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Corporate Governance And Firm Performance: A Review Of Literature From Indian Perspective

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Abstract

This paper reviews recent research on corporate governance, with a special focus on Indian markets. It finds that better corporate governance benefit firms through greater access to better performance, and more favourable treatment of all stakeholders. Numerous studies show these channels to operate at the various levels of firms, with causality increasingly often clearly identified. Evidence also shows that various internal corporate mechanisms has greater effect on firm profitability when taken due care, and effect negatively when corporate governance is weak. Importantly, how corporate governance regimes change over time and how this impacts firms are receiving more attention recently. Less evidence is available on the direct links between corporate governance diversification and firm performance in the context of Indian Economy. The paper concludes by identifying issues requiring further study, including the special corporate governance issues of principal-principal problem, board structure, ownership structure, in focussed and diversified firms

Keywords: Corporate governance Indian Market, Shareholder rights Firm Performance, Stakeholders

Introduction

The large number of corporate failures that occurred at the beginning of the 21st century has damaged public confidence in many economies. Fraud and scandals were seen as contributing to company of the collapses. As a consequence, corporate governance has been debated extensively with structures improved in several countries. Although there had been significant corporate failures in Europe, it was the Asian financial crisis in 1997 that led to the realisation of the need for investor protection and improved corporate governance practices in the Asian region (Balachandran & Bliss, 2004).

Corporate governance systems vary a great deal around the world. Several committees around the countries in the world was formed to form the guidelines of corporate governance

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for companies i.e. Cadbury committee (England), 1992, King committee (South Africa), 1994, CII committee (India), 1996, Hampel committee (England) 1998, etc. Corporate governance became a pressing issue following 2002 with the introduction of the Sarbanes-Oxley Act in the U.S, which was meant for restoring public confidence in companies and markets after the accounting fraud and bankruptcy of high-profile companies such as Enron and WorldCom. Most companies strive to have a high level of corporate governance. These days, it is not enough for a company to merely be profitable; it also needs to demonstrate good corporate citizenship through environmental awareness, ethical behaviour and sound corporate governance practices.

With increasing competition and globalisation, Government of India took several steps to review and strengthen corporate governance in India like Confederation of Indian Industries (CII) evolved a desirable code of corporate governance in 1996. Kumar Mangalam Birla Committee 1999, Narayanmurthy Committee 2003, Adi Godrej Committee 2012, have introduced certain requirements to enhance good corporate governance practises in India.

In Indian context power of management are delegated to board of directors, but there exist a problem of majority and minority shareholdings (principal-principal problem), where majority shareholders have greater control on decision of companies and minority shareholders are neglected, many cases can be seen in case of government agencies and PSU where government had taken decision in favour of majority shareholders.

In order to ensure proper management of firm and to satisfy the interest of shareholders, managers should pursue strategies that are consistent with maximizing shareholders' wealth. However, absence of governance control will lead managers to pursue strategies that may deviate from the interest of the shareholders. High-risk high-return strategies and less diversification are attractive to shareholders. However, as opposed to shareholders, managers always want to lead bigger and diversified firms instead of focussed firm. Hence, securing their job on survival of the firms Therefore, managers prefer low risk strategies to avoid being associated with financially distressed firms. Managers prefer to reduce their employment-risk through corporate diversification (Amihud & Lev, 1981).

Furthermore, corporate diversification may provide other private benefits to managers. For example, diversification might benefit managers through the power and prestige associated with managing a larger firm (Jensen, 1986); managerial compensation which is positively related to firm size (Jensen & Murphy, 1990); and make managers indispensable to the firm

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(Shleifer & Vishny, 1989). As a result, managers may pursue diversification strategies even though shareholders' interests might be at stake.

