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Published on: 01 Nov 2015 - Pacific-basin Finance Journal (North-Holland)

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Accepted Manuscript

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PII: S0927-538X(15)30004-4
DOI: doi: 10.1016/j.pacfin.2015.07.002
Reference: PACFIN 776

To appear in: *Pacific-Basin Finance Journal*

Received date: 13 July 2015
Accepted date: 13 July 2015

Please cite this article as: Balachandran, Balasingham, Faff, Robert, Corporate Governance, Firm Value and Risk: Past, Present, and Future, *Pacific-Basin Finance Journal* (2015), doi: 10.1016/j.pacfin.2015.07.002

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Corporate Governance, Firm Value and Risk: Past, Present, and Future

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9 July 2015

Abstract:

This paper, which serves as the lead article for this special issue of the Pacific-Basin Finance Journal published in conjunction with the 5th FMCG Conference 2014, reviews and comments on the current state of and potential for future research on the linkage between corporate governance and risk. The corporate governance-risk nexus is founded on the fundamental premise that corporate governance regulation primarily aims at curbing opportunistic managerial behavior and excessive risk taking. Accordingly, we discuss the key work on managerial risk taking, idiosyncratic risk, information risk, accounting opacity, executive compensation, directors and shareholder activism and finally governance, risk and value creation in a way that gives strong hints on possible future research directions across this broad academic landscape. Such coverage dovetails nicely with the special issue content featuring twenty one papers on the theme "Governance and Risk". As such, our paper naturally concludes with a brief roadmap of the papers published within.

Keywords: Governance; Risk; Liquidity; Accounting Scandals

JEL: G32, G38

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Corporate Governance, Firm Value and Risk: Past, Present, and Future

1. Introduction

The impact of corporate governance is diverse and resounding. Corporate goverance improves the timeliness of financial information, helps combat accounting fraud, enhances transparency in reporting, and entrusts responsibility to the top corporate officials in the case of non-compliance. There are various first order relationship networks connecting corporate governance and firm value creation. Arguably, the nexus between corporate governance and risk is one of the most important first order linkages which explains the ultimate link between corporate governance and the maximization of firm value. The nexus between corporate governance and risk stems from the fundamental proposition that corporate governance can deter managerial opportunistic behavior and excessive risk taking.

However, such a relationship can also take place via a number of channels including managerial ownership (Holderness and Sheehan, 1988; Mehran, 1995), compensation structure and entrenchment behavior (Eisenmann (2002); Kim and Lu, (2011); accounting opacity and restoring trust building (Baber, Liang, and Zhu, 2012; Chakravarthy, DeHaan, and Rajgopal, 2014; Dechow, Sloan, and Sweeney, 1996; Farber, 2005; Klein, 2002; Krishnan, 2005); managerial risk taking (Bargeron, Lehn, and Zutter, 2010; Chen and Ma, 2011; Coles, Daniel, and Naveen, 2006; Garvey and Mawani, 2005; John, Litov, and Yeung, 2008; Laeven and Levine, 2009; Nguyen, 2011; Pathan, 2009; Wright, Kroll, Krug, and Pettus, 2007); and shareholder activism (Admati and Pfleiderer, 2009; Ertimur, Ferri, and Muslu, 2011; Karpoff, Malatesta, and Walkling, 1996; Smith, 1996). Our review and discussion on the key work on executive compensation, directors and shareholder activism, managerial risk taking, idiosyncratic risk, information risk, accounting opacity, provides strong signposts on possible research directions across these broad academic landscapes.

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We also discuss in turn twenty-one papers published in this special issue of *Pacific-Basin Finance Journal*, sourced from the Financial Markets and Corporate Governance Conference in 2014. Each of these papers along with our review and discussion, advances our understanding on the important research question of how governance mechanisms affect the firm's risk level vis-à-vis the value of the firm. Throughout the paper we keep the focus on linking a wide spectrum of issues relating to the broader corporate governance framework in pursuit of augmenting new research dimensions such as the proposition of a value maximizing disclosure equilibrium.

Our paper proceeds as follows. We begin in Section 2 by examining the impact of corporate governance and managerial risk taking. Section 3 presents the link between corporate governance, information risk, and liquidity. Section 4 discusses the role of corporate governance in reducing accounting scandals. Section 5 discusses the role of managerial ownership, compensation structure and entrenchment behavior in risk-taking by firms. We present the role of corporate governance in the context of risk-taking by financial firms in Section 6. Section 7 presents the link between corporate governance and firm value. Section 8 outlines suggestions of a future research agenda. Section 9 concludes the paper by briefly outlining the contribution of the papers published in this special issue.

2. Corporate governance and managerial risk taking

What are the economic implications of stronger governance achieved through higher investor protection, especially with regard to the potential impact of risk taking by firm managers? The literature in this area is divided. The argument for a positive investor protection-risk taking linkage is built on the fact that, other things equal, managers always try to pursue their self-interest. John et al. (2008) argue that the risk choices are affected not just by the insiders' or the managers' explicit ownership and compensation structures, but also by the private benefits that they can capture, including the corporate cash flows that they plan to divert to

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themselves. They suggest that investor protection dampens the magnitude and the importance of private benefits to insiders, resulting in less forgoing of positive net present value risky projects. Shleifer and Wolfenzon (2002) develop a model and demonstrate that firms are larger, more valuable, and more plentiful, dividends are higher (and diversion of profits lower), ownership concentration is lower, and stock markets are more developed in countries with better protection of shareholders. John et al. (2008) suggest that arguments can also be made for a negative relationship between investor protection and risk taking. For example, the reduction in dominant shareholders' presence may result in greater managerial discretion to implement conservative investment policies, and this can give rise to a negative relation between investor protection and risk-taking. However, using both a cross-country panel and a US-only sample, John et al. (2008) examine the relationship between investor protection and the risk choices in corporate investment and show that corporate risk-taking and firm growth rates are positively related to the quality of investor protection.

