CORPORATE GOVERNANCE AND INSTITUTIONAL OWNERSHIP: A CRITICAL EVALUATION AND LITERATURE SURVEY

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Abstract

This paper aims to analyse how effective the role of institutional shareholders is in corporate governance by examining the association between the different types of institutional shareholders and earnings management. Many prior studies have investigated the nature of several corporate governance practices and mechanisms and how they exist to strengthen institutions, however, there have been questions related to the role of governance failures in preventing unethical behavior by top management. The recent financial and accounting scandals that have engulfed major financial companies in the United States and other developed countries have renewed the interest in corporate governance issues and the role of shareholders. This study provides critical reviews of the theoretical and empirical literature on the inter-relationship between different types and composition of shareholders and influences on corporate governance outcomes. We evaluate what we can say with confidence about the interaction between ownership structures and corporate governance. Overall, there is a consensus among researchers that institutional investors and other outside blockholders vote more actively on corporate governance amendments than non-blockholders to enhance profitability and market valuation of firms.

Keywords: Corporate Governance, Institutional Shareholders, Performance, Firm Value

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1. Introduction

The study explores the effectiveness of institutional shareholders in corporate governance by examining the association between types of institutional ownership and earnings management. It is widely acknowledged that institutional investors have stronger incentives to monitor corporations and can better afford the monitoring costs (for review, see Brickley et al., 1988; Bushee, 1998; David et al., 2001; El-Gazzar, 1998; Shleifer and Vishny, 1986; Watts and Zimmerman, 1986). The literature well documents institutional shareholders' activism as one of the ways in which they exercise their rights as members and monitor managers. Shareholders' activism includes private negotiations with managers, contributing to decisions on board composition, proxy contests (Gillan and Starks, 2000; Boone et al., 2007; Pound, 1988), to mention but a few. However, the importance of institutional shareholders in monitoring firms' managers is not well known (Hartzell and Starks, 2003, p. 2351). Brickley et al. (1988) find that while some groups of institutional investors tend to side with managers due to existing or potential business relations, other groups of institutional investors are more likely to provide an oversight of managers to maximize shareholders' value. The former (such as banks and insurance companies) are classified as pressure-sensitive institutional investors, whereas the latter (such as pension funds and mutual funds) are labeled as pressure-resistant institutional investors. Several studies provide empirical evidence that is supportive of the difference between these two types of institutional investors (for example, see David et al., 2001; Kochhar and David, 1996; Pound, 1988; Van Nuys, 1993).

Moreover, corporate governance has been a subject of numerous studies during the last two decades (for example, see Chung et al., 2010; Gompers et al., 2003; Grossman and Hart, 1986; Huang, 2009; Shleifer and Vishny, 1997; Williamson, 1985), however none of these studies examines the effect of corporate governance on institutional ownership. Table 1 provides more details about the recent studies in corporate governance.

Table 1. Summary of recent corporate governance studies

Study	Research finding(s)
Bushee & Noe (2000)	Show that institutional investors prefer stocks of companies with better disclosure.
Gompers & Metrick (2001)	Show that institutional investors prefer stocks of larger companies.
McKinsey & Company (2002)	Survey more than 200 institutional investors in 31 countries and showed that institutional investors put corporate governance quality on a par with financial indicators when evaluating investment decisions' portfolios toward firms with better governance mechanisms, there is no significant relation between institutional ownership and corporate governance.
Dahlquist et al. (2003)	Find no relation between the ratio of control to cash flow rights and the holdings of foreign investors
Gompers et al. (2003)	Show that better corporate governance leads to greater firm values and higher stock returns.
Parrino et al. (2003)	Show that institutional investors prefer stocks of companies with better managerial performance.
Grinstein & Michaely (2005)	Show that institutional investors prefer stocks of companies that pay cash dividends or repurchase shares.
Giannetti & Simonov (2006)	Show that both foreign and domestic financial institutions are reluctant to holdshares of companies that have high control to cash flow rights ratios of principal shareholders.
Ferreira & Matos (2008)	Show that institutions hold fewer shares of companies that have more closely held ownership structure.
Li et al. (2008)	Show that institutions avoid investing in companies with dual-class shares.
Huang (2009)	Show that institutional investors prefer stocks that have higher market liquidity and lower return volatility.
Leuz et al. (2009)	Find that U.S. institutions invest less in foreign firms with large insider block ownership.
Al-Najjar (2010)	Investigates the relationship between ownership structure and corporate governance, namely the factors that determine institutional investors' investment decisions in emerging markets using Jordanian data. The results show that the Jordanian institutional investors consider firms' capital structure, profitability, business risk, asset structure, asset liquidity, growth rates, and firm size when they take their investment decisions. In addition, institutional investors in Jordan prefer to invest in services firms rather than manufacturing firms. Furthermore, the study cannot find any significant relationship between firms' dividend policy and institutional investors.

