

## 2

### **The Two Sides of the Governance Coin: Competition and Regulation**

Chandrasekhar Krishnamurti

#### **1. Introduction**

Corporate governance has been defined by Daily et al. (“Corporate governance”, 2003) as “the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in the organizations” (p. 371). Ostensibly, the goal of a firm in deploying its governance is to mitigate the agency conflicts among the various stakeholders, thereby enhancing the overall performance. One of the fundamental tenets of neoclassical economics posits that a firm which operates in a competitive product market and meets its capital requirements in an efficient capital market should maximise the welfare of its owners and its customers. But in the real world, the results are not that straightforward. In the words of Prowse (1996):

Creditors want to be sure that they will be repaid, which often means firms taking on less risky projects...managers would rather maximize benefits to themselves [by] preferring policies that justify paying themselves a higher salary, or divert company resources for their personal benefit or simply refuse to give up their jobs in the face of poor profit performance... Large shareholders with a controlling interest in the firm would, if they could, increase their returns at the expense of minority shareholders.

(Prowse, 1996, p. 3)

There are significant costs that arise from the divergence of the interests of the different agents. Corporate governance is the product of the relationships and interactions between these agents. An optimal corporate governance structure is one that minimises the institutional costs that arise from the conflicts of these divergent interests. These costs can be dichotomised into two sources—the complex web of agency relationships that currently define large corporations, and the impossibility of writing complete contracts between principals and agents in order to eliminate such costs. Thus, Hart (1995) characterises a governance structure as “a mechanism for making decisions that have not been specified by contract” (p. 680).

A large volume of recent research has concentrated on two critical factors related to corporate governance obtaining at the firm level. The impact of a country-level regulatory environment on the companies has been the focus of a large body of research pioneered by La Porta et al. (1998). The impact of firm-level governance on performance has also garnered considerable research attention. We posit that in addition to the regulatory atmosphere, the competitive economic environment in which a firm operates is a key determinant of firm-level corporate governance. Surprisingly, the impacts of competitive pressures as well as the interactive effects of regulatory pressures and competitive forces on a firm’s corporate governance practices have not received adequate research attention. In this paper, this lacuna is addressed by drawing upon the results of a cross-country empirical study involving firms from 15 emerging markets.

Corporate governance is deemed important due to its perceived impact on a firm’s performance and due to its role in mitigating conflicts between the various stakeholders. In the context of performance, the empirical evidence available to date regarding the impact of corporate governance is mixed. We argue that this tenuous link between corporate governance and performance is due to the competitive economic environment in which a firm operates. We posit that there are four major factors determining the economic performance of a firm. The external governance environment in which a firm operates is a major determinant of the firm’s performance.

This is often referred to as the legal or regulatory environment. The second factor is the internal governance of the firm. This factor pertains to the rules and stipulations that a firm has agreed to follow in conducting its business operations, and encompasses all types of stakeholders. The third factor that has a bearing on a firm's performance is managerial actions. There are both positive and negative managerial actions that could affect a firm's performance. Managerial slack, shirking, overconsumption of perquisites, and commitment of fraud constitute some of the negative ones. Positive managerial actions include optimal investment, financing, and risk management activities. Finally, the competitive economic environment has a bearing on a firm's economic performance. Our major focus in this paper is on a firm's internal governance, significantly affected as it is by its external regulatory environment and its competitive setting.

It is generally recognised that the primary objective of competition is to increase business efficiency via market mechanisms, consequently leading to greater customer welfare. By contrast, regulation endeavours to directly enhance customer protection in a prescriptive manner. Although their comparative merits along several dimensions have been widely examined, their influence on corporate governance choices has received little consideration. This glaring omission is surprising as this aspect is especially relevant to emerging countries such as India and China for several reasons. First, a firm's governance structure typically reflects a number of factors that are likely to be influenced by a country's competition and regulation policies—availability of human capital, existence of conflicts of interest, strength of institutions, and awareness of ethical considerations.<sup>1</sup> Second, previous research indicates that a country's characteristics are much more important than a firm's characteristics when it comes to explaining governance choices.<sup>2</sup> Third, since emerging economies such as India and China are undergoing rapid changes in their regulatory landscape and competitive environment, a study that directly examines the direct and interactive effects of regulation and competition is deemed to be extremely appropriate at this juncture. As these big emerging countries experience explosive growth, they also hastily try to improve their institutional

framework in addition to enhancing their competitiveness. In fact, the relative impacts of regulation and competition, and their interactive effects on corporate governance are of relevance to all countries that are facing rapid changes in their competitive environment.

