

Determinants of the corporate governance of Korean firms

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Abstract

This paper investigates the determinants of the corporate governance of the firms listed on the Korea Exchange. We find that controlling shareholders has a negative effect on the corporate governance of their firms, while institutional or foreign shareholders exercise positive roles even though their effect is limited. The empirical results imply that internal corporate governance mechanism as a monitoring tool may not work due to resisting controlling shareholders, and that the exploitation of minority shareholders by controlling shareholders may persist. It suggests the need for regulatory intervention in setting corporate governance, and also for an active market for control to complement malfunctioning internal governance mechanism.

Key Words: Corporate governance; controlling shareholders; institutional investors; foreign investors; board of directors; corporate governance scores

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1. Introduction

In this paper, we investigate whether controlling shareholders purposefully intervene in the early stage of determining the corporate governance structure of their firms and succeed to manipulate it to their advantage. Our conjecture is that controlling shareholders would affect the governance structure of their firm since they usually control the board of directors, which has the ultimate power to decide the overall structure of corporate governance. In this sense, controlling shareholders of a firm with a concentrated ownership structure are harder to be monitored or checked for their misbehaviour than are professional managers.

For the analysis, we use those firms listed on the Korea Stock Exchange as sample firms. Korean firms are interesting subjects of analysis since most of the listed companies on the Korea Stock Exchange have controlling shareholders, a feature that differentiates them from the keiretsu of Japan. The controlling shareholders of Korean firms actively participate in the management of their companies as well as dominating the board of directors, and so are properly called ‘owner-managers’.

The Korean firms also provide an advantage in overcoming the endogeneity problem in the analysis of the relationship between ownership and corporate governance. While ownership structure generally affects governance structure, governance structure also affects ownership structure in a long run. For example, institutional investors would prefer to invest in companies with good corporate governance, which in turn increases the ownership of outside investors.

In dealing with the endogeneity issue, researchers generally use two or three stage simultaneous models, but harder part of such a model is to find an instrument variable that is closely related with one dependent variable, but not so with other dependent variables. However, in Korean case, the corporate governance mechanisms have been introduced only recently and the data allows us to resort to one-direction empirical analysis.

For the convenience of analysis, we select two measures of corporate governance that can be easily identified and quantified. They are the proportion of outside directors on the board of directors, and the corporate governance scores surveyed by the Korea Corporate Governance Service, a public entity under Korea Stock Exchange. As conjectured, the empirical analyses show that insiders strongly resist the introduction of new governance schemes that will improve the monitoring of their behaviour, despite the efforts of outside shareholders and regulatory authorities to strengthen the monitoring system.

After this introduction, section 2 overviews existing literatures, section 3 develops hypotheses for empirical tests, section 4 describes the data and the empirical results, and section 5 concludes with some policy implications.

2. Existing Literatures

Many papers have dealt with the determinants of corporate governance. Weisbach (1988) and Klein (2002) look into the incentives of insiders and show that there exists a negative correlation between the ownership of managers and the proportion of outside directors on the boards of directors, or on audit committees. Shivdasani and Yermack (1999) claim that CEO exercises major influence on the selection of new directors when the ownership distribution of his firm is dispersed, while it is the controlling shareholder under concentrated ownership structures. Recently, Durnev and Kim (2003) show that firms with good investment opportunity, higher sales growth rates and higher dependency on external financing would maintain a better corporate governance not to lose those good investment opportunities. However, their focus is not on the incentives of controlling shareholders, and they use governance scores, as evaluated by outside institutions, as a proxy for corporate governance, while we use specific governance schemes in addition.

In this paper, we focus on the incentives of controlling shareholders and outside investors. This paper tests two competing hypotheses regarding the relationship between ownership and corporate governance. First, it would be a natural choice for a firm to optimize on the use of governance mechanism since it is costly, and there would be a substitution effect between governance and the concentration of ownership. For example, institutional investors can be a good monitor on the management and as such they can substitute for other governance mechanism such as outside directors. Second, block shareholders who have major ownerships in their firms might prefer a stronger monitoring system to protect their stakes, in which case we would observe a positive correlation between block ownership and governance, which we term as a complement hypothesis. This paper tests whether specific types of investors tend to substitute for governance mechanisms or reinforce them.

The Korean economy is an interesting subject of analysis since it is dominated by chaebols and controlling families. The controlling shareholders of Korean chaebols maintain their control with the help of affiliated ownerships as well as their family ownerships. As of the end of 2001, the average family ownership for those firms that belong to the 30 largest chaebols in Korea is 8.27%, while their average affiliated ownership is 20.1%. On the other hand, for those firms that do not belong to the largest 30 chaebols, the numbers are 21.51% and 10.79% respectively, showing a reversed pattern of ownership structure between chaebol firms and non-chaebol firms. In either case anyway, no outsider could possibly challenge their control, mainly due to the interlocking ownership structures among affiliates, even though their capability and integrity as managers were in doubt.

3. Hypotheses and Variables

This section develops empirical hypotheses that relate corporate governance to firm characteristics based on existing theories and empirical results, and identifies variables that will be used to test the hypotheses.