Bushee et al. (2010)	Analyse whether institutional investors tilt their portfolios toward firms with preferred governance mechanisms. The authors conclude that although institutional investors have incentives to tilt their survey results indicate that institutional investors prefer companies with good governance structure.
Chung et al. (2010)	Show that better governance results in higher stock market liquidity.
McCahery et al. (2010)	Conduct a survey to elicit institutional investors' views on country-level investor protection and firm-level corporate governance mechanisms. They find that among the institutions that responded to the survey, corporate governance is important to their investment decisions, and a number of them are willing to engage in shareholder activism (e.g., 80% of the institutions are willing to vote with their feet by selling their shares). They also show that the preferences for governance mechanisms vary across the institutional investor types.
Chung & Zhang (2011)	Examine the relation between corporate governance and institutional ownership. The empirical results show that the fraction of a company's shares that are held by institutional investors increases with the quality of its governance structure. In a similar vein, they show that the proportion of institutions that hold a firm's shares increases with its governance quality. Furthermore, the results are robust to different estimation methods and alternative model specifications. These results are consistent with the conjecture that institutional investors gravitate to stocks of companies with good governance structure to meet fiduciary responsibility as well as to minimise monitoring and exit costs.

This paper addresses the question of whether the different types of institutional investors affect managers' engagement in earnings management. The main objective of this paper is to enhance the understanding of how institutional blockholding can improve shareholder protections and corporate governance regulations by drawing on the latest research results of the streams of intellectual thought and experts in an array of academic fields, particularly in behavioral finance. The remainder of the paper is structured as follows. Section 2 presents the objectives and motivations of the study. Section 3 provides a review of corporate governance and institutional activism literature. Section 4 discusses the relationship between institutional shareholders and corporate behavior. Section 5 investigates the association between types of different institutional shareholders and corporate

governance. Section 6 is dedicated to the association between short-term and long-term oriented institutional shareholders and corporate governance. The final section provides conclusions and suggestions for future research.

2. Objectives and Motivations of the Study

The purpose of this study is twofold. Firstly, it addresses the question of how effective the role of institutional shareholders is in corporate governance by examining the association between different types of institutional shareholders and earnings management. Studies of this kind will contribute to the assessment of the merits of calls for institutional shareholders to play a more active role in corporate governance (Al-Najjar, 2010; Parliamentary Joint Committee on Corporations and Securities, 1994). Secondly, the study contributes to the understanding of the effect of institutional shareholdings on the practice of earnings management.

The separation of ownership and control and subsequent agency problems, calls for corporate governance to provide assurance of shareholders' value maximization (Watts and Zimmerman, 1986). Recent years have witnessed significant changes to the ownership structure of listed corporations, including the emergence of greater institutional ownership. In the United States, for example, institutional holdings of publicly traded shares grew from 26.8% in 1986 to 51.6% in 1996 (Gompers and Metrick, 2001, p. 236). In Australia, institutional investment in listed equities rose to around 49% in 1997 (Stapledon, 1998, pp. 242-260). Despite the growth of institutional ownership over the last few decades, their importance in monitoring firms' managers is not well known (Hartzell and Starks, 2003).

Table 2 presents some details, which illustrates the failure of a bank as an institutional investor to monitor managers of a firm. The facts given concern the failure of ABC Learning Centre Ltd. The reader may be tempted to believe that ABC's accounting information prior to the appointment of receivers must have been of a dubious nature. Yet the question remains: why did the Commonwealth Bank as an institutional investor of ABC not keep a closer eye on the childcare centre and ultimately failed to fulfill its fiduciary duties to its own shareholders? This question is closely related to the roles of institutional investors' activism in corporate governance. By examining the association between the types of institutional ownership and managers' engagement in earnings management, the study will shed some light on the roles of institutional investors in corporate governance. In some developed countries for example, it seems that there is considerable leeway under their corporate law for institutional investors to engage in shareholder activism; however, there have been legal obstacles to institutional investor activism (Chung and Zhang, 2011; Hill, 1994).