Although risk-reduction, earning smoothing, increased debt capacity and administration economies of scale are often cited as economic gains from diversification, recently many researchers found that the diversification strategies might not benefit shareholders (Byrd & Hickman, 1997). Various control mechanisms such as effective board monitoring on managers (Baysinger & Hoskisson, 1990), managerial ownership (Denis et al., 1997), outside blockholder ownership (Denis et al., 1997) and institutional shareholding (Baysinger, Kosnik & Turk, 1991), have been suggested to help mitigate the agency cost associated with diversification strategy. Most of the empirical studies on corporate diversification have been conducted in developed countries. However, in developing countries like India, the practices of corporate governance may be different from that of developed countries such as United States, Germany and Japan that have relatively successful corporate governance systems (Shleifer & Vishny, 1997) due to corporation law, economic, cultural and political differences. To date, published empirical studies on the relationship between governance control and corporate diversification in India are virtually negligible.

Corporate Governance

Corporate governance is considered a performance driver of firm and much of the discussions of corporate governance focus on the assumption that governance mechanism influence firms' performance (Ali et al., 2008). However there is no conclusive empirical evidence on how corporate governance mechanism influence corporate performance. Most research examines the influence of specific aspects of corporate governance such as board of directors, remuneration policy, ownership structure and capital structure on firm performance (Agrawal and knoeber, 1996; Demsetz and Villalonga, 2001; Jackson and Moerke, 2005; Thomson et al., 2006).

The prior studies regarding the relationship between various aspect of corporate governance and firm performance (firm value) have produced mixed result. For example, Beasley (2005) carried out analysis of 75 fraud and 75 non fraud firms which indicated that no fraud firms had significantly higher percentage of outside member than fraud firms. However, (Agrawal and knoeber, 1996) found that more outside director on the board were negatively related to firm performance. Chung-Cheng et al. (2006) suggested that firms with better corporate governance are likely to have better access to critical resources which are essential to achieve competitive advantage.

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La Porta et al. (2002) determined higher firm valuation in nations with better minority shareholders protection. Durnev and Kim (2005) and Klapper and Love (2004) use data on firm-level corporate governance rankings and found that companies with better governance and better disclosure standards exhibit higher Tobin's q. Drobetz et al. (2004) constructed a broad Corporate Governance rating related to the German Corporate Governance Code and document a positive relationship between governance practices and firm valuation for German public firms. A study by (Black et al., 2003) also indicates a positive relation between their governance index and Tobin's q for a sample of Korean companies. Klapper and Love (2004) and Durnev and Kim (2005) argued that firms with better investment opportunities and larger needs for outside financing had more incentives to adopt better governance practices. Market valuation of the company indicates its future growth opportunities, entailing a positive correlation between governance and Tobin's q. Beiner et al. (2006) supported the hypothesis of positive relationship between corporate governance and firm value, i.e., firms with better Corporate Governance standards receive higher market valuations. For the median firm, a one standard deviation increase in the Corporate Governance index causes an increase of the market capitalization by at least 12 percent of a company's book asset value. Bai et al. (2004) demonstrated that better governance of listed companies in China have higher firm valuation.

In emerging markets various institutional investors are ready to pay thirty percent more for shares belonging to well-governed firms. To what extent these investors claims holds true? In order to analyze the relationship between market valuation and corporate-governance practices McKinsey (Newell and Wilson, 2001) surveyed 188 companies belonging to India, Taiwan, Mexico, Korea, Turkey, and Malaysia. The result indicated that good Corporate Governance practices helps in maintaining high level of price-to-book ratios i.e. companies can anticipate at least 10 to 12% increase in the firm's market value by improving at least one single component of governance. Himmelberg et al. (1999), (Black et al, 2003), (Klapper and Love,2004) and others argue that there may be an endogeneity problem when performance measures are correlated with proxies for good governance practices, such as control and cash flow rights concentration or a governance practices index.

There are also single country studies on India (Balasubramaniam et al., 2008), Russia (Black, 2001; Black et al., 2006), Hong Kong (Cheung, et al., 2007) and Thailand (Limpaphayom and Connelly, 2004), Ukraine (Zheka, 2005 and Zelenyuk and Zheka, 2006) investigated the association between some individual governance elements and index of Corporate

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Governance quality (constructed from Corporate Governance indicators) and firms' efficiency and concluded that there exist a positive association between corporate governance index and firm market value.