Bargeron et al. (2010) examine whether risk-taking by publicly traded US companies declined significantly after adoption of the Sarbanes-Oxley Act of 2002 (SOX). The study finds that after SOX there is a significant reduction of investment, as measured by capital expenditure, by US firms as opposed to their non-US counterparts. Moreover, US firms have increased their cash holdings, representing a non-operating and low risk investment. Furthermore, US firms equity risk has also declined compared to non-US firms. Bargeron et al. (2010) suggest that the magnitude of the risk decline is related to several firm characteristics, including pre-SOX board structure, firm size, and R&D expenditure. They further document a decline in investment which is greater for larger firms, firms with more R&D expenditures, and firms with less independent boards in the pre-SOX period. They argue that the key driver is the costs of complying with SOX. Their evidence is consistent with the proposition that SOX discourages risk-taking by US public companies.

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Dey (2010) in a commentary on the work of Bargeron et al. (2010) argues, however, that the effect of SOX in reducing the risk taking by managers might not hold if one considers that having independent directors does not necessarily increase the cost of acquiring information on risky projects. This is because the primary goal of SOX is to improve corporate transparency by providing more timely and reliable information. Therefore, it can reduce the cost of information acquisition by independent directors. Moreover, research suggests that the effectiveness of outside directors depends on the information environment, and when outside directors can acquire information at relatively low cost, they can be effective (Adams and Ferreira, 2007; Raheja, 2005). Moreover, Dey (2010) argues that one of the implications of better policing by independent directors is taking on fewer negative NPV projects. This does not necessarily equate to less risk-taking. Furthermore, one of the primary goals of SOX is to prevent fraud by executives undertaking a host of mechanisms. Post SOX with greater accountability in place, independent directors are less likely to scuttle risky projects.

Cohen and Dey (2013) extend the work of Bargeron et al. (2010) to examine the mechanism(s) through which SOX affects corporate investment strategies, CEO incentives, and risk-taking behavior. In general, Section 302 of SOX requiring CEOs and CFOs to certify financial statement information coupled with other provisions increase the legal and political exposure for directors. Therefore, the obvious manifestation of such regulation is an overall decline in corporate risk-taking behavior (Bargeron et al. (2010)). Further, increased litigation risk could also encourage boards to reduce the level of risk taken by their corporations and change the reward structure accordingly. Cohen and Dey (2013) document that the passage of SOX was followed by a significant decline in performance- and incentive-based compensation awarded to CEOs, which were in turn associated with a decline in risky investments by corporations. They also find evidence that the changes in investments are

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related to lower operating performances of firms, suggesting that these changes were costly to investors. Their findings demonstrates how corporate governance regulation interacts with firms' and managers' incentives, and ultimately affects corporate operating and investment strategies.

King and Wen (2011) examine the relation between the CEO ownership, overall corporate governance structure and managerial risk-taking behavior. Using a simultaneous equations framework, they show that strong (weak) bondholder governance is often combined with weak (strong) shareholder governance. Additionally, strong bondholder governance leads to more low-risk investments; while, weak shareholder governance encourages high R&D expenditures. They also show that risky (conservative) investment policy results from a weak (strong) overall corporate governance structure. However, a governance structure either with strong (weak) bondholder but weak (strong) shareholder governance suggests mixed implications for risk-taking behavior. Kim and Lu (2011) study the relation between specific governance mechanisms such as CEO ownership in affecting firm value and risk taking. Generally, within the agency framework, a higher level of CEO ownership will result in a lower agency conflict by aligning managerial interests with the interests of stockholders. However, this only partly fulfills what corporate governance mechanisms are designed to achieve. For example, Kim and Lu (2011) document that firm valuation and risk taking by CEOs with material ownership depends on the strength of external governance mechanism proxied by product market competition. Specifically, high CEO ownership increases the wealth-performance sensitivity thereby inducing lower risk taking. While it is true that with increasing CEO ownership, a CEO's share of the value loss due to overly conservative risk choices also increases, Kim and Lu (2011) posit that if decisions are made to satisfy CEO personal risk tolerances, the incremental increase in value loss may not deter CEOs from making more risk-averse decisions.

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Kim and Lu (2011) argue that R&D is a channel through which CEO ownership affects firm value since successful R&D can substantially improve corporate growth opportunities. Since R&D is risky and discretionary, the incentive effect of CEO effort is reflected in a positive R&D-CEO ownership linkage at low levels of CEO ownership. However, at high levels of ownership the risk reducing effect starts to dominate the incentive effect and CEOs devote fewer resources to risky R&D activities resulting in a negative relation between R&D and CEO ownership. Therefore, the relationship between R&D and CEO ownership is non-linear hump-shaped. To conclude, corporate governance must play an effective role in determining the optimum level of risk taking that minimizes potential agency cost of suboptimal risk taking by the managers.

3. Corporate governance, information risk, and liquidity

Information risk; a decision-making environment without timely, relevant, and reliable information; has serious ramifications for firm value in general and specific subgroups of stakeholders in particular. Thus, investigating the consequences of higher information risk vis-à-vis an insufficient or manipulated corporate disclosure environment constitutes a worthy research question. The economics of information suggests that the demand for and supply of information is governed by the relative bargaining power of the relevant stakeholders. The literature on various dimensions of agency conflict suggests that an optimum information environment is compromised since vested internal and external parties within the corporate set up always try to enforce a win-loss reality in their favor.

Hermalin and Weisbach (2012) argue that disclosure in the context of governance is a double-edged sword. From one angle, increased information improves monitoring abilities of shareholders and boards. However, the benefit of such increased monitoring is diluted with higher managerial compensation stemming either from higher bargaining power or the

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feeling of the adverse effect of higher monitoring by the managers. Hermalin and Weisbach (2012) also argue that increased monitoring creates a context for managers to engage in value-reducing activities. Taken together, the cost of higher disclosure might, at some level, outweigh the benefits. Though the production and dissemination of information is costly (Hermalin and Weisbach, 2012) and information disclosure can make the firm potentially disadvantageous through CEO actions aiming to reduce firm value, increased myopic behavior or reduction of product market competitive position (Feltham, Gigler, and Hughes, 1992; Hayes and Lundholm, 1996) but they miss a crucial point that information imbalances between external and internal parties are even dangerous, especially when the level of disclosure equilibrium is dynamic. Alternatively, there is a natural value maximizing disclosure equilibrium.

