CORPORATE GOVERNANCE IN EMERGING MARKETS AND ITS IMPACT ON FINANCE PERFORMANCE

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Abstract

This paper reviews the theoretical framework of Corporate Governance and multiple issues in which it is evaluated such as agency costs, asymmetric information, insider trading, manipulation of earnings, Board of Directors, etc. Finally, it is reviewed the impact of Corporate Governance over cost of equity, capital structure and financial performance.****

Keywords: OECD, Corporate Governance, CAF, Treasury, Asymmetric Information, Capital Market, Finance Performance, Treasury Ethics, Board of Directors, Cost of Equity, Capital Structure

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1. Introduction

To set up a unique definition to Corporate Governance could be a hard task. Different kinds of academic authors and institutions defined it into many ways.

Back in the 90ths, Cadbury Committee (1992) defined Corporate Governance as "the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting".

As per, the Organization for Economic Co-operation and Development (OECD) (2004) defined it more recently as "procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making."

However, the main purpose of Corporate Governance is to prevent one group of shareholders from expropriating the cash flows and assets of one or more other groups. It is all about governing corporations in such a transparent manner that all stakeholders" interests are protected, and with due compliance with the laid down laws. (Bhardwaj and Raghavendra Rao, 2014), so does corporate governance improve corporate performance? and it helps to reduce or mitigate the enterprise risks?.

2. Principles of Corporate Governance OECD Principles:

The OECD Principles of Corporate Governance (2004) are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The Principles focus on publicly traded companies, both financial and non-financial.

- Ensuring the Basis for an Effective Corporate Governance Framework: The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
- The Rights of Shareholders and Key Ownership Functions: it should protect and facilitate the exercise of shareholders' rights. For example, basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and

remove members of the board; and 6) share in the profits of the corporation.

- The Equitable Treatment of Shareholders: it should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. All shareholders of the same series of a class should be treated equally and also insider trading and abusive self-dealing should be prohibited.
- The Role of Stakeholders in Corporate Governance: It should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- Disclosure and Transparency: it should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. It is welcomed an annual audit within the company. It should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.
- The Responsibilities of the Board: it should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Among its main duties: 1) Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders; 2)Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly; and 3) The board should apply high ethical standards. It should take into account the interests of stakeholders.

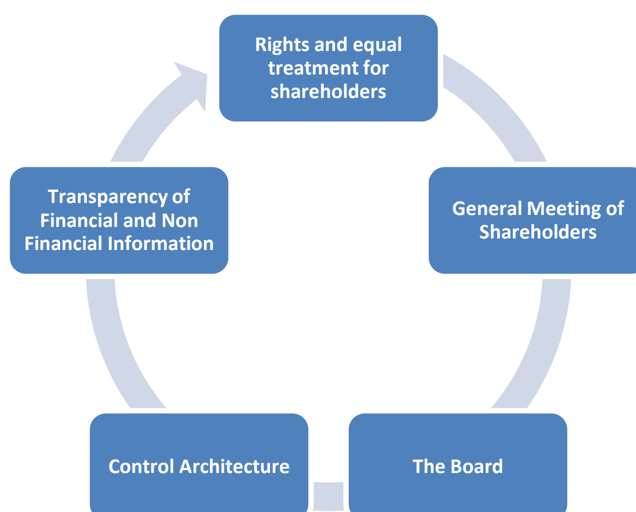
Also, the OECD Principles of Corporate Governance could be summarized as:

- Equal treatment and the protection of the interests of all shareholders.
- Recognition of the existence of third parties with interests in the corporation and its permanence.
- Responsible issuance and revealing of information as well as the transparency in the administration.
- Assurance that there are strategic guidelines in the corporation, effective monitoring in the administration and the fiduciary responsibility of the Board of Directors.
- Identification and control of risks the Corporation might face.
- The declaration of the ethical principles and social responsibility of the corporation.
- Prevention of illicit operations and conflicts of interest.
- Revealing wrongful actions and protecting the informants.
- Compliance to regulations that the corporation is held accountable for.
- Inspiring trust to the shareholders and stakeholders interested in the honest and responsible business actions the Corporation will engage in.

