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GOVERNANCE PRACTICES AND CORPORATE VALUE – A RECENT LITERATURE SURVEY

Ricardo P. C. Leal

This article offers a survey of the recent international literature on the relationship between corporate governance practices and corporate value. The review includes a number of papers dealing with Brazil as well. The survey is organized in two sections. The first one examines the relationship between corporate value and voting rights and cash flow rights percentage holdings of controlling shareholders. The greater the separation between voting rights and control rights the greater the negative impact of voting rights concentration on corporate value should be. Corporate governance practices may also be gauged with indexes. A number studies have used existing indexes or built their own. A discussion on the possibility of performance and governance practices being endogenously determined is included in each section, with suggestions on how to treat the problem in empirical research. Governance practices are strongly associated to corporate value where there is less legal protection, such as in emerging markets like Brazil.

Keywords: Corporate governance; corporate valuation; ownership and control; corporate governance indexes.

Resumo. Este artigo oferece uma revisão da literatura internacional recente a respeito da relação entre governança corporativa e o valor de mercado da firma. O artigo também inclui alguns trabalhos feitos para o Brasil. A revisão está

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dividida em duas partes. A primeira examina a relação entre o valor da companhia e a concentração dos direitos de voto e dos direitos sobre o fluxo de caixa dos acionistas controladores. Espera-se que quanto maior a separação entre os direitos de voto e os direitos ao fluxo de caixa maior o impacto negativo

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da concentração dos direitos de voto sobre o valor da firma. A qualidade das práticas de governança corporativa da firma também pode ser medida com índices de práticas de governança. Estudos recentes utilizaram-se de índices existentes ou construíram seus próprios índices. Em cada seção foi incluída, também, uma discussão sobre a possibilidade de o valor da firma e as práticas de governança corporativa serem determinadas endogenamente, oferecendo-se sugestões para o tratamento empírico da questão. A qualidade das práticas de governança corporativa parece estar positivamente relacionada com o valor da firma, particularmente em países onde a proteção legal do investidor é pior, como em mercados emergentes e no Brasil.

Palavras-chave: governança corporativa; valor da firma; controle e propriedade de empresas; índices de práticas de governança corporativa.

1 INTRODUCTION

Recent studies suggest that the Berle and Means (1932) model of widely dispersed ownership is not common even in developed countries. Large block holders control a significant number of firms even in wealthier countries. La Porta, Lopes-de-Silanes, Shleifer, and Vishny (LLSV) (1999) identified the ultimate owners of cash-flow and voting rights of firms in 27 developed countries that differ in origin of their laws and enforcement. They find that, except in economies with very good shareholder protection, relatively few firms are widely held. Most firms are controlled by families or by the state. Controlling shareholders' voting rights typically exceed considerably their cash flow rights, mainly through the use of indirect control structures, such as pyramids. Pyramids are layers of companies that control a public company, many of them non-public, that allow control to be exerted with less investment. For example, if a person owns 50% plus 1 of the voting shares of a holding company that owns 50% plus 1 of the voting shares of a public company, that person has ultimate control of the public company by owning only 25% of cash flow rights (50% of 50%).

Latest research highlights the importance of corporate governance in developed and emerging markets and suggests empirical relationships between

investor protection and corporate value. LLSV (1998, 2000a, 2002) evaluate the influence of investor protection and ownership by the controlling shareholder on corporate valuation. They conclude that better shareholder protection is associated with higher valuation of corporate assets and with more developed and valuable financial markets. When shareholders rights are better protected by law, outside investors are willing to pay more for financial assets such as equity and debt.

This article is a selective survey of the recent literature about the impact of corporate governance practices on corporate value and includes some Brazilian articles. There is a strong desire of practitioners, institutions and policy makers that promote good governance practices to believe that they lead to greater corporate value. The evidence is sometimes contradictory and there are measurement problems. How can one measure "good governance practices"? It is widely known that some practices are substitutes for others. More of the same should not impact value. There is also the issue of value added measurement, both in terms of how and when. It is reasonable to say that the impact of good corporate governance practices may not be best measured through market prices in emerging markets such as Brazil.