Companies do not perform in isolation and therefore ability of company to transform into competitive positions with better performance is influence by factor such as distortion in market economy i.e. perfect or imperfect competition, competition regulation, corporate or securities law, trade barriers, industry norms and finance providers (Dignam, 2005). Therefore corporate governance is largely determined by the corporate governance system of a country. For example, in the US where market based government is in operation, the companies achieve better performance through liquid stock markets, venture capital and strong labour market whereas the companies in Japan and Germany, where relationship based operation exist achieves better performance through practices such as network based production models, incremental innovation and shop floor skill (Jackson and Moerke, 2005). (Mourdoukoutas and Papadimitriou, 1998) argue that corporate practices lead to better performance are largely influenced by the corporate governance system and therefore practises could only be transferred to similar governance system.

Board of directors and firm performance

The board of directors is the most important internal governance mechanism that ensures stakeholders rights, corporate direction and accomplishment of corporate objectives and safeguard owners wealth. Fama and Jensen (1983) view the board as "the apex of internal decision control system of organisations. Vafeas (1998) investigated the relationship between board size and the informativeness of earnings. He suggested that earnings of firms with the smallest boards in the sample (with a minimum of five board members) were perceived as being more informative by market participants. By contrast, there was no evidence that board composition mitigates the returns.

Hermalin and Weisbach (2001) pointed out that, there are three primary issues addressing empirical studies concerning board of director and firm performance, i.e the relationship between various board characteristics and firm performance , the impact of various board characteristics on observation action of board and the factor that affect the makeup of board and their evolution over time. Two characteristics of board of directors have received much attention in the literature are board size and the relative independence of board members.

Dimitropoulosb and Asterioua (2010) investigated the effect of board composition on the informativeness and quality of annual earnings. Their data analysis over a period of five years

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(2000–2004) revealed that the informativeness of annual accounting earnings is positively related to the fraction of outside directors serving on the board, but it is not related to board size. Additionally, firms with a higher proportion of outside board members proved to be more conservative when reporting bad news but on the contrary they do not display greater timeliness on the recognition of good news. Their result further indicate that firms with a higher proportion of outside directors report higher earning as when compared to firms with a low proportion of outside directors.

Varshney et al. (2012) studied the relationship between four corporate governance mechanisms and found significant positive correlation between the size of board of directors and firm performance, researchers concluded that board meeting and firm performance has inverse relationship and also shows that CEO duality and firm performance has weak negative relationship. Haldar and Rao (2013) examines the impact of corporate governance on financial performance considering endogeneity between governance and firm characteristics and concluded firms with promoters dominated boards and lower leverage reports better performance while firm size negatively impact performance. Researchers suggest with the help of this paper that market responds positively to better governed firms as the progress of firm depends on the adoption and implementation of good governance practices hence the board should make effort to advance the governance of their firm to enhance performance.

Non-executive director plays a crucial role in monitoring corporate management. Non-executive directors accept directorships in order to signal that they are decision experts who have the ability to work even in an un-organised firm. Non-executive directors have incentives to guard shareholder interests well as they have invested their reputation in the firm. Alternatively, a case can be made for the value of executive directors too. Executive directors are an important link in the flow of information between top management and non-executive directors. Moreover, the board may be used in training and evaluating prospective CEOs. Like non-executives, executive directors are legally liable against shareholders.

Lipton and Lorsch (1992) viewed independent director as any director who has no connection with the company, either as management or substantial customer or supplier of goods or services. Director independence is compromised for non-executive directors having a fiduciary relationship with the firm, such as management consultants, executives in financial institutions, and the firm's legal counsel (collectively called 'grey' directors), and for interlocking directors. They recommend a ratio of at least two independent directors to one

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non-independent and board committees that consist solely of independent directors, one of whom should be the chair.

Rosenstein and Wyatt (1990) found that the announcement of a non-executive director appointment on the board is followed by a positive excess return. While consistent with the monitoring value of non-executives, this result may also signal a change in the firm's strategy rather than the benefits of outside guidance. Interestingly, they reported an analogous result at the appointment of executive directors with a significant amount of equity investment in the firm. Byrd and Hickman (1992), and Brickley *et al.* (1994) found that tender offer bids and poison pill adoptions elicit significantly more positive market responses when non-executives have voting control of the board. In the same vein, Cotter *et al.* (1997) found that tender offer targets experience higher announcement period returns when outside directors have voting control of the board. Similarly, Weisbach (1988) and Borokovich *et al.* (1996) found that the likelihood of ousting CEOs in poorly performing firms and replacing them with independent non-executives is positively related to the percentage of non-executives on the board of directors. Finally, Mayers et al. (1997) concluded that mutual life insurers are associated with a higher fraction of outside directors on their corporate boards than stock life insurers.

