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# Determinants in Introduction of Outside Directors in Korean Companies

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*Corporate governance is one of the major topics in strategic management, however the majority of research on this subject is limited to analysis of governance mechanism impact on management. This paper intends to analyze other various factors that influence the governance mechanism. Specific focus is placed on identifying factors that affect the introduction of outside directors to Korean companies in the post-currency crisis era. Three areas, which are generally regarded as major sources of competitive advantages of a firm, are taken into consideration in order to determine these factors: managerial, environmental and internal resources. In turn, we continue our examination of seven variables derived from these three areas. Introduction effectiveness of outside directors is measured by three factors, such as independence, information and compensation. Empirical tests from 110 Korean manufacturing companies, reveals that effective introduction of outside directors in Korean companies after the currency crisis has a positive relationship with firm size and debt ratio, a negative relationship with the ownership rate of large shareholders and mixed result with past performance.*

***Keywords: Agency Theory, Outside Director, Governance Structure***

## 1. INTRODUCTION

The governance mechanism can be divided into the internal control system and the external control system (Walsh and Seward 1990). The Board of directors, the most important internal control system, is composed of inside directors and outside directors. Through the boardroom reform during the 1970s in America, the proportion and importance of outside directors in the boardroom has been increasing. In some companies, only the CEO is included in the boardroom as the inside director. In many other companies, the CEO and the chairman of boards are separated and one of the outside directors becomes the chairman, which increase the independence of board of directors from the management. The outside director's dominance on the board of directors is considered as a way of corporate governance reform that fulfills the principal objective of a business; which is to enhance shareholder value (Kesner et al. 1986). Because inside directors are also officers, they are not in a position to express their independent opinions about the activities of the company or management their loyalty is to the CEO and without appropriate outside directors, a board can barely make a valuable contribution to the company's management (Reiter 1999).

The outside director has been introduced to Korean companies in 1998. The governance failure has been considered to be one of the main reasons of weak competitiveness of Korean companies, causing the currency crisis in Korea in 1997. Outside directors of all Korean firms listed in the Korean stock exchange were ordered to comprise more than 25 percent of the total number of directors. Researches have been conducted on the role of ownership structures in Korean companies (Kim and Bahn 2001), but there have been few

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researches on the role of board of directors or outside directors in Korean companies.

The main objective of this paper is to develop a model on the internal mechanism of outside directors and the various factors influencing them and to test the model based on the data from Korean companies. This research offers three contributions. First, although there are many researches about board of director (Johnson, et al. 1996; Pearce and Zahra 1989), there have been few researches about outside directors. This research intends to develop a model explaining the formation of the outside director governance system. Second, the simple structure of the governance researches in strategic management is overcome. In corporate governance researches, the structure of the research model is very simple, which simply investigates the relationship between governance mechanisms and strategic variables (Kosnik 1987; Cochran, et al. 1985; Daily and Dalton 1994; Seward and Walsh 1996; Zahra 1996, Sundaramurthy 1996; Boeker and Goodstein 1993). Third, the research model is tested in the Korean context. Most governance researches were performed for the U.S. companies, which are characterized by the separation of ownership and control. There are few researches for companies where the ownership and control is not separated. We need to recognize that in most nations except the U.S. and the U.K., ownership and control in the firms is not separated (OECD 1998).

## 2. LITERATURE REVIEW ON CORPORATE GOVERNANCE

Many researches I on corporate governance in strategic management are to empirically test the validity of the agency theory. Researches that deal with corporate governance in Finance also test the relationship between governance mechanisms and corporate performance (Shleifer and Vishny 1986; Morck, et al. 1988; Vafeas 1999: Rosenstein and Wyatt 1990). In strategic management, researchers have attempted to discover more variables representing corporate performance than those in Finance. In other words, governance researches in strategic management have sought many kinds of strategic situations that can be influenced by governance mechanisms. It can be said that the role of empirical researches in corporate governance is to find new dependent variables to test the validity of the agency theory.

The dependent variables in the empirical studies are summarized as follows:

First, many researches analyzed the responses of management or of shareholders to takeover bids of their company to test the agency theory and the role of governance mechanisms. Kosnik (1987) studied the relationship between board effectiveness and greenmail. Other researches deal with the golden parachute contract (Cochran et al., 1985), anti-takeover provisions (Sundarmurthy 1996), shark repellents (Frankfort, et al. 2000), and poison pills (Davis 1991).

Second, dependent variables in many empirical researches measure corporate performance. Daily and Dalton (1994) investigated the relationship between board structure and the incidence of corporate bankruptcy. Johnson and Greening (1999) analyzed the impact of governance mechanism on the social performance, while Thomsen and Pedersen (2000) investigated the relationship between large shareholder ownership and corporate performance in European companies.