The rest of this paper is organized as follows. The next section provides the theoretical background that is relevant for examining the relative effects of regulation and competition on the quality of a firm's corporate governance. In section 3, the hypotheses that form the basis of the empirical tests are developed. Section 4 contains a description of the data and the sample selection process. The empirical results are reported in section 5, and the concluding comments are provided in the final section.

## **2. Theoretical background**

We review below the relevant literature pertaining to the four popular theoretical frameworks of corporate governance—agency, resource-dependence, stakeholder, and institutional. This is followed by a description of the current state of research on measuring the level and variation in the quality of corporate governance. Finally, the relevant theoretical framework for characterising the key variables of regulation and competition is delineated.

### **Frameworks of corporate governance**

Our interest is in how different theories of corporate governance inform the means underlying the impact of regulation and competition on corporate governance. While agency and resource-dependence theories are associated with the competitive elements of corporate governance, institutional and stakeholder theories collectively imply that compliance with norms and mandates also drive firm-level corporate governance.

#### *Agency theory*

The classical arguments of Jensen and Meckling (1976) propose that ownership and managerial interest may not be aligned, leading to agency costs (Jensen, 1986; Jensen & Meckling, 1976). Past research posits that

the resolution of agency costs would increase a firm's performance (Daily et al., "Governance through ownership", 2003; Tsipouri & Xanthakis, 2004). Gillette et al. (2003) show that when agency costs are especially severe, having outside directors in control can prevent inefficient outcomes. Agency theory therefore also leads to the view that firms with high levels of agency are liable to face threats from other firms in the environment, through the mechanism of the market for corporate control (Jensen & Ruback, 1983). This assumes the functioning of an efficient competitive environment in which information asymmetries are negligible and competitive pressures are high. Efficient competition is also a prerequisite to the general belief that reduced agency and increased managerial efficiency would facilitate performance benefits in the form of improved market valuation. We therefore suggest that the agency theory of corporate governance is expected to explain the effects on a firm's corporate governance especially in competitive environments.

#### *Resource-dependence theory*

Boards of directors can contribute to the firm in a variety of ways such as by giving advice and the benefit of their expertise, and contributing social capital—legitimacy and links to other organisations—cumulatively described as board capital (Hillman & Dalziel, 2003). The association between board capital and a firm's performance is well documented (Dalton et al., 1999; Pfeffer, 1972), thereby making the resource-dependence view a key theory in corporate governance. Dalton et al. (1999) posit that larger boards potentially bring more value. However this view essentially presumes that firms are in a position to benefit from their board capital, implying that the organisation is an efficient one. The general proposition that such human capital is of value also presumes the existence of a reasonably efficient labour market. Similarly relational capital, such as channels of communication, is likely to be of more value in situations where such channels offer firms a competitive edge or an increased advantage over their competitors. The resource-dependence theory therefore is also best applied in competitive environments.

### *Stakeholder theory*

The concept of stakeholder management was proposed by Freeman (1984) to address the ethical and moral considerations of business in addition to the more competitive ones. These views have recently gained more popularity and have spilled into the investing community. Socially Responsible Investing is the term coined to represent investments that take ethical considerations into account in addition to profit potential. The stakeholder theory provides a role for intangible capital and is associated with better stock price performance (Kemp & Osthoff, 2007). In general, the functioning of an effective system of stakeholder management is consistent with a compliance regime utilising social norms. As such, the stakeholder theory provides links to the regulatory aspect of corporate governance.

### *Institutional theory*

The rich literature related to this theory shows that countries with institutions that protect investors better enjoy higher stock market valuations, lower cost of capital, and better access to external finance (Beck et al., 2003; Durnev & Kim, 2005; Gupta et al. 2010; Klapper & Love, 2004; Rajan & Zingales, 1998). Doidge et al. (2007) show that in countries with weak development, it is costly to improve firm-level corporate governance because the institutional infrastructure is lacking, and good governance has political costs. Gupta et al. (2010) find evidence of complementarity between country-level investor protection and firm-level corporate governance. The institutional perspective assumes that the business is adequately regulated and authorises institutions to recognise and reward firms with good governance while denying resources to badly governed ones. As such, the institutional theory links strongly to the regulatory facet of corporate governance.