3.1. Ownership and Corporate Governance

Ownership structure is a part of corporate governance in its broad sense, and it also affects other elements of corporate governance. Controlling shareholders have a strong incentive to monitor the management of firms and can be the most important part of corporate governance. Existing theories and empirical studies that analyze ownership structure generally identify block shareholders such as corporate shareholders, institutional investors and financial institutions as monitors in addition to controlling shareholders.

In this paper, block shareholders are assumed to affect the corporate governance of a firm in two ways, which lead to two competing hypotheses. The first one, which we term the ‘substitute hypothesis’, assumes that higher ownerships of block shareholders would act as a substitute for other governance mechanisms as the latter incurred costs to companies. Firms thereby adjust the level of corporate governance given the monitoring role of block shareholders. This would be more the case if block shareholders actively monitored the management of their firm.

On the other hand, as Durnev and Kim (2003) have claimed, higher ownership may induce block shareholders to further improve the corporate governance of their firm as they will have a larger economic stake to protect. This is what we call the ‘complement hypothesis’.

It is our conjecture that one of these hypotheses would more likely hold depending on who the block shareholders are. A controlling shareholder who usually participates in the management of his firm may not find it palatable to have a governance structure which monitors the management too tightly if he derives private benefit of control. This, however, would not be true for institutional investors who have no such control benefits and only seek higher firm value.

Therefore, we may observe a less strict monitoring mechanism with increasing ownership by controlling shareholders, which we may alternatively term the ‘control hypothesis’ to further differentiate it from the substitute hypothesis, as their purpose is not to save monitoring costs, but to secure more control. Of course, it is not easy to differentiate between these two hypotheses empirically since we would observe the same direction of signs for the coefficients

for the controlling ownership variable in both cases. We test diverse empirical models and use proxy variables to obtain a better understanding of the incentives of controlling shareholders.

We also analyze the role of ownership by affiliated companies, which provides interesting information about the incentives of controlling shareholders. As affiliated firms are under the control of controlling shareholders and usually do not intervene in the management of other affiliates, their existence would not substitute for the internal monitoring function. Therefore, if we observe a negative effect of affiliated ownership on the governance scheme, that is a strong indication that controlling shareholders exploit the affiliated ownership only to fortify their control by resisting outside monitoring.

La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999) interpreted affiliated ownerships as representing the discrepancy between the cash rights and the control rights of controlling shareholders, which tends to lower firm value. We interpret the affiliated ownership as a device to resist the introduction of a new monitoring mechanism, thus eventually leading to lower firm value.

It would also make some difference if a block shareholder assumed a management position and so officially participated in the management of his firm. A dummy variable, which takes a value of 1 if the CEO has more than 5% ownership and 0 otherwise, would be used.¹ We conjecture that its coefficient would be negative as the owner-manager would have a stronger incentive to resist outside monitoring since he is now more of a manager than a shareholder. On the other hand, controlling shareholders in Korean firms are supposed to have full control of the management even if they have no official positions. In this case, the CEO dummy may not have any effect on the governance of a firm.

One technical issue that needs to be resolved concerns the use of ownership variables in the empirical model. We have considered only the effect of ownership on corporate governance in the discussion. But, the truth is that governance can also affect ownership structure. A good example would be an investment strategy based on corporate governance, employed by some institutional investors in their portfolio management. In that case, firms with good corporate governance would have higher outside ownership and naturally lower inside ownership, and we would observe a positive correlation between institutional ownership and corporate governance, but a negative relationship between controlling ownership and corporate governance. This reversed causality would lead us to falsely accept the complementary hypothesis for institutional investors and the control hypothesis for controlling shareholders.

Previous studies such as Mak and Li (2001) used simultaneous empirical models to tackle the endogeneity issue. One problem with using a simultaneous model is that we need an

¹ It would have been better if we had a dummy variable denoting whether the controlling shareholder has a position in his company or not.

instrumental variable which is correlated with one dependent variable, but not with others. However, existing papers are not very thorough in this aspect mainly because identifying such a variable is not an easy task.

In this regard, our Korean samples offer a good solution to the endogeneity issue since the corporate governance mechanisms we are going to analyze were introduced mainly after the economic crisis, and so not much time has passed for them to affect the ownership structure of Korean firms. Even Mak and Li (2001) argued that it is ownership that affects corporate governance, but not the other way round. We also used lagged variables for ownership and other firm-specific variables to further minimize the endogeneity problem.

3.2. Business Structure and Corporate Governance

Another major factor that can affect the governance structure of a firm is business structure, and conglomerates have been a focus of interest since they offer a very comfortable environment for controlling shareholders to pursue their own benefits through transactions among affiliated firms. Tunnelling, as it is known in the literature, has been widely reported in European conglomerates by Johnson, La Porta, Lopez de Silanes and Shleifer (2002), and also in Korean conglomerates by Bae, Kang and Kim (2002). A conglomerate business structure also allows controlling shareholders to maintain their control through affiliated ownerships.

In this paper, we use a dummy variable which takes a value of 1 if a firm belongs to one of the 30 largest chaebols as defined by the Korea Fair Trade Commission for their regulatory purpose. We conjecture that those firms that belong to a chaebol suffer from the agency problem more than independent firms do, and therefore may have a more stringent monitoring mechanism as demanded by outsider investors. But, the dominance of controlling shareholders through affiliated ownership may also weaken it. This will be confirmed by empirical analysis.

