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Internal Governance Mechanisms and Managerial Decision on Foreign Direct Investment in Korean Firms[1]

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Abstract
Internal governance mechanisms affect the time horizon of foreign direct investment decisions differently because of their different objectives and characteristics. In this study, we empirically tested the relationship between internal governance mechanisms and the time horizon of foreign direct investment. Internal governance mechanisms for monitoring exert pressure on the short-term performance on a manager, causing the manager to focus on short-term perspective investment. However, internal governance mechanisms for interest alignment motivate a manager to invest in the foreign market with a long-term perspective. Outside directors and foreign ownership threaten the job and compensation of a manager. Thus, a manager cannot do anything but pursue a visible and predictable performance. However, a stock option has a structure of limited loss and unlimited gain, and it can be exercised even after resignation. Therefore, a manager with a stock option is motivated to focus on risky and long-term investments.

Keywords: Internal governance mechanisms, FDI, Long-term performance

Introduction

The function and effectiveness of internal governance mechanisms have been studied by many agency theorists (Hendry & Kiel, 2004; Shleifer & Vishny, 1997; Walsh & Seward, 1990; Wright, Ferris, Sarin, & Awasthi, 1996). Internal governance mechanisms have been in the spotlight because the global financial crisis increased the need to control the moral hazard of managers. Most previous studies on governance mechanisms focused on their effects on firm value or performance (Agrawal & Knoeber, 1996; Peng, 2004). However, studies on the different effects on managerial decisions are rare.

This study explores how representative internal governance mechanisms, outside directors, foreign investors, and stock option exert influence on the foreign direct investment strategy of a firm. Governance mechanisms affect managerial decisions differently because they have different objectives and characteristics. The main purpose of outside directors and foreign investors is to reduce information asymmetry. They can access information on the firm easier than shareholders and threaten the job and compensation of the manager (Abrahamson & Park, 1994). Stock option aims to resolve conflict of interests. It connects firm value and the compensation of a manager and encourages a manager to maximize shareholder value (Jensen & Murphy, 1990a). Foreign direct investment is generally regarded as a high-risk investment strategy (Zaheer, 1995). Considering that a manager has bounded rationality (Buckley, Devinney, & Louviere, 2007), a foreign direct investment researcher should consider the internal governance mechanisms that affect the risk-taking behavior of a manager.

To investigate the effects of the different characteristics of internal governance mechanisms on the time horizon of a firm's foreign direct investment strategy, the relationship between internal governance mechanisms and time horizon revealed in the disclosure of the foreign direct investment of a firm is tested in the current study. Many previous studies on the effects of internal governance mechanisms on the time horizon of firms' strategy and performance employed R&D investment or long-term performance as a dependent variable (Bhagat & Black, 2002; Tribo, Berrone, & Surroca, 2007). The time horizon traced from disclosure is simpler and clearer than the variable employed in previous studies, and Korean firms are required to disclose the purpose of foreign direct investment. Thus, it can be a better measure of the time horizon of investment strategy than R&D expenditure or long-term performance.

The next section presents the hypotheses developed based on the literature review. The research design is then presented, and the hypotheses are analyzed. Finally, some of the implications and limitations of the study are discussed.

Theory And Hypotheses

A.Foreign Direct Investment

Dunning (1993) argued that foreign investment is a managerial decision for using ownership-specific advantage (Hymer, 1970), internalization advantage (Buckley & Casson, 1998), or locational advantage (Dunning, 1988). However, this perspective cannot explain foreign direct investment from emerging countries to developed countries because many firms from emerging markets wish to acquire knowledge assets from developed countries (Almeida, 1996). Thus, studies on asset exploitation or asset exploration in foreign

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direct investment have significant implications (Makino, Lau, & Yeh, 2002). This study investigates the effects of internal governance mechanisms on the foreign direct investment strategy of a firm.

Asset exploitation is usually related to short-term performance, whereas asset exploration is related to long-term performance. In asset exploitation, a firm utilizes its own competitive advantage. Thus, a firm may take fewer risks and harvest its performance relatively within a short period. In asset exploration, a firm has to learn from others and develop its competitive advantage by using accessible foreign resources and knowledge. Thus, a firm has to harvest its performance within a short period and may take more risks (Makino et al., 2002).