Various types of stakeholders differ with respect to the value maximizing disclosure equilibrium. For example, for a firm value maximizing information disclosure is reached when the marginal benefit of production and dissemination of the information is higher than the marginal cost of production and dissemination. For investors, the thrust for more information exists as long as the benefit of collecting private information is higher than the cost of such private information. Indeed, the collection of private information has been the hallmark for informed traders in various circumstances especially in possible takeover attempts (Larcker and Lys, 1987). The role of corporate governance is crucial in this context. For example, Ferreira and Laux (2007) argue that governance provisions can significantly affect the information environment of the firm even when the merger is not an imminent reality. This is because fundamental governance provisions expressing openness to the market for corporate control are more common for firms that are open to sharing information with investors. Moreover, governance provisions relating to strong investor protection are linked to reduced insider activism vis-à-vis reduced expropriation of outside investors.

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Looking from an entirely different perspective, answering the question of 'if not, why not[1]'is one of the fundamental principles of corporate governance that is enshrined within the idea of reducing information asymmetry. This approach warrants an appropriate explanation of the underlying governance mechanisms that firms follow. This also ensures timely dissemination of information so that stakeholders can have meaningful interaction with the board and solve resolutions in directing the firm towards value creation.

The role of corporate governance in the level of information flow is intuitive. However, in terms of the effectiveness of such an enhanced information environment, e.g. if the SOX regulation is effective in minimizing investor' concerns, then firm return volatility i.e. the idiosyncratic risk, will be relatively low. Since informed trading reduces volatility (Glosten and Milgrom, 1985; and French and Roll, 1986), corporate governance can substantially reduce the production of such a undesirable public good. Consistent with this view, Fischer and Verrecchia (1999) show a negative link between disclosure quality and total risk or idiosyncratic risk. Their finding is consistent with Sengupta (1998) who contends and documents that disclosure quality reduces lenders' and underwriters' perceptions of default risk for the disclosing firm, reducing its cost of debt. His finding also suggests the relative importance of disclosures in situations where there is greater market uncertainty about the firm as reflected by the variance of stock return. In contrast, Bushee and Noe (2000); and earlier literature including Ross (1989) present a positive link between disclosure quality and idiosyncratic risk.

Jorgensen and Kirschenheiter (2003) develop a model on managers' equilibrium strategies for voluntarily disclosing information about their firm's risk. In their partial disclosure equilibrium model, managers voluntarily disclose if their firm has a low variance

[1] Corporate governance principles and recommendations. ASX Corporate Governance Council, 3rd Edition, 2014. Pg. 03. Accessed from http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf

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of future cash flows, but withhold the information if their firm has highly variable future cash flows. They demonstrate that, ceteris paribus, a firm that discloses risk has a higher share price than one that does not, but, relative to a voluntary disclosure regime, imposing mandatory full disclosure of firm risk will lower the ex-ante share price of each firm. They argue that firm value falls because mandating risk disclosure forces firms that would not disclose in a voluntary regime to incur disclosure costs. In a different context, Akhigbe, Martin, and Newman (2008) also address the concern whether the passage of SOX is associated with changes in idiosyncratic risk and market risk. Since SOX requires firms to disclose risk related negative information that they otherwise might have withheld, they find an increase in idiosyncratic risk in the post-SOX period compared to the pre-SOX period. However, in cross-sectional tests, post-SOX improvements in information certainty resulted in smaller increases or greater decreases in risk (Akhigbe, Martin, and Newman, 2008). Ferreira and Laux (2007) also study the link between corporate governance and idiosyncratic risk by modeling channels through which corporate governance may affect the level of idiosyncratic risk. They find that firms with fewer antitakeover provisions display higher levels of idiosyncratic risk along with higher trading activity, private information flow, and information about future earnings in stock prices. This is because of the role played by the institutions with trading interest that are active in merger arbitrage. The study also shows that openness to the market for corporate control can lead to more informative stock prices by encouraging the collection of and trading on private information, which has a significant bearing on the level of idiosyncratic risk.

Glosten and Milgrom (1985), Diamond and Verrecchia (1991), and Welker (1995) show that the degree of information asymmetry has a direct effect on the stock liquidity. By enhancing the information environment, corporate governance also affects stock market liquidity (Chen, Chung, Lee and Liao, 2007; Chung, Elder and Kim, 2010; Attig, Fong,

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Gadhoum and Lang, 2006). Chung, Elder and Kim (2010) show that good corporate governance induces higher stock liquidity and vice-versa. Specifically, companies with strong corporate governance exhibit narrower spreads, higher market quality, smaller price impact of trades, and a lower probability of information-based trading. These outcomes are the direct result of improved financial and operational transparency. Overall, these finding indicate that companies can mitigate information-based trading and increase stock market liquidity by adopting corporate governance standards that reduce information asymmetries. Attig, Fong, Gadhoum and Lang (2006) show that a large component of information asymmetry is associated with greater deviations between ultimate control and ownership of the firm. These results suggest that diverse ownership may lead to improving stock liquidity.

To conclude, various firm level information are of extraordinary value to diverse stakeholders of the firm, and empirical studies confirm such notion. However, as we move forward with the bitter memory of the global financial crisis (GFC), governance mechanism requires to be more robust and efficient to provide material information in a more accurate and timely manner.

4. Corporate governance and incidence/magnitude of accounting scandals

Jensen and Meckling (1976) contend that credible financial reporting reduces the information asymmetry between corporate managers and stockholders, improves investor confidence, raises the stock price and thereby makes it less costly for corporations to raise new equity capital and to grow. The role of corporate governance in the context of the quality of the financial statement information is arguably the most significant area of interest for academic research. In the pre-SOX period, earnings management was rampant, and most CEOs viewed earnings management as the primary mechanism to meet earnings expectations (Loomis, 1999). Therefore SOX and similar regulations would improve the quality of financial statement information. In fact the Blue Ribbon Panel in their report on Public Company

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Accounting Oversight Board (PCAOB), specifically suggests that audit committee members should be financially sophisticated to detect and deter earnings management (Xie, Davidson, and DaDalt, 2003).