Any survey is biased by its author's choice of papers. This one is no different. I hope to offer a flavor of the literature as well as some of the most recent empirical results in Brazil. I apologize to the authors not included in this survey and hope that the papers mentioned are representative. Finally, my motivation to narrow this survey to the value added issue is the current stage of research in emerging markets like Brazil. Moreover, organizations, such as the World Bank, the OECD, the IADB, the Global Corporate Governance Forum (GCGF) and others, as well as initiatives such as Bovespa's Novo Mercado, the Brazilian Institute of Corporate Governance's (IBGC) code of best practices, among others, advance good governance practices and searching for evidence that their efforts pay off is a worthwhile endeavor.

There is a good number of recent international corporate governance surveys that will certainly deepen what is discussed below and that address several important aspects of corporate governance. Becht et alli (2002) is a

comprehensive survey of corporate governance and control research with an emphasis on Europe and the US. Claessens and Fan (2002) survey corporate governance practices and research in Asia. Dennis and McConnell (2003) review international corporate governance issues. Gillan and Starks (2003) examine the role of institutional investors. Hermalin and Weisbach (2003) concentrate on the board of directors as an endogenous corporate governance mechanism. John and Senbet (1998) also focus on the board while Shleifer and Vishny (1997) provide an earlier overview of the corporate governance research.

Assessments of the evolution of governance practices have been produced in the domestic literature. Aldrighi (2003) evaluates corporate governance mechanisms in the US and why many of them fail. Carvalho (2002) surveys recent initiatives and regulatory changes to improve governance practices in Brazil. He also discusses why corporate governance practices in Brazil lag those in other large economies. Carvalho (2000) also reviews the evolution of the Brazilian capital markets with an emphasis in the 1990's. He concludes that the poor quality of legal investor protection is an impediment for the market growth. Hallqvist (2000) reviews the first code of best practices produced in Brazil by the IBGC. The IBGC has since released a revised version of its code. Lethbridge (1997) and Siffert (1998) offered early reviews of the international debate on corporate governance in Portuguese language. Leal and Saito (2003) review empirical corporate finance research in Brazil with an emphasis on corporate governance issues. Lustosa and Leal (2004) examine the role of institutional investors in Brazil and a few success and failed cases of activism.

Claessens et al. (2001?) review potential corporate governance reforms in Brazil in an assessment of the Brazilian equity market made for the World Bank. They cast doubts about the possibility of a vibrant stock market ever developing in Brazil. They believe that equity markets are a high cost market because they need very good law enforcement and high quality information and institutions. They believe that strengthening minority shareholder rights and improving governance of institutional investors are other key policy goals. They review evidence that company management is not focused on maximizing shareholder

rights. Their article details specific measures to be taken if equity markets are to develop in Brazil.

There are many ways to represent good corporate governance. One of them is to assess good board practices as a corporate governance mechanism. Hermalin and Weisbach (2003) survey the US and international literature. Leal and Oliveira (2002) survey board practices in Brazil. Dutra and Saito (2001) review board composition, practices and the use of cumulative voting in Brazil. Da Silveira et al. (2003) study the impact of board size, composition, and chairmanship on corporate value and find that firms that have different persons acting as the chairperson of the board and the CEO achieve greater market value.

The conclusions of these Brazilian studies are that boards are still largely insider dominated. Independent directors still play a minor role. Minority shareholders do not use existing mechanisms for greater activism. However, steps towards greater board independence may have an effect on corporate value. The IBGC has been doing bi-annual assessments of corporate governance practices in Brazil but their sample is limited and may suffer from the usual survey biases. Their most recent survey concludes that awareness towards better governance practices is increasing, that the perceived benefits are associated to better company image and management, and that boards are more engaged in corporate strategic and performance issues (IBGC, 2003). As reported by Hermalin and Weisbach (2003), maybe the impact of good board practices may be better measured in times of crisis.

This article will not focus on board practices but on concentration of cash flow rights and control rights concentration and on corporate governance indexes. Cash flow and control rights and board practices may just be part of the story though. An alternative way to represent good corporate governance practices are indexes based on charter measures and company practices and actions. These indices pool many different aspects of corporate governance and aim to be a better construct to gauge the quality of corporate governance practices, including board practices and ownership concentration and structure.

The article proceeds as follows. The first section discusses the issue of corporate control and its impact on corporate value. It is followed by a section on governance practices indexes and their relation with corporate value. A brief discussion of endog eneity is included in both sections because it presents a challenge to empirical research. The article closes with brief concluding remarks.