The basic view of this paper is that regulation and competition directly and interactively influence firm-level corporate governance. We examine two aspects of corporate governance to conduct empirical tests—the level of corporate governance quality and the variation in corporate governance.

Our primary interest is in the level of corporate governance quality, and this stems from the plethora of evidence that suggests that better corporate governance leads to better performance (Brown and Caylor, 2006; Durnev & Kim, 2005; Peng, 2004). Academicians have made several attempts to measure the quality of corporate governance. Among these the governance index of Gompers et al. (2003), the entrenchment index of Bebchuk and Cohen (2005), and the anti-takeover index (ATI) of Cremers and Nair (2005) deserve special mention. They measure the quality of governance based on the anti-takeover measures embedded in their corporate charter. Currently there are several sources for corporate governance ratings. Principal among them are the governance ratings provided by Standard and Poor's, FTSE (ISS), Credit Lyonnais Securities Asia (CLSA), and Riskmetrics. The ISS governance scores cover developed countries. The CLSA ratings cover less-developed countries and recently emerged countries. We use the CLSA ratings to measure firm-level corporate governance.

Our second dependent variable is the variation in a firm's corporate governance from the environmental average. This measure is a proxy for within-country convergence. There are two streams of research regarding the convergence of corporate governance practices. One stream (Aguilera & Jackson, 2003) predicts that global forces will result in a convergence towards the Anglo-American model. The other stream (Bebchuk & Roe, 1999) emphasises historical path dependence advancing variation in corporate governance practices. In this paper, we look at the effects of regulation and competition on convergence in corporate governance practices. We examine within-country convergence and extract implications for the issue of cross-country convergence.

### **Regulation and competition**

We define regulation as positive legislation and mandate, designed to enhance investor and shareholder protection, as opposed to the possible interpretation of regulation as an impediment or obstacle to the efficient conduct of business. This is in keeping with previous operationalisations of regulation in terms of shareholder protection (La Porta et al., 1998), judicial efficiency, and support for business (Klapper & Love, 2004),

and also positions our paper in line with prior findings that positively associate the level of regulation in an environment with the quality of corporate governance therein. Similarly we define competition as the operation of market mechanisms which allow for the conduct of business whereby stronger competition leads to more efficient markets. Therefore conditions with strong regulation and competition in general are viewed as desirable.

Our choice of regulation and competition as the predictor variables of interest is motivated partly by emerging research and partly by practice. Social factors such as regulation as well as economic factors such as a competitive environment distinctly and interactively influence corporate governance (Aguilera & Jackson, 2003). Each of these forces shares links with the other (Aoki, 1990), and the influence of each one may even be contingent on the other (Aguilera & Jackson, 2003). Further, governance practices found in the real world tend to emerge from a confluence of the actions of managers and policy-makers. Policy-makers attempt to change the governance environment through regulation, and while managers would be concerned with regulation, they would also be strongly driven by the competitive environment in their decision-making.

### **3. Hypotheses**

We utilise the four corporate governance perspectives of the institutional, stakeholder, agency, and resource-dependence theories to develop hypotheses that relate regulation and competition to the level and the variation in corporate governance quality.

Based on the work of La Porta et al (1998, 1999), we argue that regulation should have a positive impact on the level of corporate governance quality. When regulation is strong, firms would comply with corporate governance stipulations in order to avoid potential punitive repercussions. Further, since regulations empower stakeholders, firms would try to manage them and their interests by increasing the level of corporate governance quality.



Based on the agency and resource-development theories, we posit that as competition intensifies firms may utilise corporate governance quality to gain competitive benefits such as reduced cost of capital or improved access to resources (Khanna & Palepu, 2004a, 2004b; Hail & Leuz, 2006; Chen et al., 2009; Gupta et al., 2010). We suggest that competitive forces in themselves serve to enhance corporate governance, distinct from the positive effects of regulation.

In situations where regulation is strong, firms would have already benefitted from reduced agency costs and increased access to resources. Under these conditions, firms would not find it efficient to allocate further resources to enhance corporate governance quality. They may instead direct additional resources to deal with competition. Thus we suggest that the dual benefits arising from regulation and competition may not be distinct, but the one may subsume the other when both regulation and competition are strong. Firms may even consider devoting fewer resources to enhancing corporate governance quality under conditions of intense competition. We therefore posit that the interactive effect of competition and regulation could have a negative impact on firm-level corporate governance quality.