The literature on the role of corporate governance in the quality of financial statement information mainly focuses on two issues: the deterrent role and the confidence-building role. In terms of the former, the academic literature focuses on how effective is the corporate governance mechanism in diffusing or minimizing the potential for aggressive earnings management. Klein (2002) finds evidence among US firms to support the view that both the board's and the audit committee's independence are important constraints on earnings management. In a similar study, Xie et al. (2003) extensively examine the role of a firm's board of directors in the context of earnings management with primary focus on the role of outside directors and their level of knowledge in corporations, finance, or the law when they sit on the audit and executive committees. Their result suggests that a lower level of earnings management is a function of a greater independence of outside board members. Also, with the financial sophistication of these outside board members, the quality of monitoring increases vis-à-vis the extent of earnings management decreases. In addition, more active boards (i.e. number of board meetings), are negatively linked with the level of earnings management.

Peasnell, Pope, and Young (2005) study the role of board monitoring in earnings management by UK firms by focusing on the role of outside board members and the audit committee. They show that firms with a higher proportion of outside directors are associated with less income-increasing earnings management when pre-managed earnings fall below either zero or last year's reported earnings. However, they do not find any evidence that the presence of an audit committee directly affects the extent of income-increasing manipulations to meet or exceed these thresholds. In contrast to the findings of Peasnell et al. (2005) in UK

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context, Bedard, Chtourou, and Courteau (2004) show that audit committee with substantial financial and governance expertise significantly reduces the level of aggressive income-increasing and income-decreasing earnings management in the US. The literature also confirms that the effectiveness of the audit committee reduces if there are a greater number of affiliated directors on the audit committee. Davidson, Goodwin-Stewart and Kent (2005) also echo a similar conclusion in the case of Australia. Using a distressed firm sample, Carcello and Neal (2000) show that the probability of issuing a going-concern report is significantly lower if there is a greater percentage of affiliated directors on the audit committee. Park and Shin (2004) show that outside directors, as a whole, are not effective in reducing abnormal accruals practice, however, directors with financial expertise and the active role of institutional shareholders reduces such practices in Canada. Becker, Defond, Jiambalvo and Subramanyam (1998) argue that auditing reduces information asymmetries that exist between managers and firm stakeholders by allowing outsiders to verify the validity of financial statements and show that companies with non-Big Six auditors have significantly larger variation in discretionary accruals compared to companies with Big Six auditors.

In terms of a confidence-building role, Agrawal and Chadha (2005) examine the link between certain corporate governance mechanisms such as the independence of boards, audit committees, and the provision of non-audit services by outside auditors with the probability of earnings restatements by US firms. The study finds that the probability of a restatement is lower in companies whose boards or audit committees have an independent director with financial expertise; it is higher in companies in which the chief executive officer belongs to the founding family. Furthermore, non-audit fees, which are presumed to affect auditor independence and hence may compromise auditor quality, are not associated with restatements on average. These relations also hold in alternative specifications as well. The findings confirm that independent directors with financial expertise are valuable in providing

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oversight of a firm's financial reporting practices. Alternatively, the corporate governance mechanism is effective in rendering creditability to the financial statement information. Farber (2005) examines the link between the credibility of the financial reporting and the quality of governance mechanisms using the sample of firms identified as fraudulent reporting practitioners by the SEC. The study shows that fraud firms are characterized by fewer audit committee meetings, fewer financial experts on the audit committee, fewer numbers and percentages of outside board members, a smaller percentage of Big 4 auditing firms, and a higher percentage of CEOs who are also chairmen of the board of directors relative to a control sample in the year prior to fraud detection. Interestingly, in terms of restoring trust fraud firms take actions to improve their governance, compatible with the control firms. The improved governance influences partly inform capital market participants suggesting that credibility still might be an issue. However, such actions to improve governance are compensated with superior stock price performance.

5. Managerial compensation, ownership, and corporate governance

Since most of the opportunistic and self-motivating practices by the managers are motivated by the desire to improve the financial and non-financial rewards, the role of corporate governance in the case of executive compensation is crucial. If the corporate governance mechanism is strong enough to ensure an optimum contacting of managerial benefits as reflected in equitable pay-performance link and reporting transparency, the self-interest managerial motives can be significantly reduced.

Extant literature on the effect of corporate governance on executive compensation provides a strong positive link between weak corporate governance and excessive executive pay (Sapp, 2008; Wright, Kroll, and Elenkov, 2002). The most common argument for such findings is the fact corporate governance is not effective in setting an optimum compensation structure that is beneficial to the outside shareholders because most directors are virtually

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hired and removed by the CEO. The positive link between CEO compensation and the percentage of the board composed of outside directors (Boyd, 1994; Lambert, Larcker, and Weigelt, 1993) and interlocked outside directors (Lambert et al., 1993) attest such concern. Core, Holthausen, and Larcker (1999) argue that the firm with weaker governance faces higher agency problem, and part of the problem is reflected in higher CEO compensation. After controlling for monitoring proxies, Brick, Palmon, and Wald (2006) find a significantly positive relationship between CEO and director compensation. They hypothesize that this relationship could be due to unobserved firm complexity (omitted variables), and/or to excess compensation of directors and managers. They also find evidence that excess compensation (both director and CEO) is associated with firm underperformance. They conclude that the evidence is consistent with excessive compensation due to cronyism. CEOs in firms with strong CEO influence on governance, command higher compensation (Chalmers, Koh, and Stapledon, 2006; Cremers and Nair, 2005). Ozkan (2007) show that CEOs receive significantly higher compensation in firms with larger boards and with higher proportions of non-executive directors. However, CEOs receive significantly lower compensation in firms with active monitoring by block-holders and institutional shareholders. Therefore, the overall literature suggesting the link between weaker governance and higher CEO compensation completely accords with the essence of agency theory.