Table 2. The failure of a bank as an institutional investor to monitor managers of a firm

(1)	Angry shareholders have given the Commonwealth Bank a grilling over its $680 million exposure to failed childcare operator ABC Learning Centres.
(2)	Bank chief executive Ralph Norris confirmed CBA was writing off $440 million of listed notes issued by ABC and conceded that the bank needed to "learn from its mistakes".
(3)	ABC, with almost 1100 centre across Australia, plunged into receivership last week. Reports said a Sydney court was told ABC's total debt had so far reached $1.57 billion, including $110 million owed to external creditors.
(4)	It is also understood ABC's receivers have secured temporary funding. The ABC loss is the largest write-down for CBA since it lost more than $200 million on stricken exposures to Pasminco and Enron in 2002.
(5)	"The notes at this point are valueless-they have no ranking of any significance," Mr. Norris told shareholders.
(6)	Most of the banks were of the view until recently that ABC had a fundamentally sound business.

Source: Lekakis and Walsh, 2008.

The end of the 1990s and the beginning of the 21st century witnessed a series of worldwide accounting scandals. In the United States, Enron in 2001 marked the largest corporate bankruptcy, which was followed by a number of disclosures about errors in financial statements. Other companies included Worldcom, AOL, Qwest Communications and Xerox. Accounting failures, however, were not restricted to the United States. In Australia, for instance Adelaide Steamship, Bond Corporation, Harris Scarfe, One Tel and HIH Insurance. In Europe, companies involved in accounting scandals include Parmalat (Italy), Flowtex (Germany), Comroad (Germany), Royal Ahold (The Netherlands). In 2007, a loss of investor confidence in the value of securitised mortgages in the United States, led to the global crisis in real estate, banking and credit in the Unites

States and other countries. Again, the role of accounting has been subject to criticism (Mallin, 2007).

As Healy and Palepu (2001) stress, managers have access to information about the value of a firm and tend to overstate the firm's value through earnings management. This results in adverse selection of investment projects. On the other hand, following an investor's investment in a firm, managers are likely to expropriate investors' funds and maximise their self-interest through earnings management. According to Goncharov (2005), to resolve the problems related to allocation of capital, it is necessary to understand the determinants and implications of earnings management. Determinants of earnings management include factors motivating earnings management and factors constraining earnings management as well. As noted by Goncharov (2005) and Al-Najjar (2010), a good knowledge of determinants of earnings management is crucial for at least three reasons. Firstly, knowing the conditions under which earnings management are more likely to occur, investors can choose price protection or invest their funds elsewhere. Secondly, a good knowledge of determinants of earnings management will facilitate the decision making by regulators. Thirdly, efforts can be made to enforce inhibitors constraining earnings management to improve the quality of reported earnings.

There are very few studies that have examined how institutional shareholders influence specific actions of managers (Chung et al., 2002, p. 32; Chung and Zhang, 2011). Among these studies, there are even fewer which investigate how institutional shareholders affect earnings management. Rajgopal et al. (1999) show the absolute value of discretionary accruals declines with institutional ownership. The reason is that institutional owners are better informed than individual investors, which reduces managers' incentive to manage accruals. Chung et al. (2002) found the presence of large institutional shareholdings prevents managers from manipulating reported profits upwards or downwards. While the above studies provided evidence in support of a linear relationship between earnings management and institutional ownership, studies undertaken in Australia predict a non-linear relationship.

Koh (2003) classifies institutional shareholders into short-term oriented institutional shareholders (Bhide, 1993 and Porter, 1992) and long term oriented institutional shareholders (Bushee, 1998; Majumdar and Nagarajan, 1997). Koh (2003) uses levels of institutional ownership to approximate these two types of institutional shareholders, and yields results that support a non-linear relationship between institutional investors' ownership and earnings management: at a very low institutional ownership level, institutional ownership is not associated with income-increasing discretionary accruals; beyond the very low institutional ownership level, a positive association exists between institutional ownership and income-increasing discretionary accruals, supporting the view that transient institutional shareholders encourage managerial manipulating earnings upwards; beyond a certain higher institutional ownership level, a negative association exists between institutional ownership and income-increasing accruals management, supporting the view that long-term oriented institutional shareholders discourage managers from manipulating earnings upwards. Hsu and Koh (2005) examine the generalisability of Koh's (2003) findings beyond the income-increasing context by focusing on incentives created by threshold mentality and income-decreasing discretionary accruals. Their study indicates that the association between institutional ownership and earnings management is not systematic across all firms and is dependent on the context.

As Hsu and Koh (2005, p. 820) point out, future studies on the relationship between institutional ownership and earnings management could explicitly consider the effects of different types of institutional investors. Rather than using levels of institutional shareholdings to approximate types of institutional shareholders, the study classifies institutional shareholders into two types: pressure-sensitive and pressure-resistant institutional investors according to Brickley et al. (1988), who find that when voting on anti-takeover amendments, pressure-resistant or insensitive institutional shareholders (eg. mutual funds, foundations and pension funds) are more likely to oppose managers than pressure-sensitive institutional shareholders (eg. banks, insurance companies and trusts) due to the latter's existing or potential businesses relationships with the company.