Third, many researches selected various strategic variables as dependent variables. They considered diversification (Hoskisson, et al. 1994; Hill and Snell 1989), innovation (Kochran, et al. 1996; Hill and Snell 1989; Balkin, et al. 2000; Hansen and Hill 1991),

entrepreneurship (Zahra 1996), restructuring (Bethel and Leibeskind 1993) and strategic changes in hospitals (Goodstein and Boeker 1991).

Fourth, another category of dependent variables is CEO. Other researches in this category deal with CEO compensation (Boyd 1994; Conyon and Peck 1998), CEO succession (Boeker and Goodstein 1993) and the concealment of negative outcome by top manager (Abrahamson and Park 1994).

### 2.1. Strategic Contingencies of Governance Research: Management, environment and resources

After studying the relationship between governance mechanisms and corporate strategic situations or performance, it is necessary to examine which factors influence this relationship and to examine which factors affect the formation of the governance mechanism. From this approach, we learn how to implement corporate governance mechanisms effectively by recognizing which factors in a company are related to the operation of governance mechanisms. Three contingencies: management, environment and resources, were identified from the existing research.

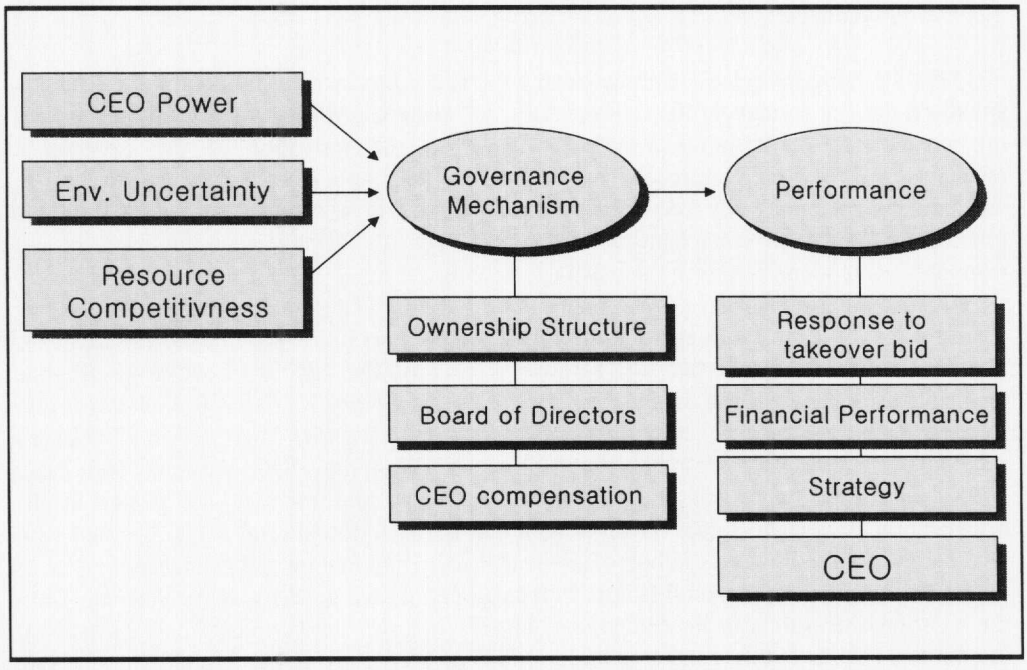
Because the top manager plays a major role in deciding corporate strategy and corporate performance, he exerts influence on the formation or function of governance mechanisms. Therefore, it is suggested that CEO power is a constraint against effective governance mechanisms (Changanti and demanpour 1991; Tosi and Gomez-Mejia 1989; Finkelstein and D'Aveni 1994; Pearce and Zahra 1991) from the many researches interested in CEO-board relation (Westphal 1998;Westphal 1999; Zajac and Westphal 1996; Westphal and Zajac 1995). The CEO who wants to dominate the board and increase his power in his organization is eager to select directors with similar backgrounds and social ties and who are able to adapt to increases in board independence by ingratiation and persuasion.

Furthermore, environmental factors influencing corporate governance mechanisms from the existing literature can be categorized into 1) industry environments and 2) national institutions (North 1990). Li and Simerly (1998) pointed out that past studies in corporate governance failed to consider the impacts in an environmental context. They analyze the degree to which environmental dynamism moderates the managerial ownership- performance relationship. Zahra (1996) also hypothesizes the moderating effect of technological opportunities on the relationship between governance mechanisms and corporate entrepreneurship. Finally, Pedersen and Thomsen (1997) explain that institutional environments, such as stock markets, the banking sector, the openness of the economy, influence ownership structures.