2 CONTROL AND CASH FLOW RIGHTS

Jensen and Meckling (1976) and Morck, Shleifer, and Vishny (1988) have provided important early contributions to research on ownership structures and corporate valuation. Jensen and Meckling concluded that concentrated ownership is beneficial to corporate valuation because large investors are better at monitoring managers. Morck, Shleifer, and Vishny distinguish between the negative control effects (entrenchment) and the positive incentive effects of greater shares of ownership. They suggest that there are less conflicts of interest and greater shareholder value when ownership and control shares are the same. Morck, Shleifer, and Vishny (1988) find that profitability rises with ownership concentration up to a point in the US, falling for larger concentrations. The rise is consistent with the incentive hypothesis but after a given point there is too much voting power concentration (entrenchment) and that leads to the fall in corporate value due to a greater likelihood of expropriation. This is sometimes called the inverted U-shaped relationship between ownership rights and value. This early literature focused on shareholder-manager conflicts.

Shleifer and Vishny (1997: 758-759) review the empirical evidence for the US and believe that that the ability of controlling shareholders to take advantage of minority shareholders is greater if they have superior voting rights, if the concentration of their voting rights is greater than the percentage of their cash flow rights (the wedge), if they use indirect control structures (pyramids) or non-voting shares. Claessens & al (2002) find evidence for entrenchment in Asia, Lins (2003) finds a consistent pattern for 18 emerging markets as well. Shleifer and Vishny (1997:754-755) also comment that monitoring by large minority shareholders is effective only in countries with good investor protection. In

countries with poor investment protection, only a majority of ownership would be effective. This is exactly what we see in most countries.

Brazil is no different and presents a very large concentration of control rights, according to Valadares (2002) and Valadares and Leal (2000) for 1996, Leal et alli (2000, 2002) for 1998, Carvalhal da Silva and Leal (2003) for 2000, and Leal and Carvalhal da Silva (2004a and 2004b) for 2002. All of these papers examine the direct and the indirect control structures and the latter ones also consider the effect of shareholder agreements. Early Brazilian evidence was presented by Procianoy (1994) and Procianoy and Comerlato (1994) who examine succession and related party transactions and their expropriation potential due to very high concentration of voting rights. Procianoy and Caselani (1997) find that controlling shareholders can be quite risk averse in Brazil.

Shleifer and Vishny (1997: 764) state that the ability, incentive, and easiness to vote for the board of directors is a common governance arrangement to grant minority shareholders voice because their investment is sunk in the firm. The same goes for inferior voting rights. Shleifer & Vishny (1997: 748, 759) present evidence of private benefits of control and minority shareholder expropriation through large control premiums. Nenova (2001) reports very high premiums for Brazil in a period in which tag along rights have been removed from the law. When these rights were reinstated, corporate values rose again. Becht et alli (2002: 35) discuss that indirect ownership structures may create strong incentives for expropriation of minority shareholders, particularly when coupled with the presence of non-voting shares. For instance, Claessens et alli (2002), Lins (2003) and Leal et alli (2000) find evidence that pyramids are negatively related to value for Asian countries, emerging markets, and Brazil, respectively. Nascimento (2000) and Procianoy and Schnorrenberger (2004) present evidence that the proportion of debt financing is inversely related to the percentage of voting rights of controlling shareholders in Brazil.

Previous literature documents that there are both costs and benefits associated with ownership concentration. The presence of controlling shareholders may be harmful to the firm because their interests may not align

with those of non-controlling shareholders (Shleifer and Visnhy (1997) and LLSV (1998, 2000a, 2002)). Alternatively, the presence of controlling shareholders may not necessarily be detrimental to the firm. Large shareholders may mitigate the free rider problem of monitoring a management team, and hence reduce agency costs. LLSV (1999) argue that in countries where the legal and institutional frameworks do not offer sufficient protection to outside investors, concentrated ownership can mitigate shareholder conflicts. In any case, it is always possible to have expropriation of minority shareholders by controlling shareholders.

Recent research (Shleifer and Vishny (1997), LLSV (1998, 2000a, 2002), and Claessens et alli (2002)) suggests that greater cash flow rights are associated with greater valuation. In contrast, the concentration of control rights and the separation of voting from cash flow rights are negatively related to firm value. This latter literature focuses on the conflicts between controlling shareholders and outside shareholders. When one or a few investors control a corporation, their actions may result in the expropriation of outside shareholders. Such companies are not attractive to outside shareholders and their shares may present lower market valuations.