The coercive nature of a clearly defined regulatory environment would result in isomorphism (Scott, 2001) with respect to corporate governance quality. Since the firms within a specific country environment are exposed to the same regulatory regime, we would logically expect such firms to have similar corporate governance quality. As the regulatory mandate becomes stronger, the coercive nature of this force would ensure higher compliance with prescribed standards, and would consequently reduce the variation in firm-level corporate governance quality. We therefore hypothesise that regulation has a negative effect on the variation in firm-level corporate governance quality.

In an environment of intense competition, the relative level of corporate governance quality is a crucial factor. Firms may signal their superiority through corporate governance quality to enjoy differential access to resources. Thus corporate governance could be utilised by firms to get an additional source of competitive advantage for themselves.

Overall, we expect superior firms to benefit from increased legitimacy, beneficial comparison, enhanced reputation, and therefore higher market valuation and differential access to resources. Since investment in corporate governance quality is not costless, other firms of lower standing would be unable to mimic the behaviour of superior firms. Thus we expect competition to have a positive effect on the variation in firm-level corporate governance quality.

#### **4. Data and sample selection**

The sample was selected on the basis of the availability of firm-level corporate governance scores. The data on firm-level governance was obtained from Credit Lyonnais Securities Asia (CLSA, 2002). The corporate governance scores are contained in the CLSA Emerging Markets report entitled *Make Me Holy...But Not Yet!* (CLSA, 2002), which represents the most comprehensive report quantifying the quality of governance at the firm level, and covers 495 firms from 25 emerging countries. The report categorises corporate governance into seven components—Discipline, Transparency, Independence, Accountability, Responsibility, Fairness, and Social Awareness. The aggregate score was arrived at by using weights of 15% for the first six components, and 10% for the Social Awareness component. The components and the questionnaire used for quantifying the scores are provided in the Appendix at the end of the paper. Table 1 shows the distribution of the firms over the various countries. Due to the low number of observations in three Latin American countries—Brazil, Chile, and Mexico—the firms from these countries were clubbed together, and were treated as representing the South American region collectively.<sup>3</sup>

**Table 1: Country-wise distribution of data**

<b>Environment</b>	<b>Country</b>	<b>Number of Firms in Sample</b>
Weak regulation, weak competition	Indonesia	18
	Philippines	20
	Turkey	17
Weak regulation, strong competition	India	79
	Korea	24
Strong regulation, weak competition	Latin America	45
	South Africa	40
Strong regulation, strong competition	China	25
	Hong Kong	38
	Malaysia	47
	Singapore	43
	Taiwan	47
	Thailand	20
	<b>Total</b>	<b>463</b>

These data have been well used in recent studies (Black et al., 2006; Chen et al., 2009; Doidge et al., 2007; Durnev & Kim, 2005; Klapper & Love, 2004; Krishnamurti et al., 2005). Palepu et al. (2002) in particular use the CLSA (2002) report in their study of convergence in corporate governance at the country level, and after testing, they note that the CLSA data does indeed meet the standards of reliability required. We preferred the CLSA (2002) report as our source of data on corporate governance over other available academic and practitioner indices for two reasons: a) the construction of the index with emphasis on the most number of indicators or mechanisms of governance; and b) the availability of data for as many countries as possible.

Our source of the data on the independent variables used in this study was the World Competitiveness Report (WCR, 2000), which has also been used recently by other researchers (Glaeser et al., 2001; Yiu & Makino, 2002; Wan & Hoskisson, 2003). We lagged the independent variables by a year in order to allow time for firms to respond to environmental forces. The WCR (2000) ranks countries according to four components—Government Efficiency, Economic Performance, Business Efficiency and Infrastructure—covering a total of 286 criteria. Using a standard deviation

method (SDM) that is discussed in detail in each edition of the World Competitiveness Yearbook, the criteria are scaled to compute the overall competitiveness factor and its components for each country surveyed (WCR, 2000). We used Government Efficiency (which covers 73 criteria) as proxy for the strength of coercive forces in a country, and Economic Performance (which covers 79 criteria) as proxy for the strength of mimetic forces, as these two components were best suited to capture the conditions based on mimetic and coercive influences as we conceptualised them.