By investigating the association between these two types of institutional ownership and earnings management, Hsu and Koh's (2005) study extends the studies of how institutional shareholders affect specific actions of managers by examining the association between types of institutional shareholders based on a new classification, and earnings management. This study differs from Brickley et al. (1988) in the sense that the former seeks systematic and inexpensive evidence about the effectiveness of the role of institutional shareholders in corporate governance whereas the latter provides piecemeal and costly evidence.

4. A review of Corporate Governance and Institutional Activism Literature

Shleifer and Vishy (1997, p. 737) adopt an agency perspective on corporate governance by defining corporate governance as "dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". Hart (1995, p. 680) regards corporate governance as "mechanism for making decisions that have not been specified in the initial contract". According to Hart (1995), good corporate governance is necessary if two conditions are present: firstly, there is a conflict of interests and secondly the agency problem cannot be fully dealt with by contracts primarily due to large contracting costs. Therefore, corporate governance serves as a mechanism for making decisions where they are not specified by contracts.

Thus, it is agency problems, namely conflicts of interests among stakeholders that make corporate governance necessary. Berle and Means (1932) explain these conflicts by examining the separation of ownership and control. The agency theory is further developed by Jensen and Meckling (1976), Fama and Jensen (1983), Jensen and Ruback (1983), Jensen (1986), and Watts and Zimmerman (1978, 1986 & 1990). Within the agency theory developed by them, the agency problem results from the separation of ownership and control. Managers (agents) raise funds from investors (principals): investors expect managers to generate returns on their funds and managers put investors' funds into productive use or to cash out their holdings. Principals, however, anticipate that managers are likely to take opportunistic actions that are detrimental to the interests of principals. In the absence of contracts, managers' likelihood of taking opportunistic actions results in higher costs of managers' raising capital. Thus, managers have an incentive to enter into contracts with principals. Yet it is technically impossible to sign a complete contract as future contingencies are hard to foresee and contracting is not costless. In other words, the agency problem can be mitigated but it always exists. This necessitates corporate governance as it constraints managers' opportunistic actions and assures financiers of returns on their funds (Gillan and Starks, 2000).

Gillan and Starks (2003) give a list of factors constraining executives' activities: the board of directors, financing agreements, laws and regulations, labor contracts, the market for corporate control and the competitive environment. They classify these factors as internal control mechanisms and external control mechanisms, and stress that the rise of institutional investors is an important external control mechanism affecting governance. The question then arises of how institutional investors can serve as an external control mechanism. The following section will discuss the role of institutional investors in corporate governance. As Mallin (2007, p. 76) points out, the pattern of ownership has been constantly changing with the decline of individual investors and the rise of institutional investors. The latter own large portions of equity in many corporations across the world and play a significant role in corporate governance. With the emergence of institutional investors, their role in corporate governance has been a subject of debate (Gompers and Metrick, 2001; Stapledon, 1998).

Many researchers argue that institutional shareholders reduce agency problems as they have the incentive and resources in monitoring and controlling managers' activities. Shleifer and Vishny (1997) describe two common approaches to corporate governance: legal protection of investors from managers' opportunism; and concentrated ownership, which is ownership by large investors. Large investors have "the incentive to collect information and monitor the management, thereby avoiding the traditional free rider problem" (Shleifer and Vishny, 1997, p. 754). The question then arises as to who are these large shareholders. Shleifer and Vishny (1986) examined a sample of 456 of the Fortunate 500 firms and found a significant number of large shareholders are families represented on boards of directors, pension and profit-sharing plans, financial firms such as banks, insurance companies and investment cases.

Admati et al. (1994) developed a model with an attempt to analyze the effects of large shareholder activities on securities market equilibrium: passive shareholders benefit from large shareholders' activism and yet don't incur the related monitoring costs; despite the free-rider problem, large shareholder activism is consistent with equilibrium. Their analysis, however, deals only with one large investor. Huddart (1993) predicts that share prices will increase with increasing concentration of share ownership and explains why the pattern of stock ownership affects a firm's market value. Shareholders with less than the threshold amount of stock delegate the task of monitoring managers to large shareholders. Large shareholders have the incentive to do so because monitoring results in their access to more information about the firm's value and they could earn a return by trading on this information. Large shareholders' incentives to monitor managers increase with the concentration of share ownership, and thus the ownership structure affects a firm's market value. Several studies provide empirical evidence on the effective monitoring of institutional investors by examining the association between institutional ownership and corporate behavior, although empirical results from these studies are somewhat mixed. Corporate behavior under investigation includes executives' compensation,

research and development investment, and earnings management (for review, see Bushee et al., 2010; Chung et al., 2010; Gompers et al., 2003; Grossman and Hart, 1986; Williamson, 1985).