3.3. Firm Size and Corporate Governance

Since governance mechanisms consume corporate resources, we expect that larger firms would have better corporate governance, and we include asset size as a control variable. Most of the monitoring system such as the board of directors, internal control system, and financial reporting and disclosure system incur financial costs, most of which are of a fixed component and can be borne more efficiently by larger firms. The more complicated business structure of large firms may also require better corporate governance.

We also use a dummy to accommodate the effect of regulatory requirements on corporate governance based on asset size.² A dummy variable, which takes a value of 1 if the total asset size of a firm exceeds 2 trillion won, and 0 otherwise, is included.

3.4. Other Financial Characteristics and Corporate Governance

We also expect that some financial characteristics would affect the governance decision and need to be controlled. We include control variables that represent profitability, liquidity, financial structure and growth rates of firms.

The effects of profitability on corporate governance may be two way. High profitability implies a good capability of management and so monitoring them may not be necessary. On the other hand, high profitability means the company can afford a better governance system. Outside investors may also demand better governance as they have a greater economic stake to lose.

Higher liquidity as measured by the amount of free cash flow would lead to a better governance mechanism since it can be appropriated by the management for their private benefit. It also allows firms to maintain a costly monitoring system. The growth potential would also be related to better governance since those firms with high growth rates have more to lose from a lack of investment capital, and would try to satisfy outside investors with better governance as Durnev and Kim (2003) have argued.

We also include the debt ratio and the bank loan ratio. A higher debt ratio implies a larger amount of interests and principals to be paid periodically, and the management would be under pressure to ensure enough cash flow to cover the debt payment, which can be done through more efficient management (Grossman and Hart (1982)). We expect the debt ratio to be negatively correlated with the corporate governance mechanism. Among the different types of debt, a bank loan is of particular interest since banks, as larger creditors with a long-term relationship with firms, are supposed have an incentive and capability to monitor their client firms.

4. Data and Empirical Models

4.1. Samples and Data

² The Korean listing law requires one quarter of the boards of listed firms to be filled with outside directors with the minimum number being one. The minimum proportion is increased to one half for the firms with an asset size over 2 trillion won, with the minimum number being three.

We analyze Korean firms listed on the Korea Stock Exchange (KSE) as of the end of 2001. For the financial data, we use the data from the Korea Listed Company Association. Ownership data were collected using the Electronic Disclosure System of the KSE, and governance data were provided by the Korea Corporate Governance Service, which is an independent corporate governance scoring agency in Korea. We exclude financial companies from our samples, leaving 438 manufacturing companies listed on the KSE.

<Table 1> shows the summary statistics of the major variables. The average ratio of outside directors on the boards of the sample firms is 0.3095, which is relatively low compared with that of U.S. firms, which on average have 80% of their boards made up of outside directors.³ The average number of committees is 0.283, implying that many of the sample firms do not have any committees. Twenty-two point six percent of the CEOs of the sample firms own more than 5% of the shares when including those shares owned by their families.

[<Table 1> here]

<Table 2> shows the correlation coefficients of the variables. Controlling ownership is negatively correlated with the ratio of outside directors, while institutional and foreign ownerships are positively correlated with it, as expected. Surprisingly, affiliated ownership is positively correlated with the ratio of outside directors. Asset size and the chaebol dummy also show strong correlations with the ratio of outside directors and the number of committees.

[<Table 2> here]

4.2. Empirical Models

In this section, we set up empirical models and test our hypotheses. The dependent variables are the ratio of outside directors and the corporate governance scores of sample firms. Cross-sectional regressions are employed to test the hypotheses reviewed in the previous section.

4.2.1. Ownership and the Composition of the Board

³ Korn/Ferry International, 29th Annual Board of Directors Study 2002.

One of the key factors in evaluating the corporate governance system of a firm is the number, or more accurately the proportion, of outside directors on its board. Boards of directors are known to be the most important institution that can directly and effectively monitor and check the management of a company. The ratio of outside directors in our model to measure the level of corporate governance is justified as the boards use majority rule in their decision making.⁴ For example, if more than half of the directors are executive directors, the management would be able to force whatever agendas they want to see implemented.

The empirical model is as follows.

$$\begin{aligned} OBOARD = & \beta_0 + \beta_1 * Family + \beta_2 * Affiliates + \beta_3 * CEODummy + \beta_4 * ChaebolDummy \\ & + \beta_5 * Foreign + \beta_6 * Institution + \beta_7 * CF + \beta_8 * Growth + \beta_9 * Size + \beta_{10} * SizeDummy \\ & + \beta_{11} * BoardSize + \beta_{12} * Leverage + \beta_{13} * LoanRatio + \beta_{14} * IndustryDummy + \varepsilon \end{aligned}$$

where OBOARD denotes the proportion of outside directors on the board; Family denotes the family ownership of controlling shareholders; Affiliates is the sum of the ownerships owned by affiliated companies; CEO Dummy is a dummy variable which takes a value of 1 if the CEO owns more than 5% of the shares; Chaebol Dummy is a dummy variable which takes a value of 1 if the firm belongs to the 30 largest chaebols; Foreign denotes the sum of the ownerships owned by foreign investors; Institution denotes the sum of ownerships owned by institutional investors; CF denotes cash flow from operations divided by total assets; Growth denotes the average growth rates of sales over the past 5 years; Size is calculated as the log of total assets; Size Dummy is a dummy variable which takes a value of 1 if the asset size of the firm is over 2 trillion won; Board Size denotes the total number of directors on the board; Leverage denotes total debt divided by total assets; Loan Ratio denotes total bank loans divided by total debt; and Industry Dummies are dummy variables which take a value of 1 if a sample firm belongs to a specific industry.