The Government Efficiency component emphasises the existence, strength, and efficiency of various governmental entities, their functions and regulatory activities which capture both the presence and the strength of regulatory forces, which are particularly relevant to business. Included in this component are sub-components dealing with the nature and quality of various business legislations, the role of the central bank, and the extent of protectionism among others. We prefer this measure of overall efficacy of the regulatory environment over measures of legislation alone, to capture both the existence of mandates and their adequate and efficient enforcement. In keeping with our definition of regulation as a positive impetus to business, the Government Efficiency component accords a lower ranking to countries that have protectionist regulation which either impairs economic development (such as subsidies) or is inflexible. Political interference in judicial processes and bureaucratic inefficiency are also considered to be negative. The component also includes variables that examine the role of the judiciary, existing legislation and potential to introduce legislation, transparency, and corruption, suggesting that the Government Efficiency component of the WCR (2000) is a valid measure of regulation in the context of the present study.

Similarly, the Economic Performance component covers basic economic and competitive elements such as foreign and domestic trade, foreign investment, threats to factors of production, economic health of the economy, and potential for growth, all of which capture the overall competitive health of the country economy, and would therefore reflect the likelihood that firms would use their corporate governance mechanisms in

order to meet competitive pressures. For example, the potential to access capital markets and foreign investments, as captured by the WCR (2000), could impact firm-level corporate governance (Fiss & Zajac, 2004), and may provide incentives for firms to engage in mimetic behaviour vis-à-vis corporate governance. This component includes variables traditionally considered as indicators of the level of competition in countries such as Gross Domestic Product (GDP) and Purchasing Power Parity (PPP), as well as recent factors that are linked to competition and market efficiency such as economic resilience, real growth rates of goods and services, exports and employment, as well as Foreign Direct Investment (FDI), and outflow of investment.

We therefore identify the WCR (2000) in general, and the Government Efficiency and Economic Performance components in particular to be appropriate measures of coercive and mimetic influences for the purposes of this study.<sup>4</sup> We specifically tested these two components of the WCR (2000) against other available measures to establish their reliability. We found that our measure of regulation—the Government Efficiency component—was strongly correlated with another measure of regulation that was used in prior corporate governance research—the country measure of Legality used by Klapper and Love (2004) in their study of corporate governance (0.9,  $p < 0.01$ ). We also found that the Economic Performance component was strongly correlated with the Global Competitiveness Rankings (GCR, 2000) reported by the World Economic Forum (0.59,  $p < 0.01$ ), suggesting that the former is an accurate and reliable measure of competition.

We coded the regulation and competition scores for each country into categorical variables ('1' for strong, and '0' for weak) based on whether they fell below or above the middle rank for the population subgroup covered by the WCR (2000) (greater than or less than 20 million).<sup>5</sup> We calculated the four combinations of these two components of the environment, namely weak/strong regulation and weak/strong competition. The distribution of the countries across the four conditions is also represented in Table 1. We found that Indonesia, the Philippines, and Turkey fared poorly on both the

regulation and competition components. India and Korea exhibited strong competition, but were poor on regulation. South Africa and Latin America were strong on regulation, but weak on competition. Six of the fifteen countries in our sample exhibit strong regulation and strong competition. While we expected economies such as Singapore, Hong Kong, and Taiwan to belong to this category, we found it particularly interesting to see that China, Malaysia, and Thailand were also included in this group.

The corporate governance scores of firms and the variance of corporate governance scores are the dependent variables for the tests of our hypotheses. We measured firms' corporate governance using the weighted average of the seven components of the CLSA corporate governance scores. The variation in corporate governance scores of firms is sensitive to both the number of firms in the country, as well as the difference in the corporate governance scores of the firms. The sum of the values of this variable for all the firms in a particular country would give the variance of the corporate governance scores for all the firms in that country in our dataset. Variance in CG is defined as follows:

$$\frac{(\text{Country Average CG} - \text{score Firm CG Score})^2}{N_{\text{country}} - 1}$$

### **Control variables**

Since our hypotheses broadly examined the social and economic contexts of corporate governance, there remained little by way of environmental factors that did not come under the purview of these two variables. We were aware that the inclusion of further variables in our model could result in over-specification; on the other hand this could contribute positively to the statistical outcomes of our tests. In order to avoid such potential over-specification, and also bearing in mind that the focus of our testing was predictive as opposed to explanatory, we consciously traded off the explanatory potential of our model as a whole for accurate predictive capability.