However, the recent focues of research on strategic management has been in a resource-based view. Thus, it will be very challenging to analyze the relationship between resource and governance mechanisms in a firm. There are rare researches considering the relationship between resources and governance mechanisms. Following studies may not fit properly in this category, but they can lead to certain implications and aid the examination of the relationship between firm characteristics and governance mechanisms. Sanders and Carpenter (1998) explainthat the complexity resulting from a firm's degree of internationalization is accommodated by its more complex governance structure. Especially for firms in an emerging market, (Hoskisson et al. 2000; Khanna and Palepu 2000) like Korea, knowledge on management skills of foreign firms in industrialized countries acquired from internationalization may help implement more sophisticated governance

mechanisms. The study by Balkin and Gomez-mejia (1987) explore the relationship among compensation strategies and organization characteristics. Corporate culture, which is typical in small firms at the growth stage or in the high-tech industry, may lead the CEO's interest to align with that of shareholders and reduces the possibility of agency cost.

**Figure 1**. Literature Review




## 3. RESEARCH MODEL

As mentioned in the literature review, most studies about corporate governance analyze the impact of the governance mechanism on management. This paper intends to find out the various factors influencing the governance mechanism; concentrating on the factors influencing the introduction of outside directors in Korean companies. The introduction of outside directors is considered as a dependent variable affected by the CEO, environment, and resources.

### 3.1. Introduction of outside director

In this paper, we suggest the critical success factors for the introduction of outside directors in a firm by reviewing the existing literature. Three critical success factors are required to make outside director effective (Cluttebuck and Waine 1994; Reiter 1999; Houston 1992): independence, information and compensation.

***Independence.*** Early skepticism of the board arose when the outside director was introduced into the boardroom reform process. Many believed that the manager dominated the boards by using his power to select and compensate directors and by exploiting personal ties (Herman 1981; Mace 1971; Pfeffer 1972; Vance 1964). The lack of independence from management is a basic cause of inability in board of directors. According to the outsider dominance perspective, outsiders should be the majority on corporate boards, because they offer independence, knowledge and experience (Kesner, et al. 1986). Outside directors are believed to monitor firm management more effectively than insiders. Outsiders' effectiveness derives from their independence from the CEO and the firm as a function of their employment status. A considerable amount of research relies on the proportion of outside directors as an indicator of board independence.

***Information.*** Because the outside director belongs to external organizations, he does not have enough knowledge about the complex management situations of the firm. This lack of information about the internal situation of the firm weakens the effectiveness of the outside director.Some researches have reported that a higher ratio of inside directors is associated with higher R&D expenditures (Baysinger et al. 1991), greater likelihood of CEO dismissal in times of financial crises (Ocasio 1994), and higher firm performance (Pearce 1983). These studies argue that inside directors who have access to richer, fuller information about their firms are in a better position than outside directors to make decisions about many critical areas of firm operation and performance.

According to Baysinger and Hoskisson (1990), the decision control orientation is different between outside directors and inside directors. They argued that outside directors evaluate and reward CEOs based on financial control orientation (outcome control), while inside directors monitor CEOs based on strategic control orientation (behavior control). Inside directors, who are part of the decision-making process, have relatively greater access to subjective information about the top management's performance. Outside directors, on the other hand, lack the type of subjective information needed for evaluating and rewarding managers on the quality of their decision process.

***Compensation.*** The limits of the outside director, such as lack of information (Baysinger and Hoskisson 1990), can be overcome by effective compensation for the outside director. Zahra (1996) suggests that there is a negative association between the proportion of the outside director in the boardroom and entrepreneurship of the CEO. Zahra argues that this disadvantage of the outside director can be solved by the stock ownership of the outside director.

Hambrick and Jackson (2000) maintained that the stock ownership of outside director is a practical solution for ineffective boardrooms. They explain that the skepticism about the boardroom arises from the fact that directors cannot devote enough time and attention to fully understand the company's environment and prospects. Proponents of significant director holdings argue that the most effective way to get outside directors to vigorously represent the firm's principals is to make them principals themselves. Some empirical studies, despite their limitation, have examined a measure of current company effectiveness and its associations with director holdings (Elson 1995; Stobaugh 1993; McLaughlin 1994; Bhagat et al. 1999).

3.2. Factors influencing the introduction of outside directors

***CEO characteristics.*** There are two opposing viewpoints about the role of top manager in deciding corporate strategy and performance. One stresses the strategic importance of top management in an organization (Child 1972; Hambrick and Mason 1984), the other regards top management only as a symbol of an organization (Pfeffer and Salancik 1978; Hannan and Freeman 1977). In the strategic choice perspective, the top management plays a strategic role through which he identifies environmental opportunities and problems, interprets relevant information, considers organizational capabilities and constraints, and formulates and implements strategic change (Child 1972; Wiersema and Bantel 1992). Hambrick and Mason (1984), conversely, argue that organization outcomes, strategic choices and performance level, are partially predicted by managerial background characteristics.

