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# The Role of Corporate Governance in Financially Constrained Firms<sup>1</sup>

<sup>1</sup>Shinae KANG

*1. First Author*, Associate Professor, Seoul National University of Science and Technology, Email: [sakang@seoultech.ac.kr](mailto:sakang@seoultech.ac.kr)

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## Abstract

**Purpose** – This paper empirically investigates what factors contribute to management decisions by corporate governance in the Korean stock market. In the paper, dividends and investments were employed as management decisions and major stockholders' shares and foreign investors' shares were used as corporate governance.

**Research design, data, and Methodolog** – Samples are constructed by manufacturing firms listed on the stock market of Korea as well as those who settle accounts in December from 2001 to 2018. Financial institutions are excluded from the sample as their accounting procedures, governance and regulations differ. This study adopted the panel regression model to assess the sample construction including yearly and cross-sectional data.

**Results** – This results support the literatures that major shareholders showed insignificance to dividends, positive significance to investment in financially unconstrained firms and negative significance to investment in financially constrained firms. Whereas foreign investors favor firms to increase dividends but they decrease investments only in financially constrained firms.

**Conclusion** – This paper documented evidence that financial constrained firms use dividends for their investment and foreign investors decrease investments under financial constraints. But for dividends decisions, foreign investors give significant positive impacts irrespective of financial constraints.

**Ke words:** Major Shareholder, Foreign Investor, Dividend, Investment, Panel Regression.

## 1. Introduction

Concerns are high over US and Chinese trade friction. Since the global financial crisis in 2008 and the Greek debt crisis in 2011, global economic uncertainty has increased. The external economic conditions of Korean companies are not good. Given the uncertainty of the environment, the impact of corporate financial constraints on corporate management should be further examined. Among the many theories that determine a company's financial structure, it is necessary to apply the financial constraint hypothesis in consideration of various environmental factors and unstable economic conditions (Ra Young-soo, Lee Yoon-gu, 2012). Corporate governance has a significant impact on corporate management decisions such as dividends and investments. Poor corporate governance was cited as a cause of the financial crisis. Many efforts have been made to fix this. One of these was removing foreign investment restrictions. Since the 1997 Asian financial crisis, foreign investment in Korea had lifted, excluding some sectors. Since 1997, the percentage shares of foreign investors in stock market have gradually grown and many studies have

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continued to study what factors contributed foreign investments and what influence they had given. Among those studies, some showed conflicting findings on their information asymmetry. They try to solve the information asymmetry by selecting companies with good performance and low risk and low debt .

This paper empirically investigates what factors contribute to management decisions by corporate governance in the Korean stock market. In the paper, dividends and investments were employed as management decisions and major stockholders' shares and foreign investors' shares were used as corporate governance. Using sample firms whose fiscal month is December from 2001 to 2018 by applying a panel model, this paper contribute to what factors impact firm's management decisions under financially constrained and unconstrained condition.

## **2. Literature Review**

Since 1997, major shareholders and foreign investors have had considerable impact on companies' dividends and investments. Literatures has given conflicting results. And decisions by companies can be affected by financial constraints.

Kim et al. (2015) analyzed the securities market and KOSDAQ market in total from 2009 to 2013. The results show that the controlling shareholder (ownership management) has a negative effect on earnings management and a negative (-) sign on dividends. This has resulted in the ownership managers mitigating the agency problem between ownership and profit management, and the relationship between ownership management and dividends is sparse and yields insignificant results. Nam (2017) studied small and medium-sized companies with the highest shareholder equity ratio with dividend yield and dividend yield. This suggests that even in the case of SMEs, the higher the maximum shareholding ratio, the greater the incentive to reduce agency costs with external shareholders by increasing dividends. In the analysis considering the financial constraints, the relationship between the largest shareholder's share and dividend policy was significantly negative. The results of 2SLS analysis were also performed to control the endogenousness of the governance variables, and the results were consistent. These findings indicate that the largest shareholder is reducing dividend policy under financial constraints, thus affecting the dividend policy in the long term without compromising corporate value.