However, given that our process of calculating the two independent variables—regulation and competition—involved rankings which were

bifurcated on the basis of country size, we included a control variable to capture the potential effects of the same. We controlled for country size using a simple categorical variable which had a value of '0' if the population of the country was less than 20 million, and a value of '1' if the population was 20 million or greater (following the WCR (2000) classification of country size). We specifically did not control for industry- and firm-level effects in the interests of parsimony. Recent literature suggests that the specific industry does not seem to affect corporate governance, with the exception of the distinction between financial services and non-financial services (Doidge et al., 2007; Palepu et al., 2002).

## **5. Summary of empirical results**

We used a lag of a year between the independent and dependent variables. This was done to ensure that the firms had the time and opportunity to react to environmental changes through their corporate governance practices. We performed OLS regressions to test the validity of the hypotheses developed in section 3. We used a partial Gram-Schmidt transformation procedure to orthogonalise the interaction variable (regulation x competition). This was done to ensure its mathematical independence from other predictor variables. For robustness checks, we used the GLM-Multivariate analysis to simultaneously estimate the effects of the independent variables on both the dependent variables. Our results were qualitatively similar. The results of our hypotheses tests are summarised below.<sup>6</sup>

### **Differences across countries**

In countries where regulation is strong, one would expect firms to comply with the best practices of corporate governance so as to minimise the chances of punitive action from the regulator. That is, regulation should have a positive impact on the quality of corporate governance. Similarly, when competition is strong, high-quality governance choices can attract favourable attention and enhance company legitimacy in the eyes of the investors. Consequently, firms may use corporate governance as a means of gaining a competitive benefit such as a lower cost of capital, or better

access to resources, i.e., competition should also have a positive impact on the quality of corporate governance.

These hypotheses are only partly supported by the data. Although stronger regulation does indeed have a positive effect on firm-level governance scores, our empirical results do not support the predicted positive impact of competition on firm-level corporate governance scores. Thus the results of our study imply that a competitive business environment does translate into a higher corporate governance score for the typical firm. Furthermore, empirical evidence supports a negative interactive effect of regulation and competition on firm-level corporate governance scores. Our results imply that for a typical firm in a country with strong regulation, a more competitive environment results in a lower corporate governance score.

### **Differences within countries**

Also of interest is the variation in the quality of governance choices within a given country. It is expected that where regulation is strong, its coercive nature should ensure higher compliance with prescribed behaviour (including governance choices), and consequently reduce diversity in corporate governance within a given country. On the other hand, a competitive business environment is characterised by an efficient and rapid transmission of information; it is an environment in which firms have incentives not only to exhibit good governance but also to display governance that is better than that of their competition. The relative quality of governance is important and a typical firm in this environment would seek to derive significantly more benefits from corporate governance than its competitors. This tendency to search for an edge over competitors should lead to greater diversity in governance choices.

Our results indicate that this is exactly what happens—all else being equal, the variation in corporate governance scores is significantly greater in strong-competition countries, but significantly less in strong-regulation countries. There appear to be two distinct forces at work which act in opposite directions. One of them arises from regulatory strictures



and engenders convergence, i.e., the tendency of firms to compete in achieving the highest corporate governance scores. The other force occurs due to competitive pressures and produces a divergence in corporate governance scores. The results of our empirical work suggest that some firms operating in a competitive environment need to display superior corporate governance quality as compared to their peers in order to gain access to resources, and enhance their credibility. This tendency to increase relative corporate governance scores is the underlying driving force for the observed divergence.

## **6. Conclusion**

We draw upon multiple theories of corporate governance to examine the effects of competition and regulation on firm-level corporate governance quality. We find that regulation enhances firm-level corporate governance and within-country convergence. Competition has a negative effect on corporate governance. The interactive effect of regulation and competition is negative on firm-level corporate governance. Furthermore, competition reduces within-country convergence.

Internal, i.e., firm-level governance choices are significantly influenced by external (country-level) choices. This suggests that governance choices are likely to converge across countries while simultaneously diverging within countries. For example, while firms in the top governance score cluster of each country will be different from lower-scoring clusters of firms in the same country, the similarity of the competition-regulation environment in which they operate means that these firms are likely to be very similar to firms in the top governance clusters of other countries.