In implementing governance mechanisms like outside director, the role of the CEO is important, because he decides how to manage outside directors. CEO's characteristics measured by his demography can be a predictor for effective implementation of outside directors. Therefore, this paper suggests that the innovativeness of the CEO is a predictor of whether the outside director will be effectively implemented in the firm; effective implementation of the outside director functions to prevent the entrenchment of the CEO himself. The board of directors in Korean firms is in the initial stage of development and the CEO's intention to implement the outside director is crucial for the firm's governance structure reform. In Korea, the outside director was introduced to restructure Korean companies after the currency crisis in 1997. The agency problems caused by the owner-manager were considered to be a reason that caused the weak competitiveness of Korean companies.

Three proxies of CEO characteristics are considered. They are the CEO's age, the CEO tenure and the ownership rate of large shareholders.

Some researches maintain that the CEO's age is expected to influence strategic decision-making perspectives and choices (Hambrick and Mason 1984; Wiersema and Bantel 1992; Daily 1995). These researches suggest that flexibility decreases and rigidity and resistance to change increase as people age. Habrick and Mason (1984) suggest that decreased physical and mental stamina, the inability to grasp new ideas and behaviors, greater psychological commitments to the organizational status quo and increased preference for financial and career security are the factors that cause stagnation of innovativeness among older executives. .

Here, I hypothesize that there exists a negative relationship between CEO age and the effectiveness in the implementation of outside directors. In Korea , the younger CEO who is more innovative than the older CEO is more likely to try to improve governance mechanisms. Daily (1995) argues that if youth is positively associated with the executives' propensity to initiate change and foster firm growth, a younger CEO is expected to invite greater numbers of outside directors for board service.

**H1-1: The age of the CEO is negatively related with the implementation effectiveness of outside directors in Korean companies**

Many researches assert that the longer organization tenure of a CEO is related with his reluctance to change his organization and risk-aversion attitude (Wiersma and Bantel 1992).

CEOs with longer tenures become more conservative and pursue stability in his position and income, which make him less interested in governance reforms, like the introduction of outside directors.

**H1-2: The length of organization tenure of the CEO is negatively related with the implementation effectiveness of outside directors in Korean companies.**

Concentrated stock ownership is a governance mechanism that reduces agency costs by top managers. Hill and Snell (1991) argued that when stockholdings are concentrated, it is relatively easier for individual stockholders to overcome information asymmetries and, thus, coordinate action and demand information from the management level. Other empirical studies reveal a positive relationship between concentrated ownership structures and corporate performance or strategic choice (Thomsen and Pedersen 2000).

In Korea, concentrated stock ownership by large shareholders is not a governance mechanism but a reason of agency cost by top management officials. In Korean companies that usually have concentrated ownership structures and large shareholder power , the CEOs are dependent on the large shareholders and, in many firms, the large shareholders actually participate in the management as an owner-manager. In this context, the strong control by large shareholders can be an obstacle to the innovativeness of the CEO to improve governance mechanisms.

**H1-3: The ownership rate of large shareholders is negatively related with the implementation effectiveness of outside directors in Korean companies.**

***Environment.*** Several strategic management researches investigate the association between the environment and corporate strategy formulation and corporate performance. In organization theories, adaptation is explained by two opposing perspectives, which are environmental determinism and strategic choice. According to environmental determinism (Hannan and Freeman 1977; Hrebiniak and Joyce 1985), organizations exert virtually no control over exogenous factors. Adaptation is determined by the environment, which selects organizations and allows only those forms with appropriate variations to remain. From these arguments, organizations either adapt to the environment or are selected out (Hannan and Freeman 1977). Institution theory also attempts to explain the role of outside environmental pressures in deciding organizational structures (DiMaggio and Powell 1983; Meyer and Rowan 1977).

Based on the arguments above, we assume that the implementation of outside directors can influence the characteristics of the environment. In fact, there are some researches that explain the effect of environments on the board composition, that is, the ratio of outside directors in board of directors.

Pearce and Zahra (1992) suggest that the characteristics of the environment play an important role in shaping decisions on board compositionby examining the impact of environmental uncertainty on board composition. It was hypothesized that high environmental uncertainty is positively related with board size and outside representation on the board. Li and Simerly (1998) argue that the positive relationship between insider ownership and performance is strengthened when the environment is more dynamic, because the uncertainty faced by the firm is high. When the industry profitability is high, it may be required to give high discretion to the CEO (Zahra 1996).

Three explanations reveal why firms implement outside directors to avoid low industry profitability. First, the knowledge and expertise of outside directors are more valuable in this situation. In Korea, strategic advice to the management is the main function of outside directors. Second, strong monitoring systems, like outside directors, overcome bounded rationality and opportunism that are the reasons of agency problems to adapt to high environmental uncertainty. Third, in Korea, when industry profitability is low, firms require immediate restructuring, as was implemented after the currency crisis, and are, consequently, motivated to implement outside directors.