4. Institutional Shareholders and Corporate Behavior

According to O'Reilly et al. (1988), chief executive officer (CEO) remuneration primarily has three components: cash compensation such as salary and bonus, long-term incentives including various forms of stock options and deferred compensation, and perquisites and supplementary benefits such as insurance and club membership. Several factors affect executives' remuneration with one of them being ownership and control (O'Reilly et al., 1988, p. 258). The reason is that without strong owners, CEOs are more likely to have power to extract higher pay than is justified by market considerations (David et al., 2001; Kochhar and David, 1996). Bertrand and Mullainathan (2001) find that pay for luck (CEO is rewarded for changes in firm performance that are beyond CEO's control) is strongest in poorly governed firms and yet adding a large shareholder on the board will reduce the pay for luck by 23% to 33%. Also, Hartzell and Starks (2003) find a positive relationship between institutional ownership concentration and pay-for-performance sensitivity of executive compensation, and a negative relationship between institutional ownership concentration and the level of compensation, even after controlling for firm size, industry, investment opportunities and performance. These findings support the hypothesis that institutional investors play a monitoring role in mitigating the agency problem between shareholders and managers. On the other hand, Cosh and Hughes (1997) find little evidence that the presence of significant institutional shareholdings or non-executive directors restrains the discretionary component of executive pay, and that it affects the sensitivity of pay to shareholder performance measures.

Previous studies explore the relation between a firm's institutional ownership and its investment in research and development (R&D) with an attempt to find evidence of institutional investors' impact on managers' activities (for example, see Bushee, 1998, 2001; Chung et al., 2010; Chung et al., 2002; Coffee, 1991; David et al., 2001). As a firm's earnings can be affected by managers' decisions to incur research and R&D, these studies also provide evidence of the association between earnings management and institutional holdings. Bushee (1998) finds a lower likelihood of managers to cut R&D to reverse an earnings decline when institutional ownership is high. This provides empirical evidence of institutional shareholders' monitoring and disciplining managers. Nevertheless, they find that a large portion of institutional ownership with a high portfolio turnover increases managers' likelihood to reduce R&D to reverse an earnings decline. The research is therefore seminal in the sense that it explores how myopic and non-myopic behavior of institutional investors affects managers' discretion to reduce R&D to manage earnings. Wahal and McConnell (2000), however, find a positive relation between firms' expenditures for PP&E and R&D and the level of institutional ownership and trading activity based on a sample of around 2500 firms between 1988 and 1994. The findings cast doubt on the view (Blinder, 1992; Thurow, 1993) that institutional owners can encourage managers to behave myopically. In other words, the findings support the view that institutional owners do play a role in monitoring managers and encourage them to have longer investment horizons. Based on a sample of 100 US corporations from 1977 to 1986, Bange and DeBondt (1998) find that R&D expenditure is used to reduce the perception gap between reported income and analysts' earnings forecasts. While much of the cross-sectional variation in gap closure can be explained by information asymmetry and managerial incentives, there is less gap closure where CEO and institutional investors own a large stake of a firm's ownership interest. Hence, the latter findings do provide empirical evidence of institutional investors' monitoring earnings management by R&D which serves as a proxy for their activities.

Although, R&D investment is typical of earnings management through events' occurrence, discretionary accruals can also be used to manage earnings. In fact, only a few studies have examined the association between the level of institutional ownership and discretionary accruals management. Rajgopal et al. (1998 & 1999) show that, the absolute value of discretionary accruals declines with institutional ownership. The reason is that institutional owners are better informed than individual investors, which reduces managers' incentive to manage accruals. Chung et al. (2002) find the presence of large institutional shareholdings deterring managers from manipulating reported profits upwards or downwards with the use of discretionary accruals. Moreover, Koh (2003) examines the association between institutional ownership and firms' income-increasing accruals management and claims to be the first known research in Australia. The research yields results that support a non-linear relationship between institutional investors' ownership and earnings management. The finding of Hsu and Koh's study (2005) reveal an association between income-increasing accruals management and transient institutions, and the constraint long-term oriented institutions impose on income-increasing accruals management. This indicates that the

association between institutional ownership and earnings management is not systematic across all firms and dependent on contexts.