Kang and Min (2010) analyzed the impact of foreign investors on dividends and investment decisions of Korean companies in December-financing nonfinancial companies listed on the exchange between 2001 and 2008. The results of the study showed the overall dividend payout ratio increased for foreign investors. In addition, the separate investment objectives did not affect the company's dividend payout ratio. Second, if the equity of foreign investors increases, the capital investment decreases due to fixed self-confidence growth rate and tangible self-confidence growth rate. Seemed. In addition, the influence of foreign investors above 5% was led by foreign investors for business participation. Third, the size and significance of the coefficient values differ between the results of selecting the HT-IV / GLS method and the regression analysis and the fixed effect model in order to consider the endogenous problem between the foreign investor's equity ratio and the company's dividend decision. Kim and Jang (2012) insisted and proved that the foreign investor's investment period is important with the dividend level of domestic companies. They divided foreign investors into two groups: long-term investors and short-term investors. In the long-term foreign investors group, there was a significant positive relationship between their holding ratio and dividend level. In the group of foreign investors, no significant relationship was found between the holding ratio and dividend level. This implies that the driving force of foreign investors' dividend policy on domestic companies is not their superficial holding ratio, but their investment period, and the domestic previous research that analyzed the relationship with dividend level only by their holding ratio is limited. Lee and Kim (2018) analyzed the relationship among foreign ownership, dividends and earnings management. Their results shows as follows. First, although the foreign ownership ratio has a negative (-) explanatory power in earnings management, the foreign ownership ratio combined with dividends has a significant positive effect on earnings management. Second, this tendency was stronger in companies with insufficient dividends. Third, if the company that paid out dividends in the previous year is one that lacks expected dividends, the company raised its profits to pay dividends to foreign investors. In addition,

dividends and earnings adjustments were consistently consistent in groups with foreign ownership of 5% or more. This paper shows the foreign investor controls the opportunistic earnings adjustment of managers.

Kim et al. (2013) showed that there were no significant relationships between R&D investment and management type, the largest shareholder and the stakes of related parties, and the shares of foreign investors. This indicates that management's preference for R&D investment is mixed in the face of the crisis throughout the world and the new change of prolonged low growth. Second, as the company's growth potential increases, the preference for R&D investment by professional managers is lower than that of owned managers. This suggests that under high environmental risks such as the global economic crisis, professional managers do not prefer high-risk investments such as R&D investment. Third, even in consideration of governance variables affecting the relationship between professional managers and R&D investment, professional managers showed negative results in R&D investment compared to owned managers. Professional managers significantly reduced R&D investment as the stake of the largest shareholder increased, while foreign equity investors had limited influence on R&D investment by professional managers. Ryu and Kim (2014) showed that the greater the gap in ownership, the higher the spending on R&D. These results indicate that the greater the gap in ownership, the greater the shareholder's influence on aggressive management decisions of managers in pursuit of their private benefits. Second, the greater the gap in ownership, the lower the level of advertising spending. This indicated that the largest shareholder is influencing managers to curb short-term investments because they do not prefer short-term harvest strategies to pursue their own private interests. Third, the higher the gap in ownership, the lower the level of capital investment growth of firms. This suggests that the higher the gap in ownership, the greater the shareholder's control over the control of the largest shareholder due to the additional financing of capital investment, thus influencing the management's investment decision to prevent the largest shareholder from investing in increasing the size of the company.