Our paper makes two significant contributions. First, it provides an integrative view of corporate governance that incorporates factors contributing to the variation in corporate governance across countries. Second, we contribute to the debate on within- and cross-country convergence of corporate governance. While some researchers pontificate on the eventual convergence of global corporate governance practices, others have their own doubts. The latter viewpoint is reinforced by

studies on temporal convergence in corporate governance which reveal significant cross-country variation due to path-dependence in the evolution of corporate governance practices. We provide an economic argument, namely that competition detracts from within-country convergence in corporate governance.

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## Notes

<sup>1</sup> These factors are the respective subjects of four popular theoretical frameworks of governance—resource dependency, agency, institutional, and stakeholder.

<sup>2</sup> See Doidge et al. (2007) for a detailed discussion.

<sup>3</sup> The values of the independent variables—regulation and competition—were found to be similar for these three countries, as were the values of the dependent variables. We therefore contend that aggregating data from these three countries into a single region is appropriate.

<sup>4</sup> The Infrastructure and Business Efficiency components were examined for the relevance of their constituent elements, and were found to be less relevant to the issue under examination in this paper, as compared to the two components that we used.

<sup>5</sup> The bifurcation of rankings according to country size for the year 2000 was made available retrospectively by IMD in 2003, and was advised as a more accurate representation of the relative position of countries as per the WCR (2000).

<sup>6</sup> For further details of the test results, see Udayasankar et al. (2005).

### Appendix

The 57 questions addressed to analysts in the evaluation of firms' corporate governance by the CSLA are listed below.

<b>Discipline (15%)</b>	
1	Has the company issued a mission statement that explicitly places priority on good corporate governance, or has the company or management publicly articulated principles of good corporate governance that it is committed to maintaining?
2	Is the senior management incentivised to work towards a higher share price for the company? E.g. is more than 50% of net worth of CEO or controlling family in the company's equity, or is at least 50% of expected remuneration for the top executive(s) tied to the value of the shares?
3	Does the management stick to clearly defined core businesses?
4	a) What is the management's estimate of its cost of equity? b) Is the management's view of its cost within 10% of a CAPM derived estimate?
5	a) What is the management's estimate of its weighted average cost of capital? b) Is the management's estimate of its cost of capital within 10% of our estimate based on its capital structure?
6	Over the past five years, is it true that the company has not issued equity, or warrants for new equity, for acquisitions and/or financing new projects where there was any controversy over whether the acquisition/project was financially sound, or whether the issue of equity was the best way of financing the project? Is it true that there is no reason to be concerned on these grounds about the issue of equity/warrants for new equity in the foreseeable future?
7	Does the senior management use debt for investment/capex only where ROA (or average ROI) is clearly higher than cost of debt and where interest cover is no less than 2.5? In using debt, has the management always shown sensitivity to potential asset-liability duration and currency mismatches?
8	Over the past five years, is it true that the company has not built up cash levels through retained earnings or cash calls that have brought down ROE?
9	Does the company's annual report include a section devoted to the company's performance in implementing corporate governance principles?
<b>Transparency (15%)</b>	
10	Has the management disclosed three- or five-year ROA or ROE targets?
11	Does the company publish its annual report within four months of the end of the financial year?
12	Does the company publish/announce semi-annual reports within two months of the end of the half-year?
13	Does the company publish/announce quarterly reports within two months of the end of the quarter?

14	a) In the past twelve months, what is the longest time period between the board meeting to accept results for a period (quarterly/half-yearly/finals), and the announcement of the results? b) Has the public announcement of results taken no longer than two working days after the board meeting? Is it true that there has not been any case in the past five years when the share price moved noticeably just before the release of results, and in a direction that anticipated the results?
15	Are the reports clear and informative?
16	Are the accounts presented according to IGAAP? Are the accounts free of substantial non-IGAAP compliant qualification?
17	Does the company consistently disclose major and market sensitive information punctually? Is it true that the company has not in the past five years ever failed to disclose information that investors deemed relevant in a timely fashion?
18	Do analysts have good access to senior management? Good access here implies accessibility soon after results are announced, and timely meetings where analysts are given all relevant information and are not missed.
19	Does the company have an English language Website where results and other announcements are updated promptly (no later than one business day)?
<b>Independence (15%)</b>	
20	Is it true that there has been no controversy or questions raised over whether the board and senior management have made decisions in the past five years that benefit themselves at the expense of shareholders?
21	Is the chairman an independent, non-executive director?
22	Does the company have an executive or management committee that makes most of the executive decisions, which is substantially different from members of the board and not believed to be dominated by major shareholders?
23	Does the company have an audit committee? Is it chaired by a perceived genuine independent director?
24	Does the company have a remuneration committee? Is it chaired by a perceived genuine independent director?
25	Does the company have a nominating committee? Is it chaired by a perceived genuine independent director?
26	Are the external auditors of the company seen to be completely unrelated to the company in other respects?
27	Does the board include no direct representatives of banks and other large creditors of the company?
<b>Accountability (15%)</b>	
28	Are the board members and members of the executive/management committee substantially different such that the board is clearly seen to be playing a primarily supervisory role as opposed to an executive role?