CAF Principles:

The Corporation Andina de Fomento (CAF) (2013) also established 43 principles of Corporate Governance. They were divided among five chapters that are summary up in the following figure:

Figure 1. Principles of Corporate Governance of the CAF



3. Treasury Ethics and Corporate Governance

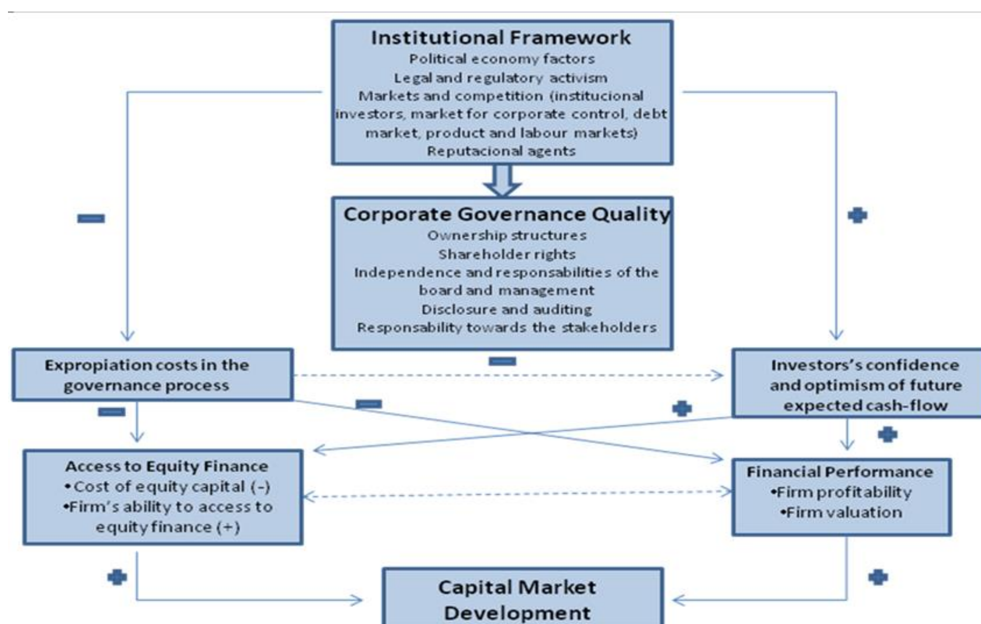
There are multiple situations in which Corporate Governance and daily trading in the capital market is evaluated and it has been review as many authors. For example, one main topic is the agency theory. Daily, Dalton and Cannella (2003) commented that is issue is very review due to two factors. First, it is an extremely simple theory, in which large corporations are reduced to two participants-managers and shareholders---and the interests of each are assumed to be both clear and con-sistent. Second, the notion of humans as self-interested and generally unwilling to sacrifice personal interests for the interests of others is both age old and widespread.

Also, it has been proven that by implementing corporate governance a company benefits economically.

Gruszcznski Marek (2006) made a study among 53 companies listed in Poland. It indicated that the degree of corporate governance for listed companies in Poland is correlated with their financial performance. Its study has shown a significant relationship between their governance rating, operating profit and debt leverage ratio. The results of study have shown that companies with higher profit margin and lower debt leverage ratio are expected to have better rating of corporate governance.

Even Haque, Arun and Kirkpatrick (2008) conclude the following: "*According to the economic approaches to corporate governance, better firm-level corporate governance not only reduces the agency costs, but also enhances the investors' optimism in the firm's future cash-flow and growth prospects. 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*".

Figure 2. Haque et al. (2008) summary up all the Institutional Framework for capital market and its influence to Corporate Governance



Another main topic on daily trading and corporate governance is asymmetric information. Corporate governance and systems for mitigating self-serving activities by company insiders receive considerable attention. One area of concern for regulators and the investing public is the risk and potential cost of buying or selling a stock when some traders have private information about the value of the firm. Informed trading includes trades by insiders plus trades by outsiders that are motivated by information superior to that of the public investor. (Jackson, Dutta and Nitani, 2008).

In order to eliminate the asymmetric information risk, some countries has implemented several prevention measures. For example, in the UK, the LSE Model Code prevents corporate insiders from trading during a blackout period, which consists of the two months preceding final or interim earnings announcements and the month prior to quarterly earnings announcements. This rule imposes severe restrictions on the trading activity of corporate

insiders, because it prohibits trading for six months of the year. It is thus an important question whether these trading restrictions are warranted. The rule is obviously based on the assumption that informational asymmetries are particularly large prior to earnings announcements. This situation varies according countries. On the other hand, in Germany, no blackout period exists. (Betzer and Theissen, 2009).