5. Types of institutional shareholders and corporate governance

There are many types of individual shareholders such as employee shareholders (managers, directors and other employees) and independent individual shareholders including entrepreneurial individual shareholders who purchase a large number of shares in a listed company in order to bring about changes to the company (Useem and Gager, 1996; Klein and Zur, 2009). Not surprisingly, individual shareholders have been perceived to be heterogeneous (Beaver and Demski, 1979, p. 39). Many studies like most of the aforementioned studies assume that unlike individual shareholders, institutional investors are homogeneous, and ignore their heterogeneity. As Hampell Committee, Final Report (1998, p.40) notes:

> "Institutional investors are not a homogeneous group. They all have an overriding responsibility to their clients, but they have different investment objectives. Typically institutions used not to take much interest in corporate governance. They tried to achieve their target performance by buying and selling shares, relying on their judgment of the underlying strength of companies and their ability to exploit anomalies in share prices regularly, and to intervene directly with company management only in circumstances of crisis."

In recent study, Ozer et al. (2010) examine whether ownership structure influences a firm's propensity to be politically active. They incorporate insights from agency theory into corporate political strategy research to demonstrate that heterogeneity of institutional shareholders affect firms' decisions to invest in political action. They also examine their model in the context of the U.S. manufacturing industry in the period of 1998-2002. Their results suggest that heterogeneous motives and objectives of institutional shareholders influence their support for firms' decision to be politically active. Ozer et al. (2010) offer insights to managers who play pivotal role in strategic decision making process. It provides a new perspective for managers to consider the heterogeneity of institutional shareholders while investing in corporate political strategies.

Coffee (1991) maintains that optimal monitors possess the following three elements: an ability to hold large equity stakes, a tendency to hold in the long run, and the absence of any substantial conflict of interest. Thus, Coffee notes that pension funds and closed-end mutual funds are more likely to be potentially superior to banks and other creditor-shareholders, and investors with business relations with firms tend to show a bias for management with regards to control matters. Brickley et al. (1988) find significant differences between various types of institutional investors in voting: pressure-resistant institutional investors (including mutual funds, endowments, foundations, and public pension funds) are more likely to oppose managers than pressure-sensitive institutional investors (including banks, insurance companies and trusts). The reason is that pressure-sensitive institutions have current or potential business relations with firms and managers might threaten to sever business relations if they don't support managers' proposals.

Van Nuys (1993) examines a proxy solicitation and subsequent restructuring at Honeywell Inc. in 1989. The evidence presented by Nuys indicates that over half of the banks and insurance companies in the sample supported managers' proposals, and in contrast, the public pension funds in the sample generally voted against the proposals. Pound (1988) also provides evidence supporting the view that it is hard for dissidents to gain victory due to three systematic incentives problems in proxy contests. One of the problem is institutional investors are more likely to vote with management against their fiduciary interests due to conflict-of-interest pressures. Take an insurance company for instance. It may hold a significant portion of a corporation' stock and meanwhile act as its primary insurer. If the insurance company votes against management, this may significantly affect the firm's business relationships with managers. Conflict-of-interest pressures are also used by David et al. (2001) explain why institutional owners that rely on a firm for their own business are not able to influence the firm's executives' compensation whereas institutional owners that only have investment relations with the firm affect its executives' compensation.

While the above studies indicate that pressure-insensitive institutional shareholders are more effective in monitoring management than pressure-sensitive shareholders, the question then arises of whether the capital market considers the different types of institutional shareholders and how their perceptions affects a firm's market performance. Borokhovich et al. (2006) are among the few studies which address this question. They classify investors according to whether they are likely to have business relationships with the firm or not, and examine the market reaction to the announcement of antitakeover amendment proposals. They find that firms with unaffiliated blockholdings exceeding affiliated blockholdings exhibit more positive stock price reactions to antitakeover amendment proposals than firms with affiliated blockholdings exceeding unaffiliated blockholdings. Furthermore, the percentage of

blockholdings and the market reactions are positively related for pressure-insensitive blockholders, and the percentage of blockholdings are the market reactions are negatively related for pressure-sensitive blockholders. This serves as evidence that affiliated blockholders are regarded as inefficient monitors of management. Similar relations are observed when the research focuses on institutional stockholdings.

Others focus on the role of a particular group of institutional investors in corporate governance. Romano (1993) argues that restraints on the effectiveness of public fund activism can arise from political pressure to support firms and engagement in other firms of social investing. Therefore, such pressure results in conflicts of interest for public fund managers. Guercio and Hawkins (1999), however, yield results that are not consistent with such an argument. They explore the effects and incentives of pension fund activism by examining the shareholder proposals submitted by five of the largest and most activist funds. They find significant additional corporate governance activity and broad corporate change following the shareholder proposals by pension funds. Hence, they conclude that pension funds' activism is effective in initiating changes at target companies and pension fund activism is consistent with fund value maximization. Wahal (1996) study firms targeted by the nine most active funds from 1987 and 1993 and find that pension funds use various monitoring mechanisms and are reasonably successful in changing the governance structure of targeted firms. While this serves as evidence of the impact of pension funds on targeted firms' corporate governance, the research finds no evidence of significant long-term improvement in either stock price or accounting measures in the post-target period. Wahal and McConnell (2000) view this as evidence of ineffectiveness of pension fund activism. The interpretation of the lack of improvement in firms' performance, however, shall be more cautious: pensions' funds activism may be effective but their impact on firms' performance may be offset by other factors which impact on firms' performance. Despite the controversy in the interpretation of the results, the study is supportive of the view that pension funds play an active role in corporate governance.