Claessens, Djankov, and Lang (2000) traced back ultimate ownership and control of East Asian Corporations. In particular, they examined the extent of deviations from the one-share-one-vote rule, the use of pyramiding and cross-holdings, the presence of single and multiple controlling owners, and the presence of controlling shareholders as top managers of the company. Their study showed that most East Asian firms are controlled by a single shareholder that often turns out to be a family. Pyramidal and cross-holding structures are very common. In contrast, the use of dual-class shares is very limited. They documented a significant separation of ultimate ownership and control, which is most pronounced among family-controlled firms and small firms. In a similar study, Faccio and Lang (2002) analyzed ultimate ownership and control in Europe and reported that families are the most frequent type of controlling shareholders and that there is a significant separation of ownership and control, mainly through the use of pyramids and cross-holdings. In the US, Anderson and Reeb (2003) assert that family ownership in S&P500 firms is beneficial to minority

shareholders. Families control about one third of the S&P500 firms with approximately 18% of the voting equity. While family ownership may be a suitable ownership structure for US firms at low levels of voting rights concentration, this may not be the case in emerging markets where concentration levels are much higher and where families leverage their control rights with the use of pyramids and non-voting shares.

Claessens et alli (2002) and Lemmon and Lins (2003) separate the effects of control and cash flow ownership on the valuation of several East Asian markets and find that more concentrated control adversely affects valuation, while cash flow ownership affects it positively. Lins (2003) finds that market value is lower for firms with 5% to 20% of managerial ownership in 18 emerging markets but that managerial cash flow rights do not affect value. Lins also shows that the presence of large non-managerial block holders mitigates the negative effect of control concentration on value, particularly in countries with poor legal protection. Finally, he finds that the impact of pyramids is greater where legal investor protection is worse. This author includes Brazil in the sample but his empirical results are obtained by pooling all countries together. Wiwattanakantang (2001) investigates the effects of controlling shareholders on corporate performance in Thailand. The results indicate that the presence of controlling shareholders is associated with better performance, when measured by accounting measures such as the return on assets (ROA) and the sales-to-assets ratio. Given that most firms in her sample do not implement control mechanisms to separate voting and cash flow rights, controlling shareholders might be self-constrained not to extract private benefits. This result is consistent with the evidence by Anderson and Reeb (2003) that family ownership is not bad to minority shareholders per se. Gibson (2003) examines CEO turnover in emerging markets and finds that turnovers are less likely in firms with large domestic shareholders, even when performance is poor. He labels governance practices in these firms as ineffective.

The negative relationship between control rights and performance (entrenchment) and the positive relationship between cash flow rights and performance (incentives) are challenged by articles that control for endogeneity. The endogeneity problem arises when ownership, performance,

and investment are simultaneously determined. Ownership would affect performance but performance would also affect ownership through investment. Some of the empirical means of dealing with endogeneity are the use of control variables, modeling a system of simultaneous equations or looking at the reaction of firms during a truly exogenous event.

Lemmon and Lins (2003) claim that they control for endogeneity because their empirical experiment compares the relationship between ownership and performance during an exogenous shock, the Asian crisis. They find that the negative effects on performance are greater when there is a greater separation between control and cash flow rights. Demsetz and Villalonga (2001), for the US, claim that when they control for endogeneity the relationship between control rights and performance disappears. They test for the inverted U-shaped form observed for US firms by Morck et al. (1988) and use simultaneous equations. Cho (1998) also challenges the hypothesis that ownership is exogenously determined and affects value in the US using the same method. Actually, he finds just the opposite; performance affects ownership for the US. Coles et al. (2003) find support for the Morck et al. (1988) US results through a structural model but state that the usual methods to address the endogeneity problem may not work and that the endogeneity may be substantial anyway. Durnev and Kim (2003) state that governance practices are more important in countries with weak legal protection and that could explain the mixed results for the US and the stronger results found for Asia and Brazil, for example. That is my opinion as well. Emerging markets show ownership levels much higher than US ownership levels and results should be more clear-cut and less influenced by endogeneity in these markets. In any case, the careful empiricist is advised to consider that governance practices, performance and investment may be simultaneously determined in Brazil. To the best of our knowledge, the only Brazilian work that considered endogeneity was Leal and Carvalhal da Silva (2004a). Let's now turn to Brazil.