In addition to board composition, Lipton and Lorsch (1992) and Jensen (1993) suggested that large boards can be less effective than small boards. The idea is that when boards get to be too big, agency problems increase and the board becomes more symbolic and less a part of the management process. Yermack (1996) tested this view empirically and founds support for it. He also examined the relation between Tobin's *q* and board size on a sample of large U.S. corporations, controlling for other variables that are likely to affect *q*. He also suggested that there is a significant negative relation between board size and *q*.

Female board member and firm performance

Female board members are examined very often in empirical studies. The female board members reflect a diversified characteristic of the board (Dutta và Bose 2006). Erhardt *et al.* (2003) find that the percentage of female directors is positively related to larger US firms' two 34 accounting measures; return on assets and return on investments. In addition, recent research in the UK finds that the presence of at least one female board director reduces company bankruptcy costs (Wilson & Altanlar 2009).

Smith et al. (2006) considered three different reasons to recognize the importance of females on a board. *First,* female board members usually have a better understanding of a market in comparison with male members. As such, this understanding will enhance the decisions made

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by the board. *Second*, female board members will bring better images in the perception of the community for a firm and this will contribute positively to firm's performance. *Third*, other board members will have enhanced understanding of the business environment when female board members are appointed. Moreover, this study also indicated that female board members can positively affect career development of junior female staff in a business. As a result, firm's performance is improved directly and indirectly with the presence of female board members. Lucas-Perez et al. (2014) found that presence of women on the board of companies results in greater board independence and greater effectiveness. There had been multiple researches which showed that there exist correlation between gender diversity on boards of directors and better financial returns. The research demonstrating the bottom line payoff of having women and men in leadership is well known. Catalyst study explored that companies with the most women directors outperform those with the least on ROIC by 26%. McKinsey & Company's studied titled Women Matter, which show that "companies where women are most strongly represented at board or top-management level are also the companies that perform best." Other studies include Credit Suisse research showed that companies with women on their boards have higher share price. Companies with gender diversity don't do better because women CEO's (or women at any level) lead differently or better, rather they do better because they have diverse perspectives both masculine and feminine strengths.

Shrader, Blackburn and Iles (1997) reported a negative relationship between the percentage of female board members and firm financial performance. They analyzed around 200 Fortune 500 firms. They used return on equity (ROE) and return on assets (ROA) as measures for firm financial performance. Zahra and Stanton (1998) examined the relationship between gender diversity and firm financial performance. They worked with 100 Fortune 500 firms and they used return on equity (ROE), profit, earnings per share, dividend per share and profit margin on sales as performance variables. Zahra and Stanton did not found a statistically significant relationship between gender diversity and firm financial performance.

Robinson and Dechant (1997) built a case for the importance of corporate diversity. They believed that diversity affects a firm's financial value in both the short and long run. They postulated that:

(a) corporate diversity promotes a better understanding of the marketplace; (b) diversity increases creativity and innovation; (c) diversity produces more effective problem solving; (d) diversity enhances the effectiveness of corporate leadership; and (e) diversity promotes effective global relationships. If one accepts that women add to the diversity of corporate

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leadership, then the proposed benefits can be reaped by having women in the boardroom. Fondas and Sassalos (2000) argued that diversity in board composition via greater female representation would lead to improved board governance and top management control.

Carter, Simkins and Simpson (2003) examined the relationship between board gender-diversity and firm value for the Fortune 1000 firms. Using Tobin's Q as a measure of firm value, they found statistically significant positive relationships between the percentage of women on the board of directors and firm value as well as presence of women on the board of directors and firm value.