Contrary to the literature on corporate governance and compensation linkage, evidence on the link between CEO ownership and the compensation linkage is relatively scarce. Mehran (1995) finds that firm performance is positively related to the percentage of equity held by managers and to the percentage of their compensation that is equity-based. Further, he shows that equity-based compensation is used more extensively in firms with more outside directors; and that firms in which a higher percentage of the shares are held by insiders or outside blockholders use less equity-based compensation. Holderness and Sheehan

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(1988) show that managers with majority shareholdings receive marginally higher salaries than other executives. David, Kochhar and Levitas (1998) show that institutional owners influence CEO compensation in two ways: reduces the level of compensation and increases the proportion of long-term incentives in the total compensation package. For this reason, the literature on CEO ownership and the compensation linkage shows mixed evidence in the US. In the Asia Pacific belt, such as Hong Kong, Cheung, Stouraitis and Wong (2005) show that CEOs with higher equity ownership receive less compensation since they supplement their income with divideds.

6. Corporate governance in financial firms

The recent global financial crisis revealed a number of shortcomings in policies and practices followed by financial institutions and regulatory and supervisory agencies. A number of new regulations in the US including the Banking (Special Provisions) Act 2008, Housing and Economic Recovery Act of 2008, Economic Stimulus Act of 2008, Emergency Economic Stabilization Act of 2008, Troubled Assets Relief (TARP) Act 2008, and American Recovery and Reinvestment Act of 2009 highlights the fragility of the regulations in the context of financial markets.

With respect to the role of governance, Laeven and Levine (2009) empirically assess the role of ownership structure and regulations on risk-taking by banks. Focusing on the conflicts between bank managers and owners over risk, they show that bank risk-taking varies positively with the comparative power of shareholders within the corporate governance structure of each bank. Also, the relationship between bank risk and capital regulations, deposit insurance policies depend critically on each bank's ownership structure. For this reason, the same regulation has different effects on bank risk taking depending on the bank's corporate governance structure. Pathan (2009) also examines the relevance of bank board

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structure on bank risk-taking. His study finds that strong bank boards positively affect bank risk-taking, while CEO power negatively affects bank risk-taking.

In assessing the effectiveness of corporate governance in banking firms, Andres and Vallelado (2008) use a sample of large international commercial banks to show that bank board composition and size are related to directors' ability to monitor and advise management. In particular, larger and not excessively independent boards might prove more efficient in monitoring and advising functions, and create more value. Caprio, Laeven, and Levine (2007) show that with strong shareholder protection laws, banks are not widely held, and such ownership structure is an important mechanism for governing banks. They also provide evidence that larger cash-flow rights by the controlling owner and stronger shareholder protection laws increase value. The role of corporate governance, in navigating firms through difficult times, is far more important than in the case of normal times. Erkens, Hung, and Matos (2012) investigate the role of corporate governance on financial firms' performance in the context of the global financial crisis using a cross country and cross-sectional financial firm level sample. The study show that firms with higher institutional ownership engaged in a more risky portfolio strategy prior to the financial crisis, which led to a larger loss of shareholder wealth. In addition, firms with more independent boards raised more equity capital during the crisis, which led to a wealth transfer from existing shareholders to debt holders, creating a more complex agency conflict.

Using a macro perspective, Cihak, Demirgüç-Kunt, Martinez Peria, and Mohseni-Cheraghlou (2013) show that regulatory and supervisory practices in crisis countries had less stringent and more complex definitions of capital but exhibited lower actual capital ratios, faced fewer restrictions on non-bank activities, were less strict in the regulatory treatment of bad loans, were less able to demand banks to adjust their equity, provisions or compensation

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schemes, and had greater disclosure requirements but weaker incentives for private agents to monitor banks.

7. Corporate governance and firm value

Extant literature has extensively investigated the impact of corporate governance on firm value (Beiner, Drobetz, Schmid, and Zimmermann, 2006; Black, Jang, and Kim, 2006; Brown and Caylor, 2006; Carter, Simkins, and Simpson, 2003; Chhaochharia and Grinstein, 2007; Core et al., 1999; Cremers and Nair, 2005; Durnev and Kim, 2005). One of the major arguments for the direct effect of corporate governance on firm value is its role in reducing the agency conflict via removing uncertainties about future cash flow, thereby reducing the cost of capital (Beiner, Drobetz, Schmid, and Zimmermann, 2006). La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2002) argue that better protection for shareholders is value enhancing. Lombardo and Pagano (2006) show that better corporate governance can reduce the uncertainty about future cash flows, reduce the auditing cost both of which are consistent with reducing the cost of capital which in turn can lead to increased firm value (Beiner, Drobetz, Schmid, and Zimmermann, 2006). Using a multicounty approach (total of 847 firms from 27 countries), Durnev and Kim (2005) provide evidence that firms with better corporate governance practices enjoys higher valuation and higher growth opportunities. Black et al. (2006) using South Korean data report that corporate governance is an important factor in explaining market value. Moreover, they also show that controlling for firm size differences using an appropriate instrumental variable and regression discontinuity approach, corporate governance predicts higher market value.

Corporate governance provisions are numerous. Several studies (Bebchuk, Cohen, and Ferrell, 2009; Black et al., 2006; Gompers, Ishii, and Metrick, 2003) put extensive effort into answering which corporate governance provisions matters more to value creation. Gompers

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et al. (2003) develop a nice story resembling corporates with republics. In particular Gompers et al. (2003) develop their G-Index using 24 governance rules that proxy for more shareholder rights i.e. a more democratic system of governance. Their study finds that corporate governance is strongly correlated with stock returns. In fact, an investment strategy to purchase stock in the highest shareholders rights firm and sell stock in of a firm with the highest managerial power i.e. fewer shareholders rights, enjoys 8.5% yearly abnormal return. Moreover, the overall result suggests that both stock return and firm value are positively explained by stronger shareholders rights.