Many previous studies argued that most foreign direct investments are performed according to several rules adopted by most firms, and firms have the same possible choices. However, Buckley et al. (2007) found that the choice of a manager does not fit well with foreign direct investment theories because the experiences and knowledge of managers influence their managerial decision on foreign direct investment. Thus, considering that foreign direct investment is performed by a manager with bounded rationality is important. Considering the variables that influence managerial decisions is also important for research on foreign direct investment.

Internal governance mechanisms affect the risk-taking behaviors and decisions of managers. Agency theory posits that internal governance mechanisms monitor a manager, control his or her decisions (Walsh & Seward, 1990), and increase his or her job risk and payment risk. Thus, these mechanisms play an important role in investment goal and time horizon.

B.Effects of Internal Governance Mechanisms on Foreign Direct Investment

Many internal governance mechanisms exist; examples include outside board of directors, foreign investors, managerial shareholding, institutional investors and block holders, performance-based payment, and stock option (Agrawal & Knoeber, 1996). Governance mechanisms are designed to reduce either information asymmetry or conflict of interest between a shareholder and a manager. This study focuses on the three most popular internal governance mechanisms, namely, outside directors, foreign investors (to reduce information asymmetry), and stock option (to resolve conflicts of interest).

Outside Directors: Ezzamel and Watson (1993) found that outside directors and firm profitability have a positive relationship in the United Kingdom. Baysinger and Butler (1985) claimed that outside directors are positively related to return on equity (ROE). Many studies support the positive relationship between outside directors and firm performance (Barclay & Holderness, 1991; Mehran, 1995; Rosenstein & Wyatt, 1997).

However, several researchers argued that outside directors do not exert a favorable influence on firm value (Chaganti, Mahajan, & Sharma, 1985; Dalton et al., 1998; Kesner, Victor, & Lamont, 1986) and instead exert a negative influence (Agrawal & Knoeber, 1996; Hermalin & Weisbach, 1988). Agrawal and Knoeber (1996) posited that the negative relationship between outside directors and firm performance results from hiring outside directors, which does not maximize firm value but instead creates a political issue. Politicians, green activists, or representatives of customers are good examples. Hermalin and Weisbach (1988) also found a negative relationship between outside directors and firm value. They argued that outside directors have a limit to controlling a manager and may not be different from internal directors because a manager has a strong influence on hiring outside directors.

When outside directors monitor their manager, the latter focuses on short-term performance in his or her tenure to reduce the risk of dismissal and increase the probability of rehiring. Focusing on short-term performance may deplete firm resources, which have to be used for long-term growth. However, if a manager does not perform well in his or her tenure for future growth probability, then he or she may be punished by outside directors with sanctions, such as reduction in compensation or early resignation before long-term performance is realized. In addition, a manager's poor performance may influence his or her reputation in the job market, which in turn makes transferring to another firm difficult (Walsh & Seward, 1990). A large number of outside directors denote high tendency to focus on investment for short-term performance because punishment according to the failure of a manager may be enforced in a firm with the strong influence of outside directors.

Another reason for managers' focus on short-term performance is the incentives received by outside directors. Outside directors are rewarded with salaries during their tenure, rehiring, and directorship with another firm for their service (Yermack, 2004). If a firm does not perform well within their tenure (three years in Korean Commercial Law), their salary and probability of rehiring will decrease. They will also have a hard time maintaining their directorship with another firm because their reputation has been tarnished. Eventually, the characteristics of the compensation of outside directors force them to control a manager to focus on short-term investment.

Foreign direct investment is known for its high risk and uncertainty. If a manager decides to invest his or her firm resources for long-term performance, then he or she and the outside directors will bear the aggravated risk and uncertainty. Thus, managers and outside directors prefer foreign direct investment for short-term performance over that for long-term performance.

H1. The greater the proportion of outside directors on a firm's board, the higher the tendency to focus on foreign direct investment for short-term performance.

Foreign Investors: Foreign investors are internal governance mechanisms to relieve information asymmetry. They are mostly institutional or mutual fund investors (Dahlquist & Robertsson, 2001) and influence managerial decisions in various ways (Ahmadjian & Robbins, 2005). However, conflicting results exist about the effects of foreign investors on firm value or performance. David et al. (2006) posited that foreign investors stimulate resource allocation through the

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capital market and provide a manager with openness and diversity (Allen, 1993). However, Porter (1992) argued that foreign investors are myopic and exert pressure on their manager to focus on short-term investment and finally reduce the firm value because foreign investors have to provide their investors with dividends and their employees with fixed payment.