<Table 3-a> and <Table 3-b> show the results of the empirical tests.⁵ In regression (1) of <Table 3-a>, which shows the influence of insiders, family ownership has a coefficient of -0.1876, which is significant at the 1% level and suggests that higher ownership tends to lower the proportion of outside directors, as we conjectured.⁶ It is still significant at the 5% level even after controlling for other financial characteristics in regression (2). The result supports

⁴ We also tried a model that uses the number of outside directors exceeding the minimum regulatory requirement as the dependent variable, but the explanatory power of the model was much lower than that of the current model.

⁵ We controlled for the multicollinearity problem using the state factor test and the VIF test.

⁶ We use a separate model to test the influence of outside block shareholders as their ownerships are significantly and negatively correlated with those of insiders.

both the ‘substitute hypothesis’ and the ‘control hypothesis’. However, in our interpretation, the negative relationship is mainly due to the increasing controlling power of controlling shareholders with their ownership, which allows them to control the board of directors and therefore affect decisions concerning the issue of establishing their corporate governance.⁷ We provide further empirical evidence in regard to this issue later on.

Of the control variables, asset size and asset size dummy both show a very strong influence on the proportion of outside directors. A larger asset size allows firms to bear monitoring costs more easily. The coefficient of the asset size dummy implies that the proportion of outside directors increases by 17.31% if a firm has an asset size over 2 trillion won, even after controlling for asset size. Considering that the average board size of the sample firms is six directors, the regulation requiring half the board to be filled with outside directors has the effect of adding about one more outside director to their boards of directors. Consistent with the existing literature, the size of the board itself has a negative impact on the ratio of outside directors, and is significant at the 10% level.

Sales growth rate, cash flow and CEO dummy do not show any significance. Sales growth rate represents the opportunity cost of controlling shareholders as they have more to lose if they cannot obtain external financing due to bad corporate governance (Durnev and Kim (2003)). However, the empirical results show that Korean owner-managers do not have such a long-term incentive to maintain good governance. The insignificance of the CEO dummy also suggests that controlling shareholders of Korean firms are de facto managers, and therefore it does not make any difference whether they are officially part of the management or not.

Regression (3) shows the effect of affiliated ownership on the board composition. The coefficient is positive and significant at the 10% level. However, with the control variables added in regression (4), it loses significance, and it even turns negative in regression (5) where the control variables are also added. Family ownership is still negative and significant at the 5% level.

<Table 3-b> shows the influence of outside shareholders. In regression (1), higher foreign ownership leads to a higher proportion of outside directors with significance at the 1% level, which supports our ‘complement hypothesis’ as outside investors require a stronger monitoring mechanism to protect their interests. Note again that we don’t have to worry about the reversed causality since ownership precedes the new governance mechanism.

However, in regression (2), where an interaction variable between foreign ownership and the chaebol dummy is added, the coefficient of the foreign ownership variable loses its significance, and only the coefficient of the interaction variable shows a positive effect on board composition, which is significant at the 1% level. Only in chaebol firms would foreign

⁷ We checked and found no non-linearity problem in the case of the family ownership variable.

investors ask for a higher proportion of outside directors; they would not be very concerned about the composition of the boards of non-chaebol firms. This is possibly due to their being worried about a higher possibility of tunnelling among chaebol-affiliated firms.

The coefficient of institutional ownership in regression (3) also shows positive significance at the 1% level, while its effect is weakened again by the interaction variable between the ownership and the chaebol dummy in regression (4). Both these results support the 'complementary hypothesis', and confirm our conjecture that outside investors would prefer a stronger monitoring system.

In regression (5), the coefficient of the interaction variable between the institutional ownership and the chaebol dummy is significant and negative at the 10% level, while other ownership variables lose their significance. We conjecture this is partly due to the multicollinearity between the variables. Above all, institutional ownership shows a positive correlation with asset size with the significant at the 1% level.

In summary, the empirical results in <Table 3-a> and <Table 3-b> show that the insiders of Korean firms prefer not to have outside directors. This is mainly because they are managers as well as shareholders and enjoy private benefit of control. On the other hand, outside investors prefer to have a stronger monitoring system, especially for those firms belonging to chaebols. The results imply that firms with controlling shareholders would set their corporate governance below the level asked for by outside investors or by regulatory authorities, despite the negative impact on firm value that this would have. The shirking behaviour of owner-managers is another form of moral hazard and is aimed at setting the governance of their firms to their advantage.