But, is not insider trading a benefit of employees inside a company? Is it part of their compensation? For Jackson et al. (2008), CEOs are compensated explicitly, through cash payments and stock options, and implicitly, through perquisites and other indirect means. One component of implicit payment is insider trading Carlton and Fischel (1983) view insider trading as a possible element of an efficient contract between investors and management. Noe (1997) shows that contracting directly to ensure manager effort can be more costly than the use of insider trading.

Another main topic on daily trading and corporate governance is manipulation of earnings and financial results by one majority group of shareholders. Igan and Pinheiro (2010) investigate about this topic and found out several issues. First, the higher the proportion of shares owned by insiders, the smaller would be the analysts' optimism for forecasting. Additionally, their analysis suggests that institutional investors can profit because of earnings manipulation and may appear to anticipate the analysts' forecasting mistakes. This characteristic of our model implies a negative relation between institutional trading and the analysts' forecast errors. More precisely, institutional investors would take advantage of the "under-pricing" in the market induced by the low forecasts and buy stocks, selling for a higher price after the "positive" surprise. Empirically, this has two implications.

First, ownership of these investors increases when analysts exhibit pessimism. In other words, forecast errors are negatively correlated with trades ("frontrunning"). Second, institutional investors buy after the forecast, at a low price, and sell after a price increase exploiting the positive earnings surprise, so their trades correlate positively with contemporaneous returns ("positive feedback trading").

Once again, their empirical evidence supports both of these implications. Finally, in their model, the managers' ability to manipulate earnings is inversely related to the quality of corporate governance in the company. Managers of companies with better corporate governance are less likely to manipulate earnings. As a conclusion, their empirical results would be accentuated for poorly governed firms. We find strong supportive evidence for this hypothesis using an index of shareholder power and conclude that good governance can provide companies with the ability to circumvent some of the negative effects of stock-price-sensitive pay packages.

Gallagher, Gardner, and Swan (2013) summarized another issues about institutional shareholders. Bennett, Sias, and Starks (2003) find that changes in institutional demand affect future prices, indicating that institutional investors possess information; however, their study does not address whether specific trading patterns incorporate information.

Sias, Starks, and Titman (2006) find evidence to suggest that institutional investors possess better information, on average, and that security prices incorporate their information when they trade. In particular, they find the number of institutional traders plays an important role in determining quarterly returns, even though some of these traders are relatively small, supportive of our as well as and focus on the number of informed traders.

Finally, Jackson et al. (2008) indicated that with the shift to investing through mutual and pension funds, it is becoming more common to find outside investors who hold large blocks, but do not sit on the board of directors. Shleifer and Vishney (1986) predict that, all else equal, the presence of a large block-holder will have a positive effect on the market value of the firm. The potential takeover threat that large block-holders can exert works as an effective device for monitoring management.

What about of external members of the Board of Directors? Daily et al.(2003) remarked outside directors who are also executives of financial institutions may as-sist in securing favorable lines of credit (e.g., Stearns & Mizruchi, 1993); outside directors who are partners in a law firm provide legal advice, either in board meetings or in private communication with firm executives, that may otherwise be more costly for the firm to secure. The provision of these resources enhances organizational functioning, firm performance, and survival.

As complementation Haque et al. (2008), summary up a review of literature about Corporate Governance and its relation with cost of equity, capital structure and financial performance into three different tables.

a. Cost of equity: In the theoretical assumption of no transaction or agency costs, the Capital Asset Pricing Model (CAPM) predicts that the cost of equity capital only depends only on the level of covariance risks of the world market portfolio and the country's risk. However, this not often true due transaction and agency costs. The empirical studies suggest that better corporate governance quality reduces a firm's cost of equity capital, which in turn enhances the firm's access to equity finance. This is probably because outsiders are likely to provide more finance and expect lower rates of return if they are given greater assurance (trough better governance) of a return on their investment.

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

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)	Ixgal determinants of the return on equity	• Shareholder rights is negatively associated cost of equity capital • 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 • Firms with more transparency and more independent audit committee have lower COE • Ownership concentration is positively linked with COE • Board independence and % of board that own stock are negatively linked with COE
Chenet 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 • Strengthening overall CG is more important than adopting better disclosure policy

Source: Haque et al. (2008)

b. Capital Structure: A review of literature suggests 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).”