In addition, foreign institutional investors are obsessed with short-term performance because the fund managers of foreign investors face severe competition and a high turnover rate (Froot, Scharfstein, & Stein, 1992; Graves & Waddock, 1990). Foreign investors globally disperse their assets. Therefore, the outward investment of a firm invested by foreign investors may ruin the portfolio of a foreign investor. Moreover, if a manager has long-term perspectives in foreign direct investment, foreign investors must involuntarily bear a weighted risk.

H2. The greater the proportion of foreign ownership, the higher the tendency to focus on foreign direct investment for short-term performance.

Stock Options: Stock options are long-term incentives designed to solve conflicts of interest (Yermack, 1995). Many researchers argued that performance-based payment increases shareholder value by decreasing agency cost (Grossman & Hart, 1983; Lazear & Rosen, 1981; Mirrlees, 1976; Murphy, 1986). Murphy (1986) found that long-term incentive contracts are related positively to firm performance.

Generally, a manager can exercise his or her stock option at any time but cannot do so in a short period because of its vesting period. Thus, a stock option has less value to a manager in the short term and compensates a manager for his effort to raise firm value after this vesting period. Even after his or her tenure, a manager can exercise his or her stock option. On the one hand, the minimum value of a stock option is zero, which means that the amount of loss experienced by a manager is fixed according to the decrease in firm value (Bebchuk & Fried, 2003). On the other hand, the amount of gain experienced by a manager is limitless according to the increase in firm value. These characteristics of stock options provides a manager an incentive to focus on long-term and high-risk performance.

H3. A firm with a manager with stock options tends to focus on foreign direct investment for long-term performance.

Method

A.Sample and Data

Manufacturing companies listed in the Korean Stock Exchange from 2004 to 2006 were considered in this study. Among the 460 companies that meet the criterion, 424 companies that settled their finances equally in December were included. Only new foreign direct investments of firms were considered because of the exception of previous investment effects. A total of 91 foreign direct investment cases were obtained, and three cases were exempted because they are performed by newly registered firms. Thus, 88 cases were considered in this study. Among these cases, 59 cases are greenfield, 12 cases are joint ventures, and 9 cases are M&A.

B.Dependent Variable

The dependent variable in this study determines whether the purpose of foreign direct investment is long-term performance or not. In Korea, a firm has to disclose its purpose and value when it invests in a foreign country. If a firm disclosed that the purpose of investment is long-term performance, then the dummy variable was coded as 1; otherwise, it was coded as 0. For example, if the purpose of foreign direct investment is R&D, acquiring several techniques, or building a production base in a foreign market, then the purpose is for long-term performance. By contrast, building sales subsidiaries or export support centers, portfolio investment, and cost reduction are considered purposes for short-term performance.

C.Independent Variables

The independent variables in this study are the three most popular internal governance mechanisms, namely, outside directors and (2) foreign investors to reduce informational asymmetry and (3) stock option for the alignment of interests between the shareholder and a manager. The effectiveness of an outside director as a representative internal governance mechanism was measured by the proportion of outside directors on the board of directors. The effectiveness of foreign investors was measured by the percentage of the shares of a firm held by foreign investors. The effectiveness of stock option was measured by a dummy variable. If a firm provides its top manager with a stock option, then the dummy variable was coded as 1; otherwise, it was coded as 0.

D.Control Variables

To control firm specific factors, we included firm size, conglomeration, reserve rate, and previous firm performance in our model. The total number of employees was included to control firm size. The variable of conglomeration was considered to control the effects of the diversification of firms and the influence of a holding firm. If a firm was a conglomerate, then the dummy variable was coded as 1; otherwise, it was coded as 0. The increase rate of operating profit was used as a proxy for previous firm performance. To control the time effect, we created dummy year variables and inputted them into our model.

E.Analysis

The logistic regression model was adopted to test Hypothesis 1 because the dependent variable is a dummy variable. We included a one-year time lag between the independent and dependent variables to avoid the potential causality problem.

Results

Table 2-1 presents the descriptive statistics and correlations (excluding the industry dummy variables). Examination of the bivariate correlations in Table 2-1 shows that multi-collinearity was not a major problem. From 2004 to 2006, 55 cases had a long-term perspective and 33 cases had a short-term perspective. Their entering mode was mostly greenfield, and the next preferred mode was joint venture.