Valadares (2002), Valadares and Leal (2000), Leal et alli (2000, 2002), Carvalhal da Silva and Leal (2003), and Leal and Carvalhal da Silva (2004a) portrait the evolution of corporate control and ownership from 1996 to 2002. They analyze direct and indirect shareholding. Direct shareholders are those who own shares in the company itself. They consider all shareholders with 5% or more

of the voting capital. Five percent is the threshold for mandatory identification of shareholders in Brazil. Indirect ownership includes stockholders who ultimately control the company. For example, if a shareholder has 51% of a company that owns 80% of another company, the former has 40.8% of cash flow rights (the total capital) of the latter company (51% times 80%) and controls 51% of the latter company (minimum of 51% and 80%). There may be slight variations in the method used in these papers, with no material difference in results. The latest papers, Carvalhal da Silva and Leal (2003) and Leal and Carvalhal da Silva (2004a and 2004b), calculate ultimate ownership percentages and adjust for the existence of shareholder's agreements. They consider the covenants in each agreement to adjust the cash flow and voting rights ownership percentages for the entire controlling block.

These authors analyze shareholding composition backwards until they are able to classify the true owners into one of the following groups: family, institutional investors (banks, insurance companies, pension funds, foundations or investment funds), foreigners (either individuals or entities) and the government. Siffert (1998) reports on the ownership change of Brazilian firms between 1990 and 1997, with less family and government controlled companies and more foreign and shareholder agreements controlled firms. Lins (2003) also reports direct and indirect ownership and control percentages for a smaller sample of Brazilian firms.

The results of these papers are qualitatively the same and are summarized in Table 1. The data for 1998, 2000, and 2002 have been obtained from Leal and Carvalhal da Silva (2004a). They considered the existence of shareholder's agreements. However, the data for 1996 come from Valadares and Leal (2000) who do not consider these agreements. To make the comparisons consistent, we looked at the 5 largest shareholders because those would very likely be the ones in a shareholder's agreement in 1996. There is a high degree of concentration of voting and total capital as expected. The median ownership of voting rights for the 5 largest shareholders went from 79% to 89% between 1996 and 2002. The median ownership of total capital for the 5 largest shareholder went from 49% to 54% between 1996 and 2002. Therefore, there is a substantial separation between voting and cash flow rights (wedge) and this separation has

been growing over time. Lins (2003) finds high concentration numbers as well for 1995, close to the numbers reported for 1996 by Valadares and Leal (2000). His analysis considers only 59 Brazilian firms while Brazilian authors have considered many more firms as seen in Table 1. Lins' (2003) results are biased towards the larger firms. The concentration of control rights and the leverage of control rights through the use of pyramids and non-voting shares are greater in Brazil now than what is portrayed by Lins for 1995.

It is worth noting that the number of companies considered has decreased substantially, particularly those without a controlling shareholder (+50%). About half of the companies that have a controlling shareholder with more than 50% of the voting shares directly, most of the firms considered in Table 1, are controlled by families, with foreigners coming in second. In 2000, Carvalhal da Silva and Leal (2003) report that 27% for the firms sampled had shareholder agreements, 86% had indirect control structures (pyramids), and that the voting shares represented 53% of the total capital on average. Siffert (1998) documented the increasing use of shareholder agreements in Brazil.

Carvalhal da Silva and Leal (2003) related ownership and cash flow rights to value. They find a negative non-linear relationship between voting rights concentration and market value, represented by a measure of Tobin's q. They also find a negative relationship between the dividend payout and ownership concentration. Procianoy (1995) finds evidence of minority shareholder expropriation when he examines dividend policy changes associated with taxation changes in the late 1980's and early 1990's. Their results support the idea of managerial entrenchment in Brazil. The same authors find weaker evidence of managerial alignment through a positive relationship between total capital concentration and value. These results are consistent with those of Lins (2003) that finds stronger evidence for entrenchment than for incentives. Earlier results by Leal et alli (2000) show that market values, represented by an estimate of Tobin's q, are lower for firms that use indirect control structures to increase the wedge between voting and cash flow rights than when pyramids are present but the wedge decreases or there is no wedge.