In a comprehensive effort to understand the effect of corporate governance in firm value, Cremers and Nair (2005) investigate the effect of external and internal governance on equity price. They use the market for corporate control as the proxy for external governance and shareholder activism as the proxy for internal governance. Arguing that both internal governance and external governance are substitutes and relying primarily on the work of Gompers et al. (2003), Cremers and Nair (2005) find that buying (shorting) a portfolio with high (low) takeover vulnerability and high (low) block holder ownership generates an annualized abnormal return of 10–15. In contrast, a portfolio that buys (shorts) firms with high (low) takeover vulnerability and low blockholder ownership, does not generate any significant abnormal return. Therefore, Cremers and Nair (2005) lend support for the argument that both internal and external governance mechanisms are complements to each other.

Bebchuk et al. (2009) use a subset of six from the 24 provisions tracked by IRRC to further investigate the role of governance provisions in driving firm valuation. The chosen six-provisions are those that have systematically drawn substantial opposition from institutional investors voting on predatory resolutions including: arrangements-staggered boards, limits to shareholder amendments of the bylaws, supermajority requirements for

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mergers, and supermajority requirements for charter amendments, poison pills, and golden parachute arrangements. Bebchuk et al. (2009) develop an entrenchment index (E index), based on these six provisions. Their results suggest that an increase in the E index is monotonically associated with economically significant reductions in firm valuation and large negative abnormal returns for the period of 1990–2003.

Similar to Gompers et al. (2003) and Bebchuk et al. (2009), Brown and Caylor (2006) develop a far more comprehensive "Gov-Score" index based on 51 firm-specific provisions representing both internal and external governance and show that Gov-Score is significantly and positively associated with firm value. In an effort to understand which of the governance variables drive this relationship, Brown and Caylor (2006) identify 7 factors (two of which correspond to E index) and construct a parsimonious index, "Gov-7", and show that there is a significant positive effect of Gov-7 on Tobin's-q. Therefore, while the index constructed based on the majority of the variables supports the result of Bebchuk et al. (2009), a small subset of significant governance variables support the findings of (Cremers and Nair, 2005; Gompers et al., 2003).

Furthermore, Chhaochharia and Grinstein (2007) using a matched sample method, study the announcement effect of the SOX Act 2002 on firm value. Specifically, they develop a separate portfolio of firms based on the degree of compliance with governance rules relating to the effect of the following provisions: insider trading, financial reporting, related party transactions, internal control and board and committee independence. In general, during the announcement period, less compliant firms earn positive abnormal returns compared to complaint firms. Furthermore, firms restating their financial statements, firms whose insiders are perceived as timing the market, firms that have related party transactions, and firms that did not comply with the board independence provisions outperform their peers during the announcement year: with an abnormal return in the range 6%–20%. However, these results

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are not consistent across firm size. Indeed, Chhaochharia and Grinstein (2007) show that small firms that are less compliant with these provisions do not outperform small firms that are more compliant with them. In fact, small firm portfolios earn abnormal negative returns.

Furthermore, a critical review of the existing literature on value relevance of corporate governance also suggests that there are many mechanisms through which corporate governance can directly or indirectly impact firm value. For example, corporate governance affects corporate financial performance (Bhagat and Bolton, 2008; Brown and Caylor, 2009; Core et al., 1999; Joh, 2003; Kang and Shivdasani, 1995; Klapper and Love, 2004; Larcker, Richardson, and Tuna, 2007), which in turn can affect firm value. Furthermore, corporate governance can substantially improve financial reporting and internal control quality (Agrawal and Chadha, 2005; Cohen, Krishnamoorthy, and Wright, 2004; Forker, 1992; Hoitash, Hoitash, and Bedard, 2009; Kelton and Yang, 2008; Lowenstein, 1996; Mallin, 2002; Sloan, 2001); improving the disclosure environment and quality by curbing earnings management and/or manipulation (Ahn and Choi, 2009; Cornett, Marcus, and Tehranian, 2008; Cornett, McNutt, and Tehranian, 2009; Davidson et al., 2005; Farber, 2005; García-Meca and Sánchez-Ballesta, 2009; Hazarika, Karpoff, and Nahata, 2012; Karamanou and Vafeas, 2005; Klein, 2002; Liu and Lu, 2007; Xie et al., 2003); improving audit quality (Abbott, Parker, Peters, and Rama, 2007; Farber, 2005; Lin and Hwang, 2010); and encouraging voluntary disclosure (Core, 2001; Eng and Mak, 2003; Lim, Matolcsy, and Chow, 2007). All of these mechanisms have a direct impact on the information environment which can improve firm value creation.

Moreover, one of the direct effects of corporate governance is enhancing investor protection (Bowen, Rajgopal, and Venkatachalam, 2008; Defond and Hung, 2004; Klapper and Love, 2004; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 2000b) and establishing checks and balances on executive pay structure (Basu, Hwang, Mitsudome, and Weintrop,

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2007; Conyon, 1997; Core et al., 1999; Cornett et al., 2008; Lee, Lev, and Yeo, 2008). Such an effect of corporate governance has a profound impact on firm value.

The Corporate and Criminal Fraud Accountability Act of 2002 specifies specific criminal penalties for manipulation, destruction or alteration of financial records while providing certain protections for whistle-blowers. Section 302 requires that the CEO and CFO certify and approve the integrity of their company financial reports quarterly. Given this context, recent literature argues that this corporate governance act likely discourages managers from undertaking risky projects that may have a significant (dysfunctional) impact on firm value creation (Bargeron et al., 2010; Dey, 2010; Ferreira and Laux, 2007; Forker, 1992; Kim and Lu, 2011).

Finally, the link between corporate governance and value creation can be seen as a complementary link between risk-taking and value creation. Corporate risk-taking is quite central to the value creation process (Merton, 1987; Fu, 2009). However, corporate governance pushes managers to become more circumspect for a variety of reasons including avoiding criminal charges and career concerns. Moreover, managers might underinvest when firm-specific uncertainty increases (Panousi and Papanikolaou, 2012). Therefore, corporate governance regulation will sustainably affect the firm value through risk-taking channel.