**H2 : Industry profitability is negatively related with the effective implementation of outside directors in Korean companies.**

***Internal characteristics.*** Internal resources are another source of competitive advantage (Penrose 1958; Wernefelt 1984; Prahalad and Hamel 1990). If we assume the positive relationship between firm resources and governance mechanism, we require three proxies to measure the internal characteristics in Korean firms influencing effective implementation of outside director. First, the size of a firm measured by the amount of sales represents the possibility of effective implementation of outside directors. Especially, in Korea, large firms, including 'Chaebols,' are usually considered to be competitive and have more financial and human resources to adapt to the oscillating Korean business environment (Guillen 2000). Guillen (2000) argues that the importance of business groups in emerging economies like Korea comes from its rare and inimitable resources to adapt. Comprehensive resources in these companies, such as management know-how of governance mechanisms, the various external linkages to select outside directors, and experiences gained from Western governance mechanisms, serve as a base for improvement.

**H3-1 : Firm size is positively related with the effective implementation of outside directors in Korean companies.**

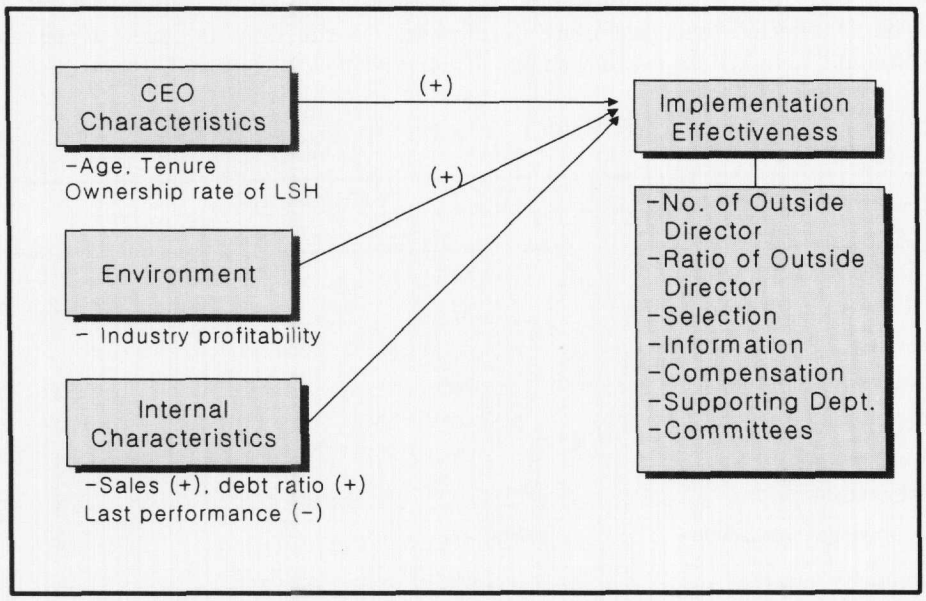
The second proxy of the internal characteristics is the debt ratio. To explain the positive relationship between debt ratio and the effective implementation of outside directors, two arguments are provided. First, in many Korean companies, the restructuring process after the currency crisis in 1997 was performed by the reduction of the debt ratio. High debt ratio was the typical problem that most Korean firms had before the currency crisis (Chung 2000). Korean firms that failed to reduce the debt ratio significantly were likely to pursue governance reform by the introduction of outside directors. This effort was performed either to reduce debt ratio and enhance the competitiveness of the firm or to show their restructuring efforts to the outside shareholders and stakeholders. Second, Pearce and Zahra(1992) maintain that more leveraged capital structures lead to larger representation of outsiders on the board. They suggest that as a firm attempts to acquire outside finances, its board will be enlarged to co-opt influential decision-makers in pertinent financial institutions (Pfeffer 1972; Pfeffer and Salancik 1978). In addition, financial institutions may insist on securing representation on a board to ensure sound fiscal policies by the borrowing company. The powerful financial institutions can then press the borrowing company to build more effective governance mechanisms.

**H3-2 : Debt ratio is positively related with the effective implementation of outside directors in Korean companies.**

From the existing literature, it is shown that there is negative relationship between last financial performance and the strengthening of governance mechanisms (Pearce and Zahra 1992; Boeker and Goodstein 1991). To escape low performance, the CEO improves governance mechanisms in order to increase his strategic decision options. When company's performance is poor, some CEOs may change the board composition by replacing inside directors with outside directors. They expect this change to provide a fresh perspective and enhance the existing pool of expertise. The restructuring effort by the governance reform in Korean companies can be interpreted to be required in a firm with low prior performance

**H3-3: Last performance is negatively related with the effectiveness implementation of outside directors in Korean companies.**

**Figure 2.** Research Model




## 4. EMPIRICAL TEST

### 4.1. Sample

Data was collected from 110 firms, which are listed in Korean Stock Exchange. Both the questionnaire and the secondary data were used to build a database for this research. Although questionnaires were sent to all the Korean manufacturing companies listed in Korean Stock Exchange, among the 489 Korean manufacturing companies listed in Korean

Stock Exchange, we received replies from only 110 companies. The response rate was 22.5 percent. As secondary source, we also acquired data from the KSE-listed firm database. The KSE-listed firm database, produced by the Korean Listed Companies Association, supplies annual financial information for KSE-listed firms. The KSE is the most comprehensive and reliable database available in Korea.