De Siqueira (1998) relates direct ownership to operating performance, measured through accounting returns and growth. His sample is possibly from 1996 or 1997. He reports a very week relationship between operating performance and direct voting and cash flow rights concentration, consistent of latter studies. He also reports that smaller firms show lower voting rights concentration and firms in highly regulated industries, such as utilities, aviation, and banking, show more concentrated voting rights. More government regulation may represent more risk, thus the more concentrated ownership.

Family ownership does not seem to particularly affect value in Brazil. Value is actually lower for government owned firms. When indirect control structures are present, value only seems to be lower when the separation between control rights and cash flow rights is greater. The relationship between ownership holdings and market value seems to be non-linear. There is little evidence that greater cash flow rights increase corporate value. The Brazilian results are consistent with the international evidence. Greater concentration of voting rights leveraged by the use of indirect control structures destroys value. However, family ownership, concentrated ownership, and the presence of indirect control structures by themselves may not affect value.

3 CORPORATE GOVERNANCE PRACTICES INDEXES

A growing number of recent papers use corporate governance indexes. These indexes may be based on subjective or objective answers to a questionnaire. For example, CLSA (Credit Lyonnais Securities Asia) uses a questionnaire that is filled out by its analysts and that includes qualitative evaluations on his or her part or on the part of the respondents to compute a governance practices index. Patel et alli (2002) report on a transparency and disclosure index computed by Standard and Poor's (S&P) using 98 true or false type of questions. Durnev and Kim (2003) use these two indexes and state that the S&P index is objective while the CLSA index has a qualitative component. Klapper and Love (2002) use the CLSA index for a number of emerging markets. Bauer et alli (2004) use an index of corporate governance practices for companies included in the FTSE Eurotop 300 index.

Barontini and Siciliano (2003) buld their own index and define a number of dummies representing the risk of expropriation that depend on the existence of a controlling shareholder, the share of voting rights of large outside shareholders, and the existence of either pyramids or non-voting shares. Agrawal and Knoeber (1996) recognize that mechanisms to control agency problems are interdependent, such as board composition and block shareholding. Correlations between any one of them with performance may be spurious because they may be compensated by another, non present, mechanism. The usual index building method does not ignore this substitution effect, also described by John and Senbet (1998: 391), because it simultaneously and addictively considers the existence of alternative mechanisms.

Gompers et alli (2003) compute a corporate governance index for 1,500 US companies consisting of the presence or not of 24 anti-takeover provisions and shareholder's rights that can be objectively assessed. Each one of their index items is a dummy variable. The index is the simple sum of such variables. They find that greater shareholder's rights are associated to greater corporate valuation and this association increases in time in the 1990's. They find that governance practices are positively related to profits and sales growth and negatively related to capital expenditures and the amount of acquisitions. Core et al. (2004) expand on Gompers et al. They find a negative relation between poor governance practices and operating performance but this negative relationship does not show in stock prices.

Shleifer and Vishny (1997: 770) state that corporate governance in Italy must be much closer to the rest of the world than corporate governance in the US, Japan, or Germany. Barontini and Siciliano (2003) test if the risk of expropriation is associated with stock returns and the Tobin's q of a sample of public Italian firms between 1991 and 2000. They use dummies to represent the risk of expropriation. Their dummies are associated to the proportion of voting rights by the controlling shareholder and the stock ownership of large outside shareholders, as well as to the presence of pyramids and non-voting shares. They also find no relationship between stock returns and the risk of expropriation and conclude that this is consistent with rational investors discounting stock prices in

anticipation of expropriation, as discussed by Jensen and Meckling (1976) and suggested by the evidence in Core et alli (2004). They also find that Tobin's q is lower for companies that present a higher risk of expropriation, particularly if they are controlled by the state or by families, and for holding companies. Their results are consistent with those of Bauer et alli (2004) for a sample of European companies. Interestingly, these authors find that corporate governance practices have a stronger positive relationship with corporate value in continental Europe, where legal protection is perceived as weaker, than in the UK.