29	Does the company have non-executive directors who are <i>demonstrably and unquestionably independent</i> ?
30	Do independent, non-executive directors account for more than 50% of the board?
31	Are there any foreign nationals on the board who are seen as providing added credibility to the board's independence?
32	Are full board meetings held at least once a quarter?
33	Are board members well briefed before board meetings? Are they provided, as far as the analyst can tell, with the necessary information for effective scrutiny of the company prior to the meeting, in a clear and informative manner?
34	Does the audit committee nominate and conduct a proper review of the work of the external auditors as far as the analyst can tell?
35	Does the audit committee supervise internal audit and accounting procedures as far as the analyst can tell?
<b>Responsibility (15%)</b>	
36	If the board/senior management have made decisions in recent years seen to benefit themselves at the expense of shareholders, has the company acted effectively against the individuals responsible and corrected such behaviour promptly, i.e., within six months?
37	Does the company have a known record of taking effective measures in the event of mismanagement? Over the past five years, if there were flagrant business failures or misdemeanours, were the persons responsible appropriately and voluntarily punished?
38	Are there any controversies or questions over whether the board and/or senior management take measures to safeguard the interests of all and not just the dominant shareholders?
39	Are there mechanisms to allow punishment of the executive/management committee in the event of mismanagement as far as the analyst can tell for certain?
40	Is it true that there have been no controversies/questions over whether the share trading by board members have been fair, fully transparent, and well intentioned?
41	a) How many members are on the board? b) Is the board small enough to be efficient and effective?
<b>Fairness (15%)</b>	
42	Is it true that there have not been any controversies or questions raised over any decisions by the senior management in the past five years where majority shareholders are believed to have gained at the expense of minority shareholders?
43	Do all equity holders have the right to call General Meetings?
44	Are the voting methods easily accessible?



45	Is all the necessary information made available prior to the General Meeting?
46	Is the senior management unquestionably seen as trying to ensure fair value as reflected in the market price of the stock, by guiding market expectations about fundamentals in the right direction through frank discussions on risk/returns, actions like share buy-backs, investor meetings, etc?
47	Is it true, over the past five years, that there have been no questions or perceived controversy over whether the company has issued depositary receipts that benefited primarily major shareholders, nor has the Company issued new shares to investors near peak prices, nor have the major shareholders sold shares near peak prices without prior guidance to the market on why such shares are seen as fully-valued?
48	Does the majority shareholder group own less than 40% of the company?
49	Do foreign portfolio managers and/or domestic portfolio investors who have a track record in engaging management on CG issues own at least 20% of the total shares with voting rights?
50	Does the head of Investor Relations report to either the CEO or a board member?
51	a) What is the total remuneration of the board as a percentage of net profit after exceptionals? b) Over the past five years, is it true that the total directors' remuneration has not increased faster than net profit after exceptionals as far as the analyst can tell?
<b>Social (10%)</b>	
52	Does the company have explicit public policy statements that emphasise strict ethical behaviour, i.e., one that looks at the spirit and not just the letter of the law?
53	Does the company have a policy/culture that prohibits the employment of the under-aged as far as the analyst can tell?
54	Does the company have an explicit equal employment policy, i.e., no discrimination on the basis of sex, race, religion, etc?
55	Does the company adhere to specified industry guidelines on sourcing of materials as far as the analyst can tell?
56	Is the company explicitly environmentally conscious? Does it promote the use of environmentally efficient products, or take steps to reduce pollution, or participate in environment-related campaigns?
57	Is it true that the company has no investments/operations in Myanmar?