The survey for the questionnaire was performed between April and June in 2001 and the questions on the questionnaire questions be answered for the period of 2000. All questionnaires were sent to the CEOs of Korean manufacturing firms and the follow-up calls were made to these companies. All data that we included in this database are for the year of 2000.

### 4.2. Measurement

***Dependent Variable.*** Independence, information and compensation are the dependent variable that determines the introduction of our side directors. The factor analysis for the seven questions asked about outside director introduction, one factor was found to be significant and, subsequently named 'independence' This factor includes the number of outside directors, the ratio of outsiders on the board of directors and the number of committees. To measure the information, we asked two questions regarding information provision to directors and supporting organizations in the firm. In order to measure compensation, we asked the average amount of compensation for outside directors

**Table 1**. Factor Analysis

| | Component | | |
|---|---|---|---|
| | 1 | 2 | 3 |
| - Number of outside directors | .888 | .178 | -2.35E-02 |
| - Ratio of outsiders in board of director | .811 | .350 | 4.124E-04 |
| - Number of committees | .768 | -.118 | .252 |
| - Selection | 4.146E-01 | .788 | .187 |
| - Compensation | .175 | .730 | 2.226E-02 |
| - Information | 8.723E-02 | 1.825E-02 | .828 |
| - Supporting Organization | 4.796E-02 | .175 | .718 |
| Cronbach's Alpha | .6877 | .4175 | .000 |
| Eigenvalue | 2.476 | 1.238 | 1.017 |
| Percentage of variance explained | 35.47 | 17.68 | 14.52 |

***Independent variables.*** Three variables are measured as the proxy of CEO characteristics: CEO age, tenure and the ownership rate of large shareholders. CEO age and tenure were asked in the questionnaire and the ownership rate of large shareholder was acquired from KSE-listed firm database. Data about industry profitability for the period of 97-99 was obtained from the Economics Statistics Yearbook of 2001, published by the bank

of Korea. Industry profitability was reported for thirty-two industries in the Economic Statistics Yearbook and measured by sales profit ratios. Three variables are measured for internal characteristics. These three variables are sales, debt ratio and past performance. Sales is measured by the total amount of sales and debt ratio, total debt, divided by the total capital (obtained from the KSE-listed firm database). Past performance was measured by net profit divided by sales in 1999 from KSE-listed firm database.

4.3. Results and Analysis

Table 2 presents the means and standard deviations of dependent and independent variables included in the research model. The average age of CEO of the sample firms is 57.96 and the average length of tenure is 108.12 months (about 9 years). It can be interpreted that because many CEOs are owner-managers, the tenure of CEO is very long. The average ownership rate of large shareholders in the sample is 33.16 percent. According to Kim and Bahn (2000), the average ownership rate of large shareholders in the 30 largest business groups is 50.5 percent in 1999 and is decreased to 43.4 percent in 2000. The ownership rate of large shareholders from the KSE listed firm database used in this research is based on the figure that every listed firm reports at the end of business year to KSE. The definition of large shareholder ownership rate in the annual report must follow the legal definition. The average industry profitability is about 0.4 percent. The average ordinary income to sales was high in the industries such as electricity, telecommunications, recreation and sports, medical instrument and communications equipment (TV, radio). In these industries, the average ordinary income to sales was about 5 percent for this period. The industry profitability is averaged from 1997 to 1999. The average of last performance, the net profit/sales, for 1999 is about 3 percent in this sample. The average amount of sales of the companies in the sample is 865,434,000 won (U$ 66,500) and the average debt ratio was 208.3 percent.

**<Table 2> Descriptive Statistics**

| Variable | Mean | | Std. Dev. |
|---|---|---|---|
| Age | 57.96 | | 16.93 |
| Tenure | 108.12 | | 7.51 |
| Ownership rate of large shareholders | 33.16 | | 130.07 |
| Industry profitability | 0.388 | (percent) | 3.877 |
| Last performance | 3.155 | (percent) | 10.225 |
| Sales | 865434 | (thousand won) | 2125707 |
| Debt ratio | 208.78 | (percent) | 319.85 |
| Implementation effectiveness of outside director | 0.389 | | 0.120 |

Table3. summarizes the correlation analysis of variables in this research. Implementation effectiveness of outside directors has a positive correlation with sales and debt, and a negative correlation with last performance and large shareholder ownership rate. The age of the CEO is positively correlated with the tenure of the CEO and negatively correlated with the industry profitability. It can be easily judged that tenure increases with older age of the CEO and when the industry profitability is high, the CEO's age is younger. As we saw in table 3, the high-tech industry generally yields greater profits in Korea and in these industries the CEOs are younger than in other industries. The tenure of the CEO is positively correlated with sales and negatively correlated with the ownership rate of large shareholders. This relationship shows that in the large Korean companies, the CEO tenure tends to be longer. The negative correlation between CEO tenure and large shareholder ownership rate is an unexpected result, because higher ownership rate can mean the higher possibility of owner-manager and longer tenure of owner-managers. The ownership rate of large shareholders has a negative correlation with sales. The ownership structure for large firms in Korea disperses among several shareholders and the power of large shareholders is weakening. Last performance is negatively correlated with the debt ratio. High debt ratio is one of main reasons that decrease the competitiveness of Korean firms. .