Ra and Lee (2012) showed financial constraint firms generally increased their cash holdings in the company's cash flows, and in fact, they tended to increase their cash holdings consistently during the analysis period. This is partly an indication that the financial constraint hypothesis holds true for Korean firms, but it has also found a tendency to increase cash reserves in financially constrained firms during the same period. Second, it was predicted that the change in financial behavior due to the financial constraint hypothesis would affect the corporate financial structure, but the results did not support the hypothesis. The relationship between financial structure fluctuations and cash holding fluctuations showed a negative relationship, but was not statistically significant. In addition, the average value of the rate of change in the financial structure did not show a downward trend as expected. After all, the factors that have a significant impact on the financial structure are profitability, future investment opportunities, and dividends, which are the traditional determinants of financial structure.

Lee and Byun (2017) empirically investigated financial constraints on firm value. The use of cash by financially-constrained firms was found to be associated with higher future management performance compared to that of financially-constrained firms. Moreover, financial constraints seem to be a practical substitute for good corporate governance in governing managers. Good corporate governance increases the efficiency of cash use in financially constrained firms but has no effect on financially constrained firms. Similarly, the regulatory impact of financial constraints was found to be concentrated in companies with weak governance.

### **3. Sample and Methodolog**

In constructing our sample, we selected manufacturing firms listed on the stock market of Korea as well as those who settle accounts in December. Financial institutions are excluded from the sample as their accounting procedures, governance and regulations differ. Our sample period covers the 2001~2018 period. This study adopted the panel regression model to assess the sample construction, including yearly and cross-sectional data.

[Table 1] shows the summary statistics of the independent variables, and indicates that the minimum values of the variables. Winsorizing was adopted to all variables and the variables were censored at 1% . The average of ROA is 2.6%, while that of Major shareholders' shares(M) is 41.585% and foreign investors' shares(FT) is 6.896%. The real asset growth(REAL) is 29.3%, dividends averaged at 0.8%, R&D(RND) at 5.7%, debt ratio(DEBT) at 120.3%,

Standard deviation of (STD) at 11.5 and log of total assets(SIZE) at 26.302. The correlation of independent variables is relatively small. So variance inflation factor and tolerance were verified for possible multi-collinearity, but it proved to have few special problems. The correlation between M and DIV, M and ROA, FT and DIV, FT and SIZE, FT and ROA shows positive significant at 5% level and M and RND, M and SIZE, M and DEBT, FT and RND, FT and DEBT shows negative significant at 5% level. From this relationship, we can expect that as major shareholders' shares and foreign investors' shares's increase, dividends and roa will increase and R&D and debt will decrease. All independent variables were used from the same years(t) and depend variables were used at time t.

**Table 1:** Summary Statistics

Variables	Mean	Correlation								
		M	FT	REAL	DIV	RND	SIZE	ROA	DEBT	STD
M	41.585	1								
FT	6.896	-0.006	1							
REAL	0.293	-0.006	-0.006	1						
DIV	0.008	0.145*	0.264*	0.046*	1					
RND	0.057	-0.146*	-0.044*	0.083*	-0.091*	1				
SIZE	26.302	-0.042*	0.489*	-0.044*	0.028*	0.0370*	1			
ROA	0.026	0.175*	0.196*	0.058*	0.444*	0.1980*	0.082*	1		
DEBT	1.203	-0.056*	-0.086*	0.055*	-0.263*	0.0239*	0.020	-0.211*	1	
STD	0.115	-0.122*	-0.063*	0.111*	-0.090*	0.3137*	-0.061*	-0.152*	0.046*	1

Note1 : M = the ownership ratio of majority shareholders and affiliated parties; FT = the ownership ratio of foreign investors; REAL = (Real assets(t) – Real assets(t-1))/Real assets(t-1); DIV = (cash dividends / net income); RND = research and development (R&D) expenditures / sales; SIZE = log (total asset); ROA = (net income / total asset); DEBT = (total liabilities / total stockholders' equity); STD = standard deviation of the operating income for the past three years

Note2 : \* indicates the significance level at 5%

#### 4. Empirical Results

[Table 2] shows the results of the panel regression analysis on dividends, which was conducted to find what factors related with dividends and governance under financial constraints. Model (1) shows the relationship between dividends and corporate governance from 2000 to 2018. And financial constraints are important in considering firms' dividend decision. So Model (2) shows the relationship for financially unconstrained firms and Model (3) shows the relationship after 2008 of financially constrained firms. Throughout the model from (1) to (3), foreign investors showed significant positive influence on dividends but major shareholders showed insignificance on dividends. Real asset growth showed significance on model (1) and (3), but showed insignificance on model (2). SIZE, DEBT, STD showed negative influence and ROA showed positive influence on dividends from model (1) to (3).

