm value                    | * Firms with higher managerial control (MC) and PS have lower stock returns   |
| Mitton (2002)                 | 398 East Asian firms (1997-98)             | CG and performance                   | * Disclosure quality and outside OC are positively linked with stock returns  |
| Gedajlovic and Shapiro (2002) | 334 firms in Japan (1986-91)               | Ownership and profitability          | * Positive association between OC and profitability   |
| Hovey <i>et al.</i> (2003)    | 100 firms, China (1997-99)                 | Valuation and ownership              | * No relationship between OC and firm value<br>* Institutional shareholding is positively linked with firm value  |
| Alba <i>et al.</i> (1998)     | 357 firms, Thailand (1994-97)              | Corporate financing and CG structure | * Firms with higher OC have lower profitability   |
| Claessens (1997)              | 287-1,198 Czech and Slovak firms (1992-93) | CG and equity prices                 | * OC and domestic shareholding is positively related with firm value<br>* Bank-sponsored investment funds is not related with prices  |
| Farrer and Ramsay (1998)      | 180 firms, Australian (1995)               | Directors' ownership and performance | * Positive link between directors' shareholding (DS) and performance, although to some extent, inconclusive   |
| Morck <i>et al.</i> (1988)    | 370 firms, Fortune500 (1980)               | Management ownership and firm value  | * Non-monotonic relationship between firm value and DS<br>* Family managed older firms have lower value than outsider managed firms   |
| Bøhren and Ødegaard (2003)    | 1,057 firms in Norway (1989-97)            | CG and performance                   | * Insider ownership (IO) improves valuation unless the stake is unusually big<br>* Direct (individual) own. is better than indirect (or institutional) ownership<br>* OC, dual-class shares and board size (BS) are negatively linked with firm value |
| Agarwal and Knoeber (1996)    | Forbes 800 firms (1987)                    | Performance and control              | * Presence of non-executive directors is negatively linked with firm value<br>* Relationship between IO and firm value is inconclusive  |
| Kiel and Nicholson (2003)     | 348 firms, Australia (1996)                | Board comp. and Performance          | * BS and non-executive directors are positively related with firm value   |
| Ong <i>et al.</i> (2003)      | 295 firms, Singapore (1997)                | Board interlocks                     | * BS and profitability are positively linked with board interlocks  |
| Craven and Marston (1997)     | 325 top UK firms                           | Investor relations and CG            | * Investor relations activities are positively linked with non-executive chairman, but not related with non-executive directors   |
| Brickley <i>et al.</i> (1997) | 737 large US firms (1988)                  | Separation of CEO and Chairman       | * No evidence that CEO duality has inferior performance<br>* Cost of dual leadership is higher in large firms   |

Source: Compiled by the authors based on a review of the literature

The literature on the association between corporate governance and the firm's equity finance appears to be limited. Shleifer and Vishny (1997) argue that the presence of large investors (such as, family or banks) might have a negative effect on equity financing because of the possibility of

expropriation of minority shareholders' rights, which prevents the latter from investing in the capital market. Gugler *et al.* (2003) and Gilson (2000) also argue that good governance practices associated with better accounting standards and credible disclosures, seem to influence higher equity investment, regardless

of a country's legal institutions<sup>41</sup>. Overall, the evidence suggests that firms with poor governance quality are inclined to have a higher level of financial leverage.

This section considered the influence of corporate governance on the cost of equity capital and the financing pattern of a firm. The next section reviews available literature on the relationship between corporate governance and financial performance.

## 5. Corporate Governance and Financial Performance

There seems to be a growing disagreement amongst researchers on whether corporate governance components should be analysed together rather than separately. Whilst a majority of corporate governance literature centres on individual governance components, a recent literature is based on corporate governance index or rating, considering all related issues of corporate governance. Table 3 summarises the empirical studies on how individual governance components (e.g. ownership structures, shareholder rights, board and management diversity and disclosure quality) and overall governance standards (e.g. corporate governance index) are associated with the firm's valuation as well as operating performance.

