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Corporate governance: A literature review with a focus on the technology firms

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Abstract

Corporate governance is often regarded as a main driver of firm performance. However, previous studies often discover contradicting findings about the causal effect of corporate governance mechanisms on firm performance. In this paper, corporate governance literature will be reviewed with a focus on technology industry. Our paper shows that contemporary literature may overlook the industry and institutional context of technology firms. We propose that a fine-grained empirical setting is important in future research. In particular, the countervailing effect of high information asymmetries in high ownership concentration context may require more attention. Lastly, future studies of technology industries in emerging economies can be focused on the potential interaction effect between corporate governance mechanisms and firm investment.

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1. Introduction

In general, firm performance of traditional and technology firms are affected by the varying economic cycles. However, unlike traditional firms, technology firms can be thought as unique business entities.

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That is, firm performance of technology firms is driven by human capital component while technology firms also face great uncertainties to sustain successive market-centric technological innovation effectively in the long run (Wu *et al.*, 2005). Specifically, there are two kinds of uncertainties in high-tech industry: (i) continuous yet rapid technology advancement, and (ii) high volatility of technological product demands but low visibility of future trends. These challenges are more prominent in technology industries compared to traditional industries such as agribusiness, trading and service industries. Stated differently, the survival of the technology firms is dependent upon firm's decision-making in response to rapid changing external environment. Undoubtedly, management capacity is an important value driver in the technology firm (Prahalad and Hamel, 1990).

Interestingly, many empirical studies have used broad samples across industries in corporate governance research. However, a study by Cui (2002) shows that using broad-based sample across industries will mask the specific characteristics in R&D intensive industries when investigating the relationship between ownership structure and firm performance. In other words, the studies used industry definition as dichotomous variable(s) to incorporate unobserved industry effect(s) in empirical models may overlook industry effect on emerged corporate governance mechanisms. In a similar vain, Le *et al.* (2006) also point out that the impact of corporate governance mechanisms differs across industries. Thus, this paper intends to shed some lights on the potential research agendas about corporate governance in technology firms.

2. Corporate Governance in Technology Firms

2.1. Why corporate governance of technology firms is unique?

Resource-based view suggests that firm's R&D investment is essentially relying on the managerial foresights to create strategic assets, which in turn establish competitive advantage (Barney, 1991). However, the great uncertainties in technology firms have caused high levels of information asymmetry between insiders and outside shareholders, particularly in terms of R&D investment. This can be explained by the fact that R&D investment is incomparable and unique to each firm for following reasons. First, productivity of R&D investment is ambiguous to outsiders. In contrast, the economic significance of physical asset investment can be evaluated clearly, for example, outsiders can estimate the productivity of a newly opened store based on industry (or historical) data. Second, R&D investment is difficult to be evaluated accurately because it is classified as expenses in the financial statement. On the contrary, physical and financial assets can be evaluated based on the accounting fair value or market value. As a result, insiders possess significant information advantages in technology firms relative to outsiders.

Similar arguments also can be detected from empirical studies that shows high information asymmetry becomes the determinant of rent-seeking behavior of insiders in technology industries. Recent study by Ahuja *et al.* (2005) show that in the United States, insiders capitalize on the information advantages in stock tradings because they have adequate information to foresee the impact of R&D investment on firm performance. In addition, a study by Aboody and Lev (2000) discovered that trading gains of insiders in R&D intensive industries are significantly higher than other industries in the United States. To re-iterate, the nature of technology industry creates a high information barrier to outsiders, whereas insiders often have timely and accurate information about R&D investment.

2.2. Corporate governance of technology firms in Anglo-Saxon economies

The diffused ownership structure of large firms in Anglo-Saxon countries is known as the root cause of agency conflicts in the firm (Porta *et al.*, 1999). In relation to this, portfolio theory suggests that investors may diversify their portfolio to reduce the systematic risks. Thus, the diversified investors may not interested in firm's monitoring activities (Fama, 1980). In addition, Shleifer and Vishny (1986) posit that dispersed ownership context provides insufficient incentive for minority shareholders to assume the monitoring role on firm management. The dispersed ownership structure, therefore, tends to generate free-rider problem among minority shareholders.

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