**Table 3.** Correlation Coefficient

| | I.E. | Age | Tenure | LSH | I.P. | L.P. | Sales | Debt |
|---|---|---|---|---|---|---|---|---|
| **I.E.** | 1.00 | | | | | | | |
| **Age** | -.011 | 1.00 | | | | | | |
| | (.913) | | | | | | | |
| **Tenure** | .081 | .523*** | 1.00 | | | | | |
| | (.421) | (.000) | | | | | | |
| **LSH** | - | -.065 | -.17* | 1.00 | | | | |
| | .308*** | (.519) | (.093) | | | | | |
| **I.P.** | (.001) | .179* | -.053 | .079 | 1.00 | | | |
| | .055 | (.072) | (.602) | (.418) | | | | |
| **L.P.** | (.574) | .089 | .092 | .093 | .128 | 1.00 | | |
| | -.202** | (.388) | (.378) | (.348) | (.197) | | | |
| **Sales** | (.040) | .081 | .234** | -.221** | -.041 | .026 | 1.00 | |
| | .245** | (.416) | (.020) | (.022) | (.677) | (.795) | | |
| **Debt** | (.011) | .056 | .001 | -.101 | -.053 | - | -.001 | 1.00 |
| | .293*** | (.587) | (.990) | (.309) | (.593) | .622*** | (.990) | |
| | (.003) | | | | | (.000) | | |

Table 4 represents the results of regression analysis. Among seven independent variables in the regression analysis, the ownership rate of large shareholders, sales, last performance and debt ratio, held significant relationships with dependent variables.

**Table 4.** Regression Analysis

| Independent Variable | Independence | Information | Compensation |
|---|---|---|---|
| Constant | .279** | 4.266 | 26745601 |
| | (2.130) | (5.791) | (2.694) |
| Age | -1.751E-03 | -2.072E-02 | -60528.510 |
| | (-.755) | (-1.588) | (-.349) |
| Tenure | -1.500E-04 | 8.018E-04 | -23.759 |
| | (-1.092) | (1.037) | (-.002) |
| ownership rate of large shareholder | -3.039E-04 | -1.237E-02** | -89737.854 |
| | (-.309) | (-2.232) | (-1.230) |
| industry profitability | 1.795E-04 | 1.039E-02 | 142185.94 |
| | (.049) | (.502) | (.523) |
| Sales | 2.335E-08*** | 3.971E-08 | 2.552*** |
| | (3.521) | (1.064) | (3.230) |
| last performance | 5.434E-03** | 6.118E-03 | -318409.2** |
| | (2.591) | (.518) | (-2.022) |
| debt ratio | 4.282E-04*** | 7.590E-04 | -2652.835 |
| | (3.562) | (1.122) | (-.294) |
| Sample size | N=110 | N=110 | N=110 |
| R square | .268 | .160 | .227 |
| Adjusted R square | .207 | .090 | .157 |
| F-statistics | 4.388*** | 2.285** | 3.263*** |

Among the three independent variables that measure CEO characteristics, only the ownership rate of large shareholders reveals a significant relationship with the implementation of outside directors. Korean companies are considered to have different ownership structures from American companies, because the sizes of the firms are small and capitalism is less developed. The resulting ownership structure of Korean companies is more concentrated to one large shareholder than its American counterparts. The average ownership rate of large shareholders in this sample is about 33 percent and the average stockownership concentration rate is 43.4 percent for the largest 30 business groups in 2000 (Kim and Bahn 2001). After the currency crisis in Korea in 1997, the governance failure was pointed out to cause the weak competitiveness of Korean firms and many foreign analysts maintained that Korean firms were undervalued in the stock market because of their weak governance structure. The agency cost in Korea can be considered not as a relationship between shareholders and the CEO, but as a relationship between large shareholders and minority shareholders (OECD 1998). The ownership concentration by large shareholders creates agency problems for Korean companies. The results of regression analysis in table 4 support this argument. The introduction of outside directors in Korean companies reduces the agency problems posed by the large shareholders and it can be concluded that higher the ownership rate of large shareholders decreases the effectiveness

of governance reform in the form of outside directors.