Existing theory claims that increased ownership by the management would align its incentive with that of shareholders, thus reducing moral hazard. However, our empirical results show that higher controlling ownership may lead to a lax monitoring system and more moral hazard. In this sense, it provides another explanation for why we observe in the literature a declining Tobin's Q after a certain level of controlling ownership is reached as Morck, Shleifer and Vishny (1988), and McConnell and Servaes (1990) show. They ascribed it to a decreasing possibility of a hostile takeover and lower corporate efficiency due to the resulting managerial entrenchment. We claim that it is also due to the lack of internal monitoring and increasing conflicts of interest between insiders and outsiders as the former with higher ownership find it easier to manipulate the internal governance structure to their taste.

[<Table 3-a> and <Table 3-b> here]

4.2.2. Ownership and Corporate Governance Scores

A stylized fact in the corporate governance area is that there exists a positive correlation between corporate governance and firm value. As LLSV (1999), Mitton (2002), Durnev and Kim (2003) and Black, Jang and Kim (2003) have confirmed, corporate governance matters and affects firm value.

But if this is so, then why do firms not improve their corporate governance so that their shareholder value is further increased? One possible answer is that the current state of corporate governance is already optimal. That is, it is too costly for a firm to improve its corporate governance.⁸ However, Park and Lee (2004), who test the relationship between corporate governance score and the value of Korean firms, show that the difference in the average Tobin's Qs of those firms in the highest quartile of corporate governance scores and those in the lowest quartile is about 0.39. Considering that the average market value of those Korean firms is US\$0.8 billion, a potential increase in shareholder value due to improved corporate governance would amount to US\$0.32 billion on average, which would well exceed any costs related to upgrading the corporate governance of those firms. Park and Lee (2004) even show that individual governance mechanism such as board composition or disclosure policy, which can be rather easily upgraded, also has a positive effect on firm value.

Below, we conjecture again that the private interests of controlling shareholders would deter firms from attaining optimal corporate governance. For the empirical analysis, we use the governance scores of Korean firms collected over the last 3 years from 2001 through 2003.⁹ The annual surveys contain over 100 questions on the corporate governance of Korean firms, and evaluate, among other factors, shareholder rights, structure and operation of the boards; disclosure and managerial transparency, and the internal control system. According to the surveys, corporate governance in Korea differs widely between firms (see <Figure 1> for the distribution of scores for 2003). The highest score, out of 300 points, was 219 points while the lowest was 117 points. Again, as in the literature, we could confirm that there exists a positive correlation between the corporate governance score and firm value as measured by Tobin's Q (see <Figure 2>).

The advantage of using the scores instead of the individual governance mechanism is that the governance scores are more comprehensive in evaluating the overall corporate governance of a firm than a specific governance mechanism, and also that it allows us to use a larger number of samples to increase the power of the models.

⁸ LLSV (1999) and Mitton (2002) use the 'wedge' between cash rights and control rights of controlling shareholders as a proxy for the conflicts of interest between controlling shareholders and minority shareholders. As the ownerships of controlling shareholders or affiliated firms cannot be adjusted easily, we can expect that the negative correlation between the wedge and firm value would persist.

⁹ The KSE initially, and then the Korea Corporate Governance Service (KCGS), a subsidiary of the KSE, has been in charge of evaluating the corporate governance of listed companies in Korea.

<Table 4-a> and <Table 4-b> show the results of a panel data analysis that covers 3 years of corporate governance scoring. As we can see from the table, the explanatory power of the regressions has increased as the higher R-squares of the regressions and the increased significance of the coefficients of the explanatory variables show.

In regression (1) of <Table 4-a>, the coefficient of family ownership is negative and significant at the 1% level, again confirming our conjecture that controlling shareholders do not like good corporate governance. The significance is maintained even if we add control variables in regression (2). The coefficient of affiliated ownership in regression (3) is not significant, but with control variables added, its significance increases to the 1% level in regression (5), where both the inside ownerships show a negative and significant influence on the governance score of Korean firms. Other financial variables also show expected signs and significance. We did not use the asset size dummy in the model since the evaluation process already reflects the size factor in the scoring.

<Table 4-b> confirms again that outside shareholders tend to strengthen the internal governance of their firms. In regression (2), the interaction variable between foreign ownership and the chaebol dummy is again positive and significant at the 1% level, confirming previous results, but loses its significance in regression (5).

5. Summary

This paper has analyzed the determinants of the corporate governance of Korean firms, focusing on the incentives of controlling shareholders. It used the data on corporate governance scores of Korean firms over the period of 2001 through 2003 as well as their individual governance mechanism for an empirical analysis.

The paper shows that controlling shareholders of Korean firms tend to resist good corporate governance that will monitor and check their decisions. This result is possibly due to the fact that they tend to assume a managerial role as well as a monitoring role as block shareholders. Naturally, they would enjoy the private benefit of control and would not like being monitored or challenged by outside investors in the matter of management.

This paper contributes to the existing literature on corporate governance by showing why the conflicts between the management and outside investors are not easily resolved by an internal corporate governance mechanism. It shows that controlling shareholders take measures to avoid monitoring. Since they have controlling ownership, they are in an even better position to deter the introduction of any monitoring mechanism than professional managers are.