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Table 1. Descriptive Statistics and Correlations

		Mean	S.D	1	2	3	4	5	6	7	8	9
1	Long term FDI	0.63	0.49	1.00								
2	Outside Boards	0.34	0.14	-0.39 **	1.00							
3	Foreign Ownership	17.68	21.13	-0.39 **	0.44 **	1.00						
4	Stock Option	0.20	0.41	-0.13	0.55 **	0.39 **	1.00					
5	Conglomerate	0.38	0.49	-0.37 **	0.58 **	0.54 **	0.42 **	1.00				
6	Prev. Performance	0.25	1.19	0.00 **	0.07	-0.10	-0.07	-0.02	1.00			
7	Reserve	1068.03	2377.69	-0.09	0.07	0.35 **	0.01	0.29 **	-0.04	1.00		
8	Firm Size	3736.77	7988.79	-0.20 †	0.51 **	0.50 **	0.42 **	0.49 **	-0.01	0.15	1.00	
9	Year_1	0.31	0.46	-0.10	-0.20 †	0.03	-0.15	0.04	-0.08	0.01	-0.03	1.00
10	Year_2	0.41	0.49	0.12	0.28 **	-0.09	-0.02	0.07	0.07	0.07	0.14	-0.55 **

†p<0.10; *p<0.05; **p<0.01

The proportions of outside directors and foreign ownership are negatively related to long-term foreign direct investment. The growth rate of operating profit is positively related to long-term foreign direct investment.

Table 2. Results of Logistic Regression

independent variables		Long term FDI					
		Model 1			Model 2		
		Coef.		SE	Coef.		SE
Conglomerate		-1.61720	***	0.571	-0.55694	*	0.721
Prev. Performance		-0.02178		0.209	0.02489		0.238
Reserve		0.00001		0.000	0.00002		0.000
Firm Size		-0.00001		0.000	0.00002		0.000
Year_1		0.02858		0.614	-0.02313		0.688
Year_2		0.78108		0.610	1.26583	*	0.762
Outside Boards	H1	—		—	-9.33268	***	3.489
Foreign Ownership	H2	—		—	-0.02802	*	0.017
Stock Option	H3	—		—	1.85150	*	1.014
constant		0.91391	*	0.467	3.63323	***	1.088
N		88			88		
χ2		14.43	**		28.84	***	
Log likelihood		-51.00			-43.80		
Pseudo R2		0.1240			0.2477		
change in χ2		—			14.40	***	

Table 2-2 shows the results of logistic regression models used to estimate the effects of internal governance mechanisms on the time horizon of foreign direct investment; it also shows the results of hypothesis testing.
The results support Hypotheses 1, 2, and 3.

Discussion

This study posits that internal governance mechanisms have different effects on investment decisions because of their different characteristics. Internal governance mechanisms aim to relieve the agency problem. Therefore, they are considered to have the same effects on a manager. However, internal governance mechanisms have different characteristics. Outside directors and foreign ownership reduce information asymmetry through monitoring, and stock option resolves conflict of interests between a manager and shareholders through interest alignment. Depending on the cause of the agency problem to control, internal governance mechanisms have quite different characteristics. Therefore, they influence managerial decisions differently.

We found that internal governance mechanisms for monitoring exert pressure on the short-term performance of a manager, causing the manager to focus on short-term perspective investment. However, internal governance mechanisms for interest alignment motivate a manager to invest in the foreign market with a long-term perspective. Outside directors and foreign ownership threaten a manager with the possibility of losing his or her job and compensation. Thus, a manager cannot do anything but pursue a visible and predictable performance. However, a stock option has a structure of limited loss and unlimited gain, and it can be exercised even after resignation. Therefore, a manager with a stock option is motivated to focus on risky and long-term investment. These differences of internal governance mechanisms are helpful in studying the relationship between governance mechanisms and foreign direct investment.

This study has several limitations. Three representative internal governance mechanisms were tested. Apart from these three, many other governance mechanisms exist (e.g., shareholding of insiders, institutions, and large block holders; debt policy; managerial labor market; and market for corporate control). Considering the characteristics of other governance mechanisms is necessary to enrich corporate governance studies. In addition, the sample size in this study is small, and the period of observation is relatively short (88 cases in three years). These conditions can limit the testing of various variables that influence foreign direct investment. To generalize the findings of this study, a long period of observation and a large sample size are required.

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