Explaining Differences in the Quality of Governance Among Companies: Evidence from Emerging Markets

Art Durnev and E. Han Kim

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Three key factors tend to distinguish companies with better corporate governance and disclosure practices:

- abundant investment opportunities
- greater need for external financing
- higher concentration of cash flow and ownership rights.

Profitable investment opportunities provide the controlling shareholder with incentives to make value-maximizing uses of investor capital rather than divert corporate resources for personal gain. Where there are no valuable investment opportunities, controlling shareholders may misuse resources instead of returning excess capital to other investors.

Companies that rely more heavily on external financing can use their reputation for effective governance to raise equity and debt at lower costs. Good corporate governance effectively creates value by reducing its cost of capital.

Concentrated ownership makes it less likely that the controlling shareholders will divert corporate resources for private benefits. As the share of cash flow rights increases, the owner bears a higher share of the costs associated with diverting resources and diluting value.

Companies in weak legal regimes have stronger incentives to structure their own governance so as to take fuller advantage of profitable investment opportunities, overcome the negative effects of poor investor protection on their ability to raise external capital and to resolve conflicts between controlling and outside shareholders.

Companies with better governance and more transparency should be valued more highly because investors will be more confident about getting their fair share of firm profits. Since high-quality governance is relatively scarce in weak legal regimes, the relatively few companies with good governance are likely to be valued more highly in a poor legal environment.

Companies that establish and maintain a reputation for good governance and transparency are likely to have higher valuations. Policy makers can leave companies with significant funding requirements on their own. The market will put pressure on them to improve their governance in ways that meet the demands of investors. Companies that require policy makers' attention are those with limited investment opportunities, little need for external financing, and controlling shareholders with voting rights disproportionate to their cash flow rights. These firms have little private incentive to improve governance.

To the extent pro-growth policies succeed in generating more profitable investment opportunities, companies in need of funds will be motivated to improve governance on their own, without prodding from regulators. Moreover, allowing companies to experiment with their own forms of governance and disclosure is likely to be more productive than imposing a "one-size-fits-all" set of requirements. By contrast, redistributionist-oriented policies that tend to weaken property rights, and dampen incentives to make investments and raise external capital, will make policy making much more complicated.