**Table 2:** Dividends, governance and financial constraints

Dependent Variable	(1)	(2)	(3)
	all	unconstrained firms	constrained firms

	DIV		
	0	0	0
M	-0.391	1.272	0.739
FT	0.000***	0.000***	0.000***
	10.901	7.477	6.946
REAL	0.001***	0	0.000*
	4.488	1.008	1.749
SIZE	-0.003***	-0.001***	-0.002***
	-11.107	-4.941	-4.991
ROA	0.030***	0.008***	0.065***
	22.623	10.469	22.305
DEBT	-0.000*	-0.000***	0.005***
	-1.891	-2.934	6.923
STD	-0.005***	-0.003***	-0.006**
	-3.776	-3.753	-2.055
Constant	0.075***	0.026***	0.056***
	12.335	5.5	5.572
Observations	5,648	2,669	2,979
R-squared	0.145	0.095	0.202

Note: The value in parentheses is z-value, and \*\*\*, \*\*, \* means significant at 1%, 5%, and 10% levels, respectively

[Table 3] shows the results of the panel regression analysis on dividends, which was conducted to find what factors related with real asset growth and governance under financial constraints. Model (4) shows the relationship between real asset growth and corporate governance from 2000 to 2018. And financial constraints are important in considering firms' investment decision. So Model (5) shows the relationship for financially unconstrained firms and Model (6) shows the relationship after 2008 of financially constrained firms.

Major shareholders showed mixed results on real asset growth. They showed positive impact on unconstrained firms but negative impact on constrained firms. Foreign investors showed significant negative impact on constrained firms. This shows that majorshare holders and foreign investors decrease real asset under financial constraints. Dividend showed positive significance on model (1) and (3), but showed insignificance on model (2). SIZE, STD showed positive influence from model (1) to (3). DEBT showed positive significance on model (2) and negative significance on model (3). These results implies that dividends were used to real asset investment in financially constrained firms compared to unconstrained firms.

**Table 3:** Real asset growth, governance and financial constraints

Dependent Variable	(4)	(5)	(6)
	all	unconstrained firms	constrained firms
	Real Asset growth		
M	0.001	0.003***	-0.002*
	1.192	2.826	-1.776
FT	-0.004***	-0.001	-0.005***
	-2.881	-0.720	-2.922
DIV	4.814***	2.954	2.430*
	4.488	1.008	1.749

SIZE	0.076***	0.068***	0.089***
	4.206	2.726	3.274
ROA	0.134	0.103	0.046
	1.237	0.891	0.202
DEBT	-0.019**	-0.017**	0.102*
	-2.216	-2.015	1.805
STD	0.603***	0.190*	0.670***
	6.204	1.766	3.236
Constant	-1.989***	-1.839***	-2.189***
	-4.159	-2.751	-3.046
Observations	5,648	2,669	2,979
R-squared	0.017	0.012	0.013

Note: The value in parentheses is z-value, and \*\*\*, \*\*, \* means significant at 1%, 5%, and 10% levels, respectively

## 5. Discussions

This paper empirically investigated what factors contribute to dividends and investments and considered financial constraints in the Korean stock market. We used Korean manufacturing firms listed on the stock market through the fiscal period from 2000 through 2018. In this paper, we documented evidence that financial constrained firms use dividends for their investment and foreign investors decrease investments under financial constraints. But for dividends decisions, foreign investors give significant positive impacts irrespective of financial constraints.

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