Payne and Robb (1997) focus on banks as a group of institutional investors. Their study aims to explore how conflicting relationships affect banks' voting behavior as fiduciaries (of shareholders of banks). The empirical results indicate that where directors interlock and income-related relations are present, banks are more likely to vote for management antitakeover proposals, and where these relations are absent, banks are more likely to vote against those proposals. Boehmer (2000) studies the impact of German takeovers on the market value of bidding firms with the aim of establishing a link between ownership structure and performance. Part of the research results indicates that the most value-reducing takeovers are completed by bidders that are majority-controlled by financial institutions. This result is inconsistent with the contention that German banks are monitoring corporations very efficiently. Franks and Mayer (1998) investigate the effects of German banks in hostile takeovers in Germany. They find that banks' influences arise from their chairmanship of boards and the proxy votes they can cast on behalf of individual shareholders. Although proxy votes provided banks with the means to protect minority shareholders, they find that banks did not succeed in securing a bid premium in the bids for Continental and Hoesch. Franks and Mayer find it hard to determine whether banks were too frustrated to protect minority shareholders or whether they were driven by self-interest or interests of other stakeholders. Yafeh and Yosha (2003) find that large shareholders impose a reduction of firm expenditures for managerial private benefits by studying a sample of Japanese firms in the chemical industry, which serves as evidence of the association between concentrated ownership and corporate governance. Yet they do not find that banks are particularly important in this respect.

6. Short-term and Long-term Oriented Institutional Shareholders and Corporate Governance

As Maug (1998) points out, it has been conventionally acknowledged that there exists a negative relation between liquidity of capital markets and control of corporations: liquid markets make shareholders' monitoring less effective because a liquid market allows them to sell out easily; a less liquid market makes shareholders' monitoring more effectively because a less liquid market forces them to hold on to their investment and use their votes to interfere in corporations. Bhide (1993), for instance, argues that liquidity of stock markets exists at the price of effective governance. Coffee (1991) employs the binary opposition of the liquidity versus control when discussing the development of a system of institutional monitoring. To put it simply, institutional investors in a liquid market are more likely to be short-term oriented in their speculation whereas in a less liquid market they tend to be more long-term oriented and monitor corporations more effectively as they find it hard to dispose of their large stakes of ownership. Not surprisingly, there have been studies which examine institutional investors' myopia or their interest in firms' long-term performance.

There has been a recurrent claim that institutional investors' obsession on short-term performance induce firms' managers to make operational and accounting decisions that increase near-term earnings at the price of long-term earnings. Jacobs (1991), for instance, argues that shares are being treated as a commodity, and so shareholders only respond to changes in current performance and don't show interest in firms' long-term performance. Porter (1992) also argues that due to the fluidity of capital in the market, the relationships between American firms and capital markets result in corporations' underinvestment in long-term projects. While arguments by Jacobs (1991) and Porter (1992) almost exclusively focus on economic dimensions, Laverty (1996) suggests a cross-discipline, multilevel research agenda for this contention. Bushee (2001) tests the contention that, institutional investors are transient or short-term oriented and prefer a firm's value to be realized in near-term earnings to long-term earnings. Such a preference arises from competitive pressures, frequent performance evaluations and prudent person standards, and induces managers to be myopic too. They find a positive (negative) association between the level of transient institutional ownership and the amount of firm value in expected near-term (long-term) earnings, and a positive (positive) association between the level of ownership by institutions held to stringent fiduciary standards and the amount of firm value in expected near-term (long-term) earnings. Hence, the study by Bushee (2001) does yield evidence supporting the contention that institutional investors are inherently short-term oriented or shortsighted. Gaspar et al. (2005) also investigate the impact of the investment horizons of a firm's institutional shareholders on the market for corporate control. They find that target firms with transient institutional shareholders tend to receive an acquisition bid but with lower premiums and are more likely to experience worse abnormal returns around the merger announcements and a higher long-run underperformance. The results suggest that firms with transient institutional shareholders have a weaker bargaining position in acquisitions because weaker monitoring from transient institutional shareholders induces managers to proceed with value-reducing acquisitions or to bargain for personal benefits. Ke and Ramalingegowda (2005) make a contribution to the understanding of transient institutional investors with a focus on the post-earnings announcement drift. They find that transient institutions exploit the post-earnings announcement drift based on 58,214 quarterly earnings announcement between 1986 and 1999.