In the small sample of Brazilian companies used by Klapper and Love (2002), relative market valuations of companies were low, while the level of the governance index was high, suggesting a weak relationship between market value and governance. Patel et alli (2002) report an average firm-level S&P transparency and disclosure score of 32 for Brazil in 2000, low when compared to an average of 43 for emerging Asian markets and 55 for the highest ranking emerging market, South Africa. They find that the S&P index is negatively correlated with large shareholdings and positively correlated with price-to-book in Brazil. They sampled 30 Brazilian firms.

Klapper and Love (2002) have noted that there is a large variation in CLSA's measure of governance practices quality within specific countries. However, Brazil presents the third highest within-country homogeneity in the firm-level governance index computed by CLSA. These authors also note that Brazil presents low relative market valuations while showing relatively high firm level governance indicators. These results, nevertheless, should be taken with caution because the number of Brazilian companies covered in the study (24) is very small, including mostly companies that listed ADRs in the US and are, therefore, very similar in terms of their governance practices.

Articles that have examined several countries, such as Klapper and Love (2002) and Durnev and Kim (2003), have found that there is a relationship between the governance practice index used and corporate value. In countries where the legal protection is worse, better governance practices have an even greater impact on market value. However, Klapper and Love (2002) establish

that even though better governance practices mitigate poor legal investor protection, they are not a perfect substitute for it. Improving the legal system continues to be important.

Leal and Carvalhal da Silva (2004a and b) follow LLSV (1998) and Barontini and Siciliano (2003) in spirit by including only aspects that can be objectively assessed in their index without the need to interview or survey interested parties. They produce an index based on information that can be objectively obtained from public sources, such as the mandatory filings with the Brazilian Securities Commission (CVM, in Portuguese), company annual and periodic reports, and websites. They structure their index based on codes of best practices. The main influence comes from the Code of Best Practices of IBGC. They also use the OECD code of best practices. Brazil has a second code of best practices produced by the CVM and they use it as well. These codes provide the framework to select the items to be measured in the index. Finally, they use control variables introduced in other studies, such as Agrawal and Knoeber (1996), Klapper and Love (2002), Gompers et alli (2003), and Barontini and Siciliano (2003). They build their index similarly to Gompers et alli (2003). They developed a set of 24 questions. If the answer is "yes" to any given question they interpret it as a good governance practice or as a pro-shareholder provision or action and attribute the value of "1" to the variable that otherwise is null. The index is the simple sum of the values of 1 or 0 assigned to each question.

Leal and Carvalhal da Silva (2004b) investigate the relationship between the quality of a firm´s corporate governance practices index and its valuation and performance. Their panel data results for the 1998-2002 period indicate that less than 4% of Brazilian firms have "good" corporate governance practices, and that firms with better corporate governance practices have higher market valuations (Tobin´s q) and better operating performance (return on assets). Their results confirm those in other emerging markets. Better governance practices do pay off. Similar studies about Korea, by Black et al. (2003), and about Switzerland, by Beiner et al. (2004), offer similar conclusions. These two studies also offer the interested reader implementations of corporate governance indexes as well as of endogeneity tests. Beiner et al. (2004) also find reverse

causality for Swiss firms. Highly valued firms seem to adopt better governance practices as well as better governance practices seem cause higher value.

Carvalho (2002) and Srour (2002) present evidence that firms associated with better governance practices show greater market valuations or lose less value in times of stress, such as during the period following the terrorist attacks in the US in 2001. They compare firms that are listed in Bovespa's "Novo Mercado" or that have level II or better ADR's listed in the US. Both types of listings required greater commitments in terms of disclosure, transparency, and shareholder rights than what is required by the Brazilian securities laws. Although these articles do not construct a governance index, they use more stringent lsting requirements as proxies for better governance practices. The results from Srour (2002) are consistent with those of Lemmon and Lins (2003) for a larger sample of emerging markets. These authors also examined corporate values during a time of crisis.