From a policy point of view, the paper shows that there exists a limit to the functioning of internal governance mechanisms as they can be neutralized by insiders. It suggests a need for

regulatory intervention by authorities in regard to the issue of establishing the corporate governance of public firms, and also a need for an active market for control as a complement to the internal governance mechanism.

<Table 1> Summary Statistics

The sample includes 405 manufacturing firms listed on the Korea Stock Exchange during the period of 2000 to 2001. Governance variables are measured as of the end of 2001, while the ownership and financial variables are measured as of the end of 2000.

| | Average | Minimum | Maximum |
|---------------------------------|---------|---------|---------|
| Proportion of outside directors | 0.3095 | 0 | 0.75 |
| Total number of directors | 6.32 | 3 | 16 |
| Number of committees | 0.2831 | 0 | 6 |
| Cumulative voting scheme | 0.0525 | 0 | 1 |
| Family ownership | 0.1849 | 0 | 0.7673 |
| Affiliated ownership | 0.1136 | 0 | 0.7362 |
| Foreign ownership | 0.0620 | 0 | 0.8294 |
| Institutional ownership | 0.0584 | 0 | 0.9107 |
| CEO dummy | 0.2259 | 0 | 1 |
| Chaebol dummy | 0.2162 | 0 | 1 |
| Cash flow from operation | 0.0547 | -0.7248 | 0.5362 |
| Sales growth rates | 0.1015 | -0.4359 | 4.6825 |
| Asset size (billion won) | 964 | 28 | 50,900 |
| Debt to asset | 0.5779 | 0.0437 | 3.2192 |
| Bank loan to debt | 0.8108 | 0 | 1 |

<Table 2> Correlation Coefficients

The sample includes 405 non-financial firms listed on the Korea Stock Exchange between 2000 and 2001. The governance-related statistics are as of the end of 2001, while the financial statistics are as of the end of 2000.

| | Proportion of outside directors | Number of committees | Cumulative voting scheme | Family ownership | Affiliated ownership | Foreign ownership | Institutional ownership | CEO dummy | Chaebol dummy | Cash flow | Sales growth rates | Asset size |
|--------------------------|---------------------------------|----------------------|--------------------------|------------------|----------------------|-------------------|-------------------------|-----------|---------------|-----------|--------------------|------------|
| Number of committees | 0.361*** | | | | | | | | | | | |
| Cumulative voting scheme | 0.058 | -0.007 | | | | | | | | | | |
| Family ownership | -0.244*** | -0.157*** | -0.095** | | | | | | | | | |
| Affiliated ownership | 0.101** | -0.015 | -0.016 | -0.301*** | | | | | | | | |
| Foreign ownership | 0.166*** | 0.318*** | -0.038 | -0.131*** | 0.055 | | | | | | | |
| Institutional ownership | 0.231*** | 0.036 | 0.164*** | -0.269*** | -0.060 | -0.009 | | | | | | |
| CEO dummy | -0.122** | -0.068 | 0.016 | 0.397*** | -0.262*** | -0.074* | -0.149*** | | | | | |
| Chaebol dummy | 0.299*** | 0.215*** | -0.011 | -0.296*** | 0.266*** | 0.246*** | 0.037 | -0.239*** | | | | |
| Cash flow | 0.130*** | 0.034 | -0.027 | 0.021 | 0.080* | 0.217*** | 0.065 | -0.049 | 0.114*** | | | |
| Sales growth rates | -0.036 | 0.019 | -0.041 | -0.011 | 0.039 | 0.058 | -0.062 | -0.017 | 0.029 | 0.020 | | |
| Asset size | 0.475*** | 0.406*** | 0.072 | -0.254*** | 0.196*** | 0.432*** | 0.220*** | -0.280*** | 0.475*** | 0.238*** | 0.044 | |
| Debt to asset | 0.095** | 0.041 | 0.072 | -0.281*** | -0.011 | -0.169*** | 0.069 | -0.103** | 0.056 | -0.212*** | -0.059 | 0.009 |

<Table 3-a> Inside Ownership and Board Composition

The sample includes 405 non-financial firms listed on the Korea Stock Exchange. The dependent variable is the proportion of outside directors on a board, measured as of the end of 2001, while the explanatory variables are measured as of the end of 2000. The numbers in parentheses are t-values, and ***, ** and * denote significance at the 1%, 5% and 10% levels respectively.