Duality of CEO and firm performance

Even though empirical studies cannot provide an agreed view on a contribution of duality to a firm's performance, there is an agreement between shareholders, institutional investors, and policymakers that a chairman or chairwoman of a board should not be the same with the chief executive officer. In their study, (Dahya et al., 2009) presented that, between 1994 and 2003, policymakers in 15 advanced nations and the United Kingdom recommended a chairman or chairwoman of a board should not be the same with the chief executive officer. In Europe, 84 per cent of firms separate the roles of a chair of a board and a CEO of a firm (Heidrick and Struggles, 2009). Accoring to a (Hewa-Wellalage and Locke, 2011) study, in Sri Lanka, the Sri Lankan code of best practice on corporate governance emphasizes the balance of power within a firm to minimize any one individual's influence to the decision making process. These rules provided recommendation that when there is a duality in a firm, a number of independent directors on a board should be a majority to provide balance and an effective and efficient operation of a board. In recognition of the importance of a separation of responsibility between a chairman and a CEO, for the period from 1999 to 2003, many businesses had altered their existing structure of duality to a non-duality structure (Chen, Lin and Yi, 2008). These authors considered that, in many businesses with a duality structure, there has been an abuse of power at the expense of the company and the shareholders. Fama and Jensen (1983), Jensen (1993) concluded that duality would reduce a board's supervision of the management of a company. This reduction results in an increase of costs to an agency.

Since 2000, hundreds of companies converted to a non-CEO duality structure, while few companies converted to CEO duality (Chen *et al.,* 2008). With the outbreak of large US corporate scandals, CEO duality received more attention, due to powerful CEOs abusing their terrific power by expropriating from the company assets and shareholders. Most of the corporations increased pressure on regulators to separate CEO and chairman roles. According

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to the Faleye (2007), the number of US shareholders calling for non-duality roles increased continuously from 3 in 2001 to 32 in 2004. Faleye (2007) also found the proportion of firms switching from non-duality increased from 55% in 1999 to approximately 70% in 2003. Overall, 84% of European companies separated CEO and chairman roles. In Australia, Germany, Netherland, Sweden and the UK, the role was always distinguished ("Corporate Governance Report 2009: Boards in Turbulent Times", 2009). The Indian mandatory code of best practice emphasised the importance of balance of power and authority in a company, so that no individual has unfettered powers of decision. Further, code also mentioned that if there is CEO duality in a company, non-executive directors should comprise the majority of the board to provide better board balance.

There are two different theories on board leadership structure. Based on the agency theory, Fama & Jensen (1983) suggested that CEO duality hinders a board's ability to monitor management and therefore increase the agency problem. As a result, CEO duality increases management entrenchment and reduces board independence (Finkelstein & D'Alene, 1994; Rhoades *et al.,* 2001). Conversely, stewardship theory argued that managers are inherently good stewards of company resources (Donaldson & Davis, 1991a; Donaldson & Davis, 1994). They explained that CEO duality creates strong leadership and a clear sense of strategic decision. Splitting roles may create high communication costs and decision making processes can be less effective and less efficient when there are two leaders. Evidence about the relationship between CEO duality and company financial performance is mixed and inconclusive. The empirical evidence showed that there is no optimal board leadership structure, and company models depend on their own organisational characteristics and business environment (Finkelstein & D'Alene, 1994; Rhoades *et al.*, 2001). Further, Finkelstein & D'Alene (1994) explained that when the company shows low performance and CEO power is informal then CEO duality is ideal. Recent studies such as Aguilera *et al.* (2008) explained CEO duality and firm financial performance is related to institutional environments. Elsayed (2007) explained firm financial performance is related to the industry as well. On the other hand, board vigilance is negatively associated when CEO power is informal and company performance is high. Boyd (1995) explained CEO duality creates more advantages when a company operates in a complex and dynamic environment with resource scarcity. Further, Faleye (2004) studied that when companies operate in a complex environment, strong CEO reputation, higher managerial ownership and small board size are more likely to have a dual role CEO. In the Australian context, Kiel & Nicholson (2003) posit

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non-CEO duality is common in larger firms with larger boards and CEO duality exists in smaller companies. Therefore company size and environment has a huge impact on CEO duality structure.