As a firm's ownership becomes concentrated in a number of institutional shareholders, the exit option becomes more expensive with large stakes of ownership being involved (Black and Coffee, 1994). Therefore, in a less liquid market, institutional shareholders are more likely to hold their ownership stake in the long run and show interest in a firm's long-term performance; therefore, they tend to be more active in the monitoring process. Solomon and Solomon (1999) provide empirical evidence of institutional shareholders' long-termism. They study the influence of reforms in UK corporate governance with a focus on unit trust managers as a particular group of institutional shareholders. This study yields strong evidence that unit trust managers are encouraging relationship investing and the development of linger and stronger communication links with their investee corporations. Bushee (1998) aims to find out whether institutional ownership affects R&D spending for firms in which a decline in earnings could be reversed by a decrease in R&D spending. The results indicate a lower likelihood of managers cutting R&D spending when institutional ownership is high. These findings support the view that institutional investors and their sophistication deter managers' myopic investment behavior by fulfilling their monitoring roles. Field (1995) also addresses the question of whether institutional investment in initial public offering related to long-term performance of these firms as typically poor long-term performance of initial public offering has been documented in the literature. The study finds that initial public offerings with higher institutional ownership are more likely to earn significantly higher long-run returns than those with lower institutional ownership. One of the possible explanations is that institutional investors show more interest in long-term performance of firms and so make an investment in firms with larger long-term returns. Cox et al. (2004) investigate the association between the pattern of institutional ownership of firms and their social performance. They find that long-term institutional investment is positively related to corporate social performance. This serves as evidence of long-term oriented institutional investors' interest in corporate social performance.[36]

7. Conclusion and Future Research

Corporate governance has attracted enormous research interest in the last decade from researchers in behavioral finance, strategy and organizational management and institutional leadership. An area that has also attracted research attention in recent years is the role-institutional shareholders and

[36] Figure 1 summarizes the relationship between institutional ownership and corporate governance and how such a relation can lead to a superior governance mechanisms and positive impact on corporate performance.

institutional factors that influence governance in modern corporate world play in effective corporate governance. Large corporate failures and the underlying agency problem have led to increased scrutiny of corporate performance and stimulated public interest in corporate governance. The fact that institutional shareholders and investors control large block of votes means that they can influence corporate behavior and decision of the board in capital investment and major strategic activities. They can also undertake monitoring roles and, by ensuring that management do not undertake projects that are not of best long-run interest of the company, enhance its long-term value. Most importantly, recent studies have actually reported that control by blockholder ownership play a positive role in reducing harmful information asymmetries, thereby reducing companies' overall cost of capital (Huyghebaert and Van Hulle, 2004).

As we have mentioned earlier, it is widely acknowledged in the existing literature that institutional investors have stronger incentives to monitor corporations and can afford the monitoring costs. However, it should also be mentioned here that institutional investors are not homogeneous. This research has attempted to provide a synthesis of prior research results concerning the types of institutional investors that affect managers' engagement in earnings management. The paper further highlights active and positive roles institutional shareholders play in corporate governance. For example, emergence of institutional ownership in the last two decades has resulted in institutional holdings in the United State increasing from about 26.8% in 1986 to 51.6% in 1996. In Australia, institutional investment in listed equity rose to around 49% in 1997. It could be argued that these increases in the level of holdings of institutional investors have enhanced companies' financial stabilities, fostered long-term profitability and growth and have had remarkable influences over corporate structure of modern financial system. Over time, these changes have also improved minority shareholder protections and led to effective risk management strategies.

Research results from recent assessment indicate that institutional investors and other outside blockholders vote more actively on corporate governance amendments than nonblockholders. In line with earlier studies such as Brickley et al. (1988), it is shown that there exist significant differences between various types of institutional investors in voting. Thus pressure-resistant institutional investors (including mutual funds, endowments, foundations, and public pension funds) are more likely to oppose managers than pressure-sensitive institutional investors (including banks, insurance companies and trusts).

To this date, most of the empirical research on the role of institutional ownership and operating performance has focused on institutional investor activism. As availability of micro-level data improves, there is a need to focus more on the linkages of ownership structure to firm performance and financial reporting outcomes and quality. Although issues remain complicated enough given the conflicting theoretical view points, the use of a dynamic model of different information together with appropriate theoretical constructs will surely provide further insights.

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Figure 1. The Relationship between Institutional Ownership and Corporate Performance