8. Corporate governance and future research agenda

The passage of corporate governance regulation is seen as the most dominant global regulation wave in corporate history. Specifically, in the US, the enactment of SOX regulation is seen by then popular press as the law containing "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt" (Akhigbe et al., 2008). However, the voluminous literature on corporate governance during the period 2001-2006 mainly attests that corporate governance is a "savior" against many (apparently) self-serving opportunistic managerial actions. Alternatively, some literature claims the lack of

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corporate governance mechanisms as an important reason behind the Asian financial crisis (Johnson, Boone, Breach, and Friedman, 2000) or accounting scandals during the onset of 21st century (Adams, 2003; Romano, 2005).

While there are arguments for (Chhaochharia and Grinstein, 2007) and against (Zhang, 2007) the corporate governance regulations especially in the context of economic consequences of the regulation, there is a growing support for easing the regulatory requirements, e.g., calls by privately funded groups such as the Committee on Capital Markets Regulation. Recently, the Financial Regulatory Responsibility Act (2013) was enacted to require enhanced economic analysis and justification of regulations proposed by certain Federal banking, housing, securities, and commodity regulators, and for other purposes. Accordingly, given the literature review and recent regulatory trends, we suggest some key future research directions.

First, Masulis, Wang and Xie (2007) find that managers facing more pressure from the market for corporate control tend to make better acquisition decisions. La Porta et al. (2000b) show that better minority shareholder protection is associated with higher dividend pay-outs in a cross-section of firms from around the world. Kim and Purnanandam (2014) find weak governance is a primary reason for investors to react negatively to the announcement of seasoned equity offerings (SEOs). As such, the linkage between the adoption of more stringent corporate governance regulations/mechanism (i.e. outside independent directors, blockholders, Big 6 Auditor and audit committees) and firm value across countries and different institutional and regualtory settings warrants deep empirical investigation.

Second, the corporate governance literature suggests that the ineffectiveness of governance stems either from the ineffectiveness of outsider directors who are hired by the CEO and/or the receipt of excessive fees by the outsider directors. This argument rests on the

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idea of cronyism. However, such ineffectiveness has only been linked to CEO compensation structure. We argue that a mechanism that reduces ineffectiveness of outside directors can also be linked with a variety of corporate realities within hoarding theory of bad news, agency theory of board of directors. In addition, the question of director motives or simply, given the complex legal bindings why someone wants to be a director forms the foundation of important future research in the corporate governance literature. Future studies can build on the recent findings on the importance of director networks (see, among others, Fracassi and Tate, 2012; Cai and Sevilir, 2012; Chiu, Teoh and Tian, 2013; Larcker, So and Wang, 2013; Ishii and Xuan, 2014).

Third, the extant literature views corporate governance within the agency theory framework to curb managerial opportunism. Corporate governance is not just a set of formal provisions or regulations. Empirical studies on how financial markets affect the effectiveness of corporate governance merit future investigation. For example, stock liquidity can encourage blockholders to monitor and intervene (Maug, 1998) or enhance the threat of exit by blockholders (Edmans, 2009; Admati and Pfleiderer, 2009; Edmans and Manso, 2011). Similarly, short selling also acts as an external governance mechanism to discipline managers (see, for example, Massa, Zhang and Zhang, 2015; Fang, Huang and Karpoff, 2015).

Forth, there is an increasing demand for re-scrutinizing corporate governance regulation and enactment of new regulation that is more productive, less costly, competitive, and efficient. The recent enactment of US regulation such as 'Regulatory Accountability Act 2015' is a major break-through in this regard. The Regulatory Accountability Act 2015 outlines that existing regulations at times play negatively in creating jobs, economic growth, innovations and competitiveness. Giroud and Mueller (2010) show that corporate governance has a negative effect in terms of increasing costs such as wages and overhead costs, and in reducing operating performance, which is also in line with argument of the recent Regulatory

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Accountability Act 2015. Accordingly, there is a need for analyzing and augmenting the reasons underlying such negative effects.

Finally, there is a growing trend of equity compensation structure since the beginning of SOX regulations. Though equity compensation was originally designed to balance the pay-performance sensitivity and also to align managerial effort with value maximization, recent literature shows that equity incentives are responsible for stock price crashes (Kim, Li, and Zhang, 2011). For this reason, the link between corporate governance and firm value needs to be revisited in the context of pay-performance sensitivity and optimum compensation structure (for example, the adoption of industry-adjusted compensation policy). In addition, the equity incentive may also be linked to the dividend payout ratio. However, there is a scarcity of literature on the possible intervening role of equity incentives in the link between corporate governance and dividend policy.

9. Contribution of the special issue papers

This section briefly outlining the contribution of the papers published in this special issue under the follwing subheadings: governance and risk; accounting standards, earnings quality and audit committees; monitoring, compensation, ownership, CSR and performance; and liquidity and stock returns.

9.1 Governance and Risk

Using a cross-country sample of 38 countries over the 1990 to 2003 period, Kusnadi (2015) examines the effect of insider trading restrictions on corporate risk-taking, documenting a positive relation. Further he shows that this relation is influenced by cross-country differences in stock market development and legal origin, and that the increase in risk-taking is beneficial to firms. Narayan, Sharma and Thuraisamy (2015) develop country-level governance indices using governance risk factors and examine whether country-level

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governance predicts stock market returns. They find such predictability only in countries where governance quality is poor. Further, they confirm that investors in such settings can informationally exploit these governance indicators to devise profitable portfolio strategies.

9.2 Accounting Standards, Earnings Quality and Audit Committees

Jin, Shan and Taylor (2015) investigate the impact of the adoption of International Financial Reporting Standards (IFRS) on the matching between contemporaneous revenues and expenses in Australia by contextualizing differences compared to the US. While the focus of financial reporting in the US has shifted from the income statement to the statement of financial position, Australia continues to focus on the former. Accordingly, Jin et al show that the quality of revenue-expense matching improved post-IFRS adoption in Australia, a sharp contrast to the US experience. A decomposed analysis into various expenses suggests that the lower 'matching' quality pre-IFRS is primarily due to the depreciation expense, amortization expense and interest expense. Overall their study affirms increased value relevance of Australian financial reporting post-IFRS. Bryce, Ali and Mather (2015) study the impact of IFRS adoption on the financial reporting quality in Australia. Somewhat in contrast to Jin et al (2015), Bryce et al (2015) show that accounting quality is not significantly enhanced subsequent to the adoption of IFRS in Australia. However, they find that audit committees are more effective in maintaining accounting quality under IFRS than under previous Australian GAAP.