Board Diversity and firm performance

The role of a board is the internal corporate governance of a firm (Fama, 1980). A board is also a control system in a business (Fama and Jensen, 1983). A board of directors supervising management decisions in an efficient manner will improve firm's performance. Doing so requires each board member to be fully equipped with management knowledge such as finance, accounting, marketing, information systems, legal issues and other related areas to the decision making process. This requirement implies that the quality of each board member will contribute significantly and positively to management decisions which is then translated into the firm's performance (Nicholson and Kiel, 2004; Fairchild and Li, 2005; Adams and Ferreira, 2007).

It is argued that board members with a higher age average will have much more experience compared to a younger age average. This experience is expected to positively contribute to the better performance of a firm. However, older-age board member appears to be more aggressive and dictatorial with decisions. These characteristics of board members may result in risky decision making, which may undermine a firm's performance (Carlson and Karlsson, 1970). In addition, board members with a higher age average may face more limited pressures to a changing business environment and this may hinder the implementation of more strategic decisions (Child, 1975). Even though there has been a conflicting view on the relationship between a board's level of experience and a firm's performance, a theory on restrained resources considers that board members with more experience will cope better within a business environment by working well in a group which will contribute positively to a firm's performance (Wegge et al., 2008).

There are two ways to describe board diversity: the observable diversity (tangible) and non-observable diversity (cognitive). Board directors' age, gender and ethnicity belong to the tangible diversity group and board directors' technical skills, experience, perceptions and education belong to the cognitive category. However, there is no single measure of board diversity ("Diversity on board of directors", 2009). There had been number of studies of aspects of board diversity on board membership and firm performance. Some of these studies suggest a positive relationship between board gender, racial diversity and firm financial performance (Carter *et al.*, 2003; Erhardt *et al.*, 2003). Watson *et al.* (1998) suggested

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diversity increases company innovation and creativity and therefore becomes a competitive advantage. Using cognitive diversification factors, Simons *et al.* (1999) argued that both educational level and cognitive diversification will positively affect organisational performance. Siciliano (1996) using 260 organisations found that occupational diversity of board members increases the social performance of companies. Moreover, board diversity can further explained using behavioural theory of the firm and signalling theory. Based on behavioural theory, a diversified board provides more comprehensive information and has quick decision making (Cyert & March, 1963). Amason (1996) found that heterogeneous groups have higher quality decision making than homogenous groups because the breadth of information availability in heterogeneous teams is higher than in homogenous groups. For example, Rodan & Galunic (2004) found that heterogeneous managerial knowledge from network structure significantly positively affects innovation and firm performance. Based on signalling theory, board diversity signals to investors the robustness of its corporate governance practices and quality of the firm. This was confirmed by Turban & Greening (1997) who said "diversity issues are silent messages about firms". In line with that, Fondas (2000) explained that gender and racial diversity on boards signals the company is well positioned to serve diverse markets. In recent research, Miller & Triana (2009) explained board diversity signals the following of cultural norms, hence boosts firm financial reputation and firm value. However, some studies found a significant negative relationship between board diversity and firm financial performance. Hambrick *et al.* (1996) discovered heterogenous top management group underperformance when compared with an homogenous group. They explained that due to the heterogenous group being slower in their communication and decision making processes; they negatively affect the company's competitive edge. This is consistent with Knight *et al.* (1999) who found that demographic diversity to be negatively related to agreement in decision making. Hence diversity slows down the decision making process. Miller & Triana (2009) using Fortune 500 companies found there is negative relationship between demographic diversity in the boardroom and firm reputation and innovation. In conclusion, though some empirical studies found a positive relationship between board diversity and firm financial performance, high board diversity increases communication problems. Hence, diversity increases agency conflicts in companies. Moreover, when firms are operating in high uncertainty environments this communication problem worsens agency conflicts among managers and shareholders and loses a company's competitive edge.

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Board's ownership and firm performance

Brickley et al. (1988) concluded that the board's ownership is an encouragement for board members. This encouragement will help board members supervise management in a more efficient way. Consistent with this view, Jensen and Murphy (1990), Chung and Pruitt (1996) considered that, board's ownership will improve firm's performance. Mehran (1995) presented empirical evidence that there is a positive correlation between board ownership and firm's performance. Other empirical studies such as Gedajlovic and Shapiro (1998); Bhabra et al. (2003) have also presented a non linear relationship between a board's ownership and a firm's performance. In their study, Fama and Jensen (1983) argued that contribution of board's ownership is considered as a "*two-edged knife*" in which there is an optimal level of board ownership which contributes positively to a firm's performance.