| Specifications | (1) | (2) | (3) | (4) | (5) |
|---------------------------|-----------------------|----------------------|----------------------|----------------------|----------------------|
| Constants | 0.3746*** (17.70) | 0.0801 (0.99) | 0.3258*** (15.42) | 0.0441 (0.55) | 0.0769 (0.91) |
| Family ownership | -0.1876*** (-6.21) | -0.0539** (-2.10) | | | -0.0674** (-2.31) |
| Affiliated ownership | | | 0.0514* (1.73) | -0.0032 (-0.14) | -0.0257 (-1.03) |
| CEO dummy | | | | | -0.0001 (-0.01) |
| Chaebol dummy | | | | | -0.0029 (-0.28) |
| Cash flow | | -0.0293 (-0.67) | | -0.0284 (-0.64) | -0.0211 (-0.47) |
| Sales growth rates | | -0.0129 (-0.98) | | -0.0104 (-0.79) | -0.0131 (-0.98) |
| Asset size | | 0.0127*** (3.12) | | 0.0138*** (3.37) | 0.0132*** (3.09) |
| Asset size dummy | | 0.1731*** (10.09) | | 0.1747*** (10.12) | 0.1724*** (9.85) |
| Total number of directors | | -0.0031* (-1.69) | | -0.0030* (-1.67) | -0.0032* (-1.71) |
| Debt ratio | | -0.0026 (-0.14) | | 0.0059 (0.32) | -0.0027 (-0.16) |
| Bank loan ratio | | -0.0016 (-0.12) | | -0.0065 (-0.48) | -0.0022 (-0.16) |
| Industry dummy | Yes | Yes | Yes | Yes | Yes |
| Adjusted R-sq | 0.0800 | 0.4655 | 0.0039 | 0.4593 | 0.4630 |
| F Value | 3.07 | 15.66 | 0.91 | 15.30 | 13.90 |

<Table 3-b> Outside Ownership and Board Composition

The sample includes 405 non-financial firms listed on the Korea Stock Exchange. The dependent variable is the proportion of outside directors on a board, measured as of the end of 2001, while the explanatory variables are measured as of the end of 2000. The numbers in parentheses are t-values, and ***, ** and * denote significance at the 1%, 5% and 10% levels respectively.

| Specifications | (1) | (2) | (3) | (4) | (5) |
|---------------------------------------|----------------------|----------------------|----------------------|----------------------|---------------------|
| Constants | 0.2934*** (31.09) | 0.2981*** (31.75) | 0.2978*** (30.88) | 0.2988*** (31.23) | 0.0079 (0.09) |
| Foreign ownership | 0.2019*** (4.75) | 0.0272 (0.42) | | | -0.0457 (-0.85) |
| Institutional ownership | | | 0.1141*** (2.71) | 0.0527 (1.11) | 0.0573 (1.55) |
| Foreign ownership*Chaebol dummy | | 0.2741*** (3.57) | | | 0.0384 (0.59) |
| Institutional ownership*Chaebol dummy | | | | 0.2102*** (2.77) | -0.1181* (-1.88) |
| Cash flow | | | | | -0.0328 (-0.72) |
| Sales growth rates | | | | | -0.0123 (-0.93) |
| Asset size | | | | | 0.0162*** (3.72) |
| Asset size dummy | | | | | 0.1731*** (9.59) |
| Total number of directors | | | | | -0.0030 (-1.61) |
| Debt ratio | | | | | 0.0019 (0.10) |
| Bank loan ratio | | | | | -0.0070 (-0.50) |
| Industrial dummy | Yes | Yes | Yes | Yes | Yes |
| Adjusted R-sq | 0.0615 | 0.0890 | 0.0253 | 0.0417 | 0.4576 |
| F Value | 2.56 | 3.20 | 1.62 | 1.98 | 14.14 |

**<Table 4-a> Inside Ownership and Corporate Governance Scores
(3-year panel data analysis)**

The sample includes 217 non-financial firms listed on the Korea Stock Exchange during the period. The dependent variable is the corporate governance scores of Korean firms over the 3-year period between 2001 and 2003, and we use the random effect model for the control of firm-specific effects. The numbers in parentheses are t-values, and ***, ** and * denote significance at the 1%, 5% and 10% levels respectively.

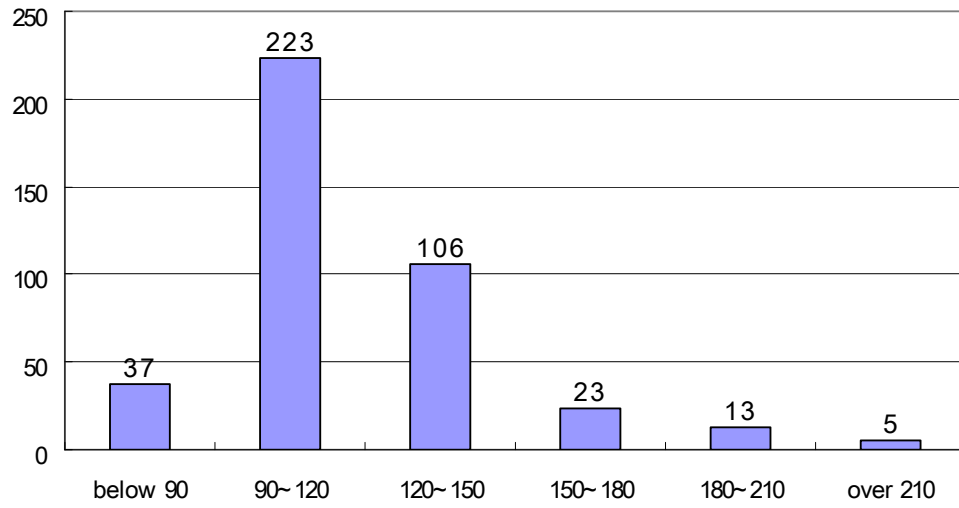
| Specifications | (1) | (2) | (3) | (4) | (5) |
|----------------------|-----------------------|-----------------------|----------------------|-----------------------|-----------------------|
| Constants | 4.6631*** (57.05) | -2.1245*** (-3.72) | 4.2147*** (64.43) | -2.9127*** (-5.73) | -2.0917*** (-3.48) |
| Family ownership | -1.8217*** (-6.19) | -0.6274** (-2.39) | | | -0.9173*** (-3.26) |
| Affiliated ownership | | | 0.4074 (1.22) | -0.3966 (-1.54) | -0.7281*** (-2.66) |
| Chaebol dummy | | | | | -0.0205 (-0.19) |
| Cash flow | | 0.7585* (1.65) | | 0.8051* (1.74) | 0.8554* (1.86) |
| Sales growth rate | | 0.6164*** (2.78) | | 0.6049*** (2.72) | 0.6006*** (2.73) |
| Asset size | | 0.3325*** (11.66) | | 0.3649*** (13.32) | 0.3394*** (11.16) |
| Debt ratio | | -0.1284 (-0.63) | | -0.0026 (-0.01) | -0.1718 (-0.84) |
| R-Square | 0.0557 | 0.2616 | 0.0023 | 0.2560 | 0.2755 |