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

Author (s)	Sample (Period)	Focus of the	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 • 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	• 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 • Weak CG and crony capitalism contributes to
Kumar (2005)	2.000 Indian firms (1994- GO)	CG and firm financing	• Firms’ with dispersed shareholding have higher leverage • Firms’ with higher FS and lower institutional shareholding have lower debt
Jirapom and Gleason (2005)	4,638 firm-yr obs. from IRRC (non-fin) (1993-02)	Shareholder rights and capital structure	• Firms with more restricted shareholder rights have higher leverage • Supports the view that leverage helps alleviate
Alba *et al.* (1998)	357 Thai firms (1994-97)	Corporate fin. and CG	• OC is positively linked with leverage

Source: Haque et al. (2008)

c. Financial Performance: Over this relationship Haque et al. (2008) comment the following: “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."

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 *etal.* (2006)	515 firms, Korea (2001)	CG and firm value	• CG has a positive influence on firm value • Better CG is less likely to predict higher firm profitability
Drobetz *et al.* (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 *et al.* (2003)	1,500 large firms (S&P) (1990s)	CG and equity prices	• Finns with stronger shareholder rights have higher firm value, higher profits and higher sales growth
Thompson and Hung (2002)	83 firms, Singapore (2001)	CG and coiporate performance	• Positive relationship between ownership concentration (OC) and profitability • Both CGI and non-executive chairman are negatively associated with profitability
Gugler *et al.* (2003)	19,010 non-fin S&P films (1996-01)	CG and investment returns	• Finns in countries with strong CG systems, strong accounting standards and strong enforcement have higher returns on investments
Gugler *et al.* (2001)	19,000 firms, 6 (economies (1996- 01)	CG and investment returns	• Managers' shareholding and cross-shareholding are negatively linked with investment perfonnance
LLSV (2002)	539 large firm, 27 wealthy economies	Investor Protection and Valuation	• Finns 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 films (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	• Finns 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 et al. (2003)	100 firms, China (1997-99)	Valuation and ownership	• No relationship between OC and firm value • Institutional shareholding is positively linked with firm value
Alba etaL (1998)	357 firms, Thailand (1994-97)	Coiporate financing and CG structure	• Finns 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 • 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 perfonnance, although to some extent, inconclusive
Morck et al. (1988)	370 firms, Fortune500 (1980)	Management ownership and firm value	• Non-monatomic relationship between firm value and DS
Bphren and 0degaard (2003)	1,057 firms in Norway (1989-97)	CG and performance	• Insider ownership (IO) improves valuation unless the stake is unusually big
Agarwal and Knoeber (1996)	Forbes 800 firms (1987)	Performance and control	• Presence of non-executive directors is negatively linked with firm value
Kiel and Nicholson (2003)	348 firms, Australia (1996)	Board comp, and Performance	• BS and non-executive directors are positively related with firm value
Ong et al. (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 nonexecutive chairman, but not related with non-executive directors
Brickley et al. (1997)	737 large US firms (1988)	Separation of CEO and Chairman	• No evidence that CEO duality has inferior performance • Cost of dual leadership is higher in large firms

4. Conclusions

The paper outlined the theoretical framework of Corporate Governance. It is a review of literature. First it is presented a mix of definition about the topic and the OECD and CAF principles of application over firms. Then it is there multiple situations in which Corporate Governance is analyzed such as agency costs, asymmetric information, insider trading, manipulation of earnings, Board of Directors, etc.

Corporate governance generally refers to the mechanisms, processes and relationships by which companies are directed and controlled. This causes organizations to make better decisions, which in the medium term can be reflected in improved financial results, ie there is a value creation, so corporate governance helps to improve the corporate performance.

Besides, the governance structures benefit, because the government implemented called "corporate", helps to identify the distribution of rights and responsibilities among different participants in the company (for example, the board of directors, managers, shareholders, creditors, auditors , regulators and other stakeholders) and includes the rules and procedures for making decisions on corporate affairs.

Another benefit of good corporate governance is to improve access to new capital (debt or equity). The better and more transparently an organization is managed, the more accountable the stewards of the company are for the allocation of capital and the generation of returns from it, the better it is able to raise capital at favorable or lower interest rates, so the corporate governance helps to mitigate the risk in the companies

Finally, it is explained the impact of Corporate Governance over the cost of equity, capital structure and the financial performance of a firm.

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