Using China as a corporate laboratory, Cai, Hillier, Tian and Wu (2015) investigate the value added by audit committees from an agency cost perspective. They show that firms with severe agency relationships, privately-owned firms, firms with better governance and concentrated ownership are more like to have an audit committee. Their study contributes to the literature on the presence of audit committees in an organization under different

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organizational frameworks and environments. Zhu, Lu, Shan and Zhang (2015) study the trade-off and accrual based and real activities based earning management practices by Chinese reverse merger firms. The study finds that such firms are involved in significantly higher levels of earning management than other reverse merger firms; however, the presence of big-4 auditors reduces such a tendency. Kim, Kim, Kwon and Lee (2015) show that the use of percent accruals, as opposed to traditional accruals, satisfactorily resolves the previous conflicting literature on the accrual anomaly in Korea.

9.3 Monitoring, Compensation, Ownership, CSR and Performance

Chang and Watson (2015) investigate incidences of delayed disclosure of trading by corporate insiders (directors) in Australian firms and link this activity to personal wealth incentives and future firm performance. They find the likelihood of delayed disclosure was affected by insider wealth factors such as total compensation levels, equity compensation, and shareholding and their positions within the firm. They also show that when executive and nonexecutive directors in small firms delayed the reporting of their purchases, these purchases signalled positive future returns. But in the case of large firms only executive directors' sales are indicative of one-year ahead negative returns. Their findings suggest that delayed disclosed trades have information content about future firm performance and compensation structure influences the decisions by some insiders to engage in such activity for personal gain.

Using a panel of 684 Australian listed firms from 2001 to 2011, Méndez, Pathan and Garcia (2015) show that firms with multiple board directorships (busy directors) pay high CEO remuneration, experience low CEO pay-performance and low CEO turnover-performance sensitivities. Their results also suggest that firms with multiple committee memberships of a board (overlap directors) have a lower probability of receiving a qualified audit opinion and are able to negotiate lower payments, both to their CEOs and to the

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external auditors. Muniandy and Hillier (2015) study the impact of corporate governance on the investment opportunity-firm performance linkage in South Africa. They find that recent changes in the South African corporate governance code (giving more importance to independent non-executive directors) have positive impact on growth potential leading to higher firm performance. Given that South Africa is a big role model for the entire continent, this is a recipe for other countries to follow similar regulation.

Low, Roberts and Whiting (2015) investigate the role board gender diversity in explaining firm financial performance in a sample of East Asian firms. They show that increasing female representation has a positive effect on firm performance. Further, they show that this positive impact dissipates in countries with higher economic participation and female empowerment.

Xie (2015) examines the impact of founders staying, on acquirers' merger performance. He shows that founders staying is value-enhancing and that this phenomenon is more prominent when founders remain as daily executives, indicating the value of founders to acquirers. Pham, Oh and Pech (2015) examine the value additive role of CEO duality in the context of M&As in Vietnam. CEO duality in Vietnam has unique cultural, political and institutional roots typifying many emerging economies. They show that the market perceives CEO duality firms as better acquirers (higher abnormal returns) than non-duality firms. Using a Chinese setting, Chen, Jiang and Yu (2015) show that corporate philanthropy (CP) significantly increases firm value by easing access to bank loans. Increased CP allows firms to gain the trust of banks, a form of social capital, which drives the result. Notably, the relationship is stronger for non-State-owned companies.

9.4 Liquidity and Stock Returns

Vu, Chai and Do (2015) examine the effects of systematic liquidity risk on stock returns in the Australian market. They find that liquidity risk, in the form of (i) the co-movement

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between individual stock liquidity and market liquidity, (ii) the co-movement between stock returns and market liquidity, and (iii) the co-movement between stock liquidity and market returns, is priced individually and jointly in Australian equities. Their findings support the importance of liquidity risk, particularly during market downturns.

In 2012, the Taiwanese stock exchange introduced a new information disclosure requirement that necessitate the release of best-simulated bid and ask after every 20 seconds for the closing call session in the market. Tseng and Chen (2015) study the impact of this new information disclosure requirement on order aggressiveness and find this is the case for both individual and institutional investors. However, such aggressiveness decreases over time. Tian, Do, Duong and Kalev (2015) examine the relation between individual investor trading and future stock returns in the Australian equity market and show that the net trading individual investors is positively related to future returns. They further show that this association is driven by individual investors who play the role of liquidity providers.

Maderitsch (2015) provides evidence regarding the structural stability of information transmission between Hong Kong, European and US stock markets. He finds that temporary positive spillovers from Europe to US, negative spillovers from US to Hong Kong. Bissoondoyal-Bheenick and Brooks (2015) examine the puzzling credit risk-return relationship; in particular, comparing the stock returns of high versus low credit risk firms in Australia and Japan. They show that the credit risk-return puzzle exists in both Japan and Australia. They further show that the credit risk-return anomaly is explained by downgrade announcements. Koh, Durand and Limkriangkrai (2015) study the behavior pattern regarding the investment in firms that have significant CSR activity ("Saints") versus those that are in alcohol, tobacco and gaming ("Sinners"). They provide evidence that investors pay a share-price premium for Saints and require discounts for Sinners. Kim, Kim and Lee (2015) examine the stock return comovements within business groups in Korea. They show that the

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stocks from the same business group co-move with each other more than with the same industry. Further, compared to within industry correlation over time, within group correlation is stronger and more visible. The study contributes to the literature by confirming the existence of non-fundamental stock returns, even at business-group level.

Acknowledgements: We greatly appreciate the comments provided by Huu Duong, Arifur Khan and Premkanth Puwanenthiren. We would like to thank Md Al Mamun for his research assistance.

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Highlights

This paper is the lead article for the special issue on Governance and Risk.
We review and comment on the current and future research directions.
We discuss twenty-one papers published in this special issue.

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