Klapper and Love (2002) and Barontini and Siciliano (2003) argue that there may be an endogeneity problem when performance measures are correlated with proxies for good governance practices, such as control and cash flow concentration or a governance practices index. Leal and Carvalhal da Silva (2004a) address this issue through as system of simultaneous equations. The issue of endogeneity can be represented using the circular notation of Hermalin and Weisbach (2003) combined with the simultaneous equation notation used by Agrawal and Knoeber (1996).

$$c_j = \boldsymbol{a} + \sum_{i \neq j} \boldsymbol{f}_i c_i + \sum_{i=1}^{N} \boldsymbol{j}_i X_i + \boldsymbol{e} \tag{1}$$

Equation 1 represents the kind of test performed by Klapper and Love (2002), with **c** as a vector of governance practices measures, such as the index or ownership percentages, and **X** as a vector of control variables that are associated with governance practices as well. Equations such as 1, one for each governance practice, may be included in a simultaneous equation system, as in Agrawal and Knoeber (1996), with the performance (Q) equation represented by equation 2. If the coefficients of **c** in equation 2, simultaneously determined,

are still significant, this will be an indication that the net effect of alternate governance practices is significant over the value of the firm.

$$Q_i = \mathbf{a} + \sum \mathbf{b}_i c_i + \sum_{i=1}^{N} \mathbf{l}_i X_i + \mathbf{x} \qquad (2)$$

4 CONCLUSION

There is evidence that good corporate governance practices may lead to lower cost of capital and greater market valuations for companies. Investors in countries with poor legal protection discount the prices of firms to compensate for expropriation. However, lower stock prices may not raise demand enough in these countries, keeping the supply of outside equity limited (Shleifer and Wolfenzon (2002)). It would be reasonable to assume that outside equity financing would increase if the risk of expropriation is reduced through better legal protection and better corporate governance practices.

Some of the studies reviewed also show that there is a relationship between the insider voting rights holdings and corporate value. In the US, at very low levels of insider voting rights holdings, value increases. It then flattens out and decreases at higher levels of insider voting rights holdings. Nonetheless, the percentage of voting rights held by insiders in the US is relatively lower when compared to emerging markets. In Asia and in Latin America, there seems to a negative relationship between the percentage of voting rights held by insiders and corporate value. This relationship is stronger and significant when insiders use mechanisms to leverage their voting rights. For example, the use of indirect control structures, such as pyramids, allows insiders to keep control of the company by investing less of their own money. The same can be said about the widespread use of non-voting shares in Brazil. The negative effect of increasing voting rights with insiders and value is called entrenchment. There is evidence of insider entrenchment, particularly outside the US. Insiders have an incentive to act in the interest of minority shareholders if they hold a greater share of total capital. The evidence for the incentive effect is not as clear as with the entrenchment effect, even among emerging markets.

Several papers have used corporate governance practices indexes and related them to corporate value, stock returns, and the operating performance of companies. Once again, the better the corporate governance practices of a firm the greater its market value. However, the evidence is not as clear when one used operating performance measures and stock prices. There is always the possibility that governance practices, value, and investment are endogenous. Therefore, researchers that sought to find causality among these concepts without considering that they may be simultaneously determined may be at error. It is very important that researchers model the potential endogenous nature of value in relation to corporate governance practices.

Finally, Brazil presents extremely high levels of insider holdings of voting shares. In fact, ultimate voting shares percentages controlled by the largest shareholder have been increasing over the years. Ultimate voting rights are those that consider the existence of indirect control structures and shareholder's agreements. More than 80% of the firm present some sort of indirect control structure and the degree of leverage of voting rights through the use of these structures and of non-voting shares is severe. There is evidence of entrenchment in Brazilian companies but no significant evidence of insider incentives.

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TABLE 1

Indirect Shareholding Composition of Brazilian Companies 1996-2002

Median indirect shareholding of Brazilian companies listed on the São Paulo Stock Exchange for the 5 largest shareholders. Such participation was analyzed backwards until the shareholder was identified to be from one of the following groups: (i) individuals or families; (ii) foreign investors (individuals or institutions); (iii) government; (iv) institutional investors (banks, insurance firms, pension funds or investment funds). A company with a majority shareholder is one where a single shareholder has more than 50% of the voting capital directly. Data obtained from Valadares and Leal (2000) for 1996 and Leal & Carvalhal da Silva (2004a) for 1998, 2000, and 2002.

	Companies with a majority shareholder			Companies without a majority shareholder			Total Sample		
Year	Voting Capital	Total Capital	N	Voting Capital	Total Capital	N	Voting Capital	Total Capital	N
1996	83%	50%	203	72%	48%	122	79%	49%	325
1998	88%	53%	195	80%	45%	45	86%	52%	240
2000	89%	57%	197	70%	39%	39	88%	54%	236
2002	90%	57%	183	72%	45%	31	89%	54%	214