A second potentially important factor that reduces manager–shareholder conflicts is stock ownership by board members (both executive and non-executive). To the extent executive board members own part of the firm, they develop shareholder-like interests and are less likely to engage in behaviour that is detrimental to shareholders. Therefore, managerial ownership is inversely related to agency conflicts between managers and shareholders. In contrast to this notion, Demsetz and Lehn (1985) found no link between ownership structure and firm performance, and assert that there is little support for the divergence of interests between managers and shareholders. In empirical contrast to the Demsetz and Lehn (1985) findings, and in line with the beneficial effects of ownership, Morck *et al.* (1988) found that firm performance first rises as ownership increases up to 5%, then falls as ownership increases up to 25% and then rises slightly at higher ownership levels. They supported the theory that managers tend to allocate the firm's resources in their own best interests, which may conflict with those of shareholders. McConnell and Servaes (1990) examined on the relation between the distribution of equity ownership and firm value found significant curvilinear relation between *Q* and the fraction of shares owned by corporate insiders. Specifically they concluded that *Q* first increases, then decreases as share ownership is concentrated in the hands of managers and board members. A possible explanation for the nonlinearity in the ownership–performance relationship is that managers become entrenched when possessing a very high percentage of ownership. Alternative governance mechanisms, such as the corporate control market, become less effective when managers become entrenched.

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Leech and Leahy (1991) found that profitability differences between ownership-controlled (closely-held) firms compared to management-controlled (diffusely-held) firms are only marginal. Such differences are unlikely to be economically meaningful. Moreover, Conyon and Leech (1994) examined, among other things, the mitigating role of ownership concentration in the pay-for-performance relationship. They found a weak relationship between pay and performance, while ownership is found to be insignificant in mitigating this relationship. A finer ownership characteristic that should be considered is the stock ownership of non-executive directors on the board in particular. Stock ownership enhances director independence by promoting shareholder-like interests among non-executive board members. Hence, non-executive board ownership should be positively related to firm value. This notion is consistent with recent research on the role of relationship investing and institutional shareholders on management monitoring. Hermalin and Weisbach (1991) empirically investigated the role of non-executive director ownership in publicly held corporations and showed that Tobin's Q was unrelated to non-executive director ownership for a sample of 142 US-based publicly traded firms.

Summary and conclusions

This paper analysed the concept of corporate governance, the theoretical reasons for the corporate governance problem and the evidence on the existence of unsolved agency problems in corporations. Some major conclusions were that residual agency costs (Jensen and Meckling, 1976) are significant and that mechanisms for controlling the dimension of these agency costs are available and include external and internal disciplining devices. It was observed that internal mechanisms are key to sound firm stability and performance, therefore have to adopt complementary internal disciplining devices in order to minimise their total agency costs (principal-principal problem. These internal corporate governance mechanism includes the composition of the board of directors, insider ownership, large shareholders, compensation packages, board diversity, duality, and female director presence. It was also observed that these monitoring devices may carry benefits but also costs, and are not unlimited in their effectiveness at reducing agency costs. Finally, it was noted that managers can, to some degree, insulate themselves from many of these monitoring mechanisms by controlling voting rights (with or without proportionate cash-flow rights), manager-specific investments. This possibility should be taken into consideration (alongside the notion that

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firms are likely to adopt bundles of management controlling mechanisms) when modelling the analysis of a particular monitoring device or interactions between different disciplining mechanisms. In accordance with this, an increasing number of studies have been recognising the simultaneous (or interactive) nature of many of the corporate governance mechanisms, suggesting that single-handed interventions on a particular mechanism may not be feasible or effective. Along the same lines, a promising area for future research is the link between the corporate governance characteristics of firms and performance. After some encouraging exploratory results, many empirical issues will have to be addressed before one can draw strong conclusions, in particular the question of the potential endogeneity of both the corporate governance characteristics of firms and their performance.

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