**<Table 4-b> Outside Ownership and Corporate Governance Scores
(3-year panel data analysis)**

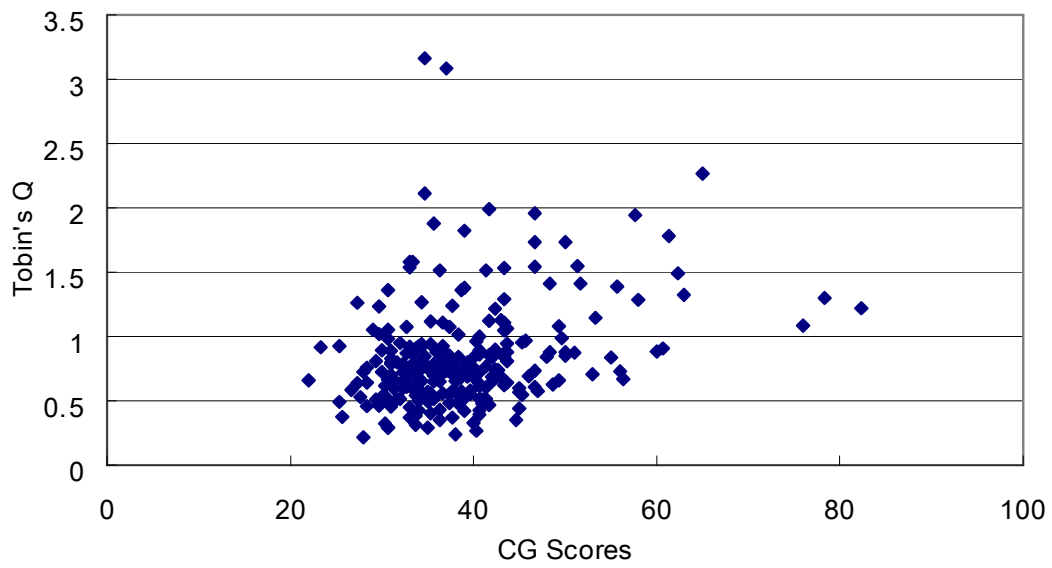
The sample includes 217 non-financial firms listed on the Korea Stock Exchange during the period. The dependent variable is the corporate governance scores of Korean firms over the 3-year period between 2001 and 2003, and we use the random effect model for the control of firm-specific effects. The numbers in parentheses are t-values, and ***, ** and * denote significance at the 1%, 5% and 10% levels respectively.

| | (1) | (2) | (3) | (4) | (5) |
|---------------------------------------|----------------------|----------------------|----------------------|----------------------|-----------------------|
| Constants | 4.0918*** (71.47) | 4.0905*** (73.52) | 4.1535*** (69.09) | 4.1586*** (68.75) | -2.1802*** (-3.38) |
| Foreign ownership | 2.1983*** (5.98) | 1.3039*** (3.01) | | | 0.2569 (0.64) |
| Institutional ownership | | | 1.4249*** (3.52) | 1.1401** (2.13) | 0.8848* (1.89) |
| Foreign ownership*Chaebol dummy | | 2.5188*** (3.91) | | | 0.7194 (1.16) |
| Institutional ownership*Chaebol dummy | | | | 0.5691 (0.81) | -0.8637 (-1.37) |
| Cash flow | | | | | 0.5042 (1.05) |
| Sales growth rates | | | | | 0.5942*** (2.57) |
| Asset size | | | | | 0.3198*** (9.10) |
| Debt ratio | | | | | 0.0815 (0.39) |
| R-Square | 0.0523 | 0.0782 | 0.0188 | 0.0197 | 0.2473 |

<Figure 1> Distribution of Corporate Governance Scores of Korean Firms (2003)



<Figure 2> Normalized Corporate Governance Scores and Firm Value (2003)



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