The table shows that the empirical evidence of the influence of individual corporate governance mechanisms<sup>42</sup> on financial performance is highly inconclusive<sup>43</sup>. Whilst several studies (for example, LLSV 2002) find a positive relationship between ownership concentration and financial performance, and thus support the prediction of the agency theory, others (e.g. Hovey *et al.* 2003) find inconsistent or contrasting evidence in this regard. Among others, Bøhren and Ødegaard (2003) support the notion of the agency theory with respect to the negative relationship between outside (e.g. institutional, foreign or state) ownership concentration and firm performance. However, Mitton (2002) finds institutional and outside ownership concentration being positively associated with financial

performance. Also, the influence of family as well as board and management ownership on firm performance tends to be indecisive (Morck, *et al.* 1988).

The table also shows that that the empirical relationships between different board and management issues (e.g. board size, board interlocks and CEO duality) and financial performance are largely inconsistent<sup>44</sup>. A related literature (e.g. LLSV 2002; Gugler *et al.* 2003) supports the prediction of the agency theory in relation to the positive influence of investors' legal protection on financial performance. Mitton (2002) also finds disclosure quality having a positive influence on firm performance.

A growing body of recent literature<sup>45</sup> combines all related corporate governance components (e.g. corporate governance index or rating) to investigate a firm's overall governance quality. These studies support the prediction of the agency theory in relation to the positive influence of corporate governance quality on valuation as well as profitability of the firm. Claessens (2003) argues that better corporate governance can enhance firm value as well as operational performance, through more efficient management, better allocation of assets, better stakeholder management and other improved mechanisms.

## 6. Conclusions

The paper outlined a conceptual framework of the relationship between corporate governance and two important determinants of capital market development namely, a firm's access to finance, and its financial performance. Although the capital market plays a crucial role in enhancing corporate governance standards, it was revealed that the effectiveness and credibility of such effort might be constrained by poor firm-level corporate governance.

The framework is based on the assumption that a firm's corporate governance is simultaneously determined by a group of related governance components and other firm characteristics. Therefore, all of these factors need to be considered together (rather than taking a single component like ownership or board) to capture a holistic picture.

Whilst the framework is primarily based on the economic approaches to corporate governance (e.g. the agency theory and the internal governance structures), it recognises part of the assumptions of the stakeholder theory in relation to a firm's responsibility towards the stakeholders. Moreover, the political economy model's assumption of the influence of the political interplay of powerful interest

<sup>41</sup> Gugler *et al.* (2003), however, acknowledge that the existence of strong accounting standards alone is not sufficient to produce a strong external capital market for equity.

<sup>42</sup> Available literature (e.g. Klapper and Love 2004; McGuire 2000; Thompson and Hung 2002; Craven and Marston 1997; Kiel and Nicholson 2003; Cremers and Nair 2003) also suggests that corporate governance is influenced by several firm-specific characteristics including, growth opportunities, intangibility of assets, firm size, profitability and capital structure pattern.

<sup>43</sup> In response to these inconclusive findings, Farrer and Ramsay (1998) argue that the empirical evidence appears to be varied depending on the performance measures used, the firm size, the type of industry in which the firm operates, whether directors are executive or non-executive, or whether director share ownership is measured in dollar value or as a percentage of the firm's total outstanding shares.

<sup>44</sup> See Kiel and Nicholson (2003); Bøhren and Ødegaard (2003); Craven and Marston (1997); Thompson and Hung (2002)

<sup>45</sup> For example, Gompers *et al.* (2003); Black *et al.* (2006); Drobetz *et al.* (2004); Klapper and Love (2004)

groups is acknowledged. Altogether, it was explained that firm-level corporate governance quality can enhance both the firm's ability to gain access to finance and its financial performance, which eventually lead to capital market development.

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