The environment measured by past industry profitability, however, does not show a significant relationship with the implementation effectiveness. From this research, it is concluded that governance reform measured by outside director introduction does not have a significant relationship with the industry difference. As seen above, the high-tech industry enjoyed higher profitability in Korea during 1997 and 1999, but no significant result was obtained from regression analysis regarding the influence of industry on the introduction of outside directors. As I hypothesized, there can theoretically exist negative impacts of industry profitability on governance mechanism implementation. CEO characteristics in hypothesis 1 and resources in hypothesis 3 are internal factors and it can be suggested that the external factors influencing the implementation of governance mechanisms, other than industry profitability, need to be derived. A possible solution is to find the external factors from institutional environments. The legal and regulation environments provide significant impacts on the formation of board of directors (Luoma and Goodstein 1999). Another possible solution is to analyze the influence of economic environments like capital market on the ownership structure and next, the impacts of ownership structure on the board of directors (Pedersen and Thomsen 1997).

All of the three variables measuring internal characteristics reveal interesting results. The positive relationship of sales, which is generally used to represent the size of the firm, means that the larger the Korean firms, the more effectively outside directors are implemented. This fact can be interpreted in two ways: first, larger firms have more comprehensive resources, such as global experience, financial resources and social relationships, to implement outside directors effectively; or second, larger firms respond more effectively to the institutional pressure coming from foreign investors and the Korean government for governance reform (Meyer and Rowan 1967; Dimaggio and Powell 1994). Future research must search for governance reforms respond effectively to environmental factors and resource types, rather than sales..

Last performance shows a relationship between independence and compensation. However, the relationship between these two variables is contradictory. From this empirical result, we suggest that there is difference in the recognition of managers about the importance of three dependent variables: independence, information and compensation. In hypothesis 1-3, large shareholders made a negative impact on the information provision. Even if large shareholders resisted governance reform, they could not influence the ratio of outside directors or the amount of compensation. The ratio or number of outside directors, the number of committees and compensation amount for outside directors are similar in most firms in 2000. But, large shareholders can prevent provision of internal information to outside directors, because there is no legal regulation to prevent this. Therefore, from the empirical results, we find that independence is more of a formal requirement than compensation or information. When profitability is high, firms tend to increase the independence of board of directors to provide signals to outsiders revealing their intention for governance reform. However, this moves does not give enough financial incentive to outside directors since it reduces the compensation amount for them.

Finally, the positive relationship between debt ratios and independence reveals that high levels of debt diversifies stakeholders, such as inclusion of creditors, and management of these stakeholders requires more effective board of directors and governance reforms.

## 5. CONCLUSION

This study makes two contributions In many papers regarding the impact of outside director on corporate performance the results are inconsistent (Pearce and Zahra 1992; Beatty and Zajac 1994; Rhoades et al. 2000; Dalton, et al. 1998; Rosentein and Wyatt 1990). In Korea, it has only been three years since outside directors were introduced and it is premature to test its effects on corporate performance. Accordingly, this research has not focused on the impact of outside directors on corporate performance, but on the factors influencing the formation of outside directors. Major requirements for effective introduction of outside directors was developed in the research model and these requirements will aid future analysis of the internal mechanism of outside directors. Again, it is meaningful in this study to test empirically the strategic contingencies affecting the introduction of outside directors in the early stage in Korea.

Second, as mentioned before, the main objective of this paper is to determine factors affecting outside directors and proper strategic implications to manage and utilize outside directors. In addition, this paper identifies factors influencing outside directors in Korean companies. For example, the impact of ownership rate of large shareholders and debt ratio on outside directors reflect Korean context.

The introduction of outside directors in Korean companies was a restructuring process to improve performance. The positive relationship of size and debt ratios and the negative relationship of large shareholder ownership rates reveal that the influence of external pressures played a significant role in the corporate effort to develop outside directors inside the company. The impact of last performance explains that the introduction of outside directors was considered as a way to restructure corporate systems and improve corporate performance.

The role of large shareholders in Korean companies is an important issue, when we consider the governance reform in Korean companies. Large shareholders of Korean companies have been business leaders who make the rapid economic development of Korea possible. However, large shareholders are also considered to be the main reason that causes Korean companies to be less competitive (Kim and Bahn 2001; Chung 2000). From this, we can argue that the governance reform of Korean companies may require changing the structure or management mechanism of Korean companies.

From this study, we like to suggest three strategic implications about governance reform in Korea. First, the role of large shareholders needs to be changed to contribute to the improvement of competitiveness of Korean firms. Large shareholders play a negative role against the governance reform in Korea. To improve the governance mechanism in Korea, we need to change the ownership structure to disperse ownership or develop a unique monitoring system that can adapt to Korean business environment.

Second, managers or shareholders are required to have a more positive attitude about governance mechanism. From this study, firms tend to pay higher attention to governance mechanisms when they are in unattractive situations (unattractive environments or low performance). Since, governance mechanisms can detect the possible problems in the firm, even if the performance is good they must be implemented as early warning system rather than repairing tools or restructuring strategies.

Third, Korean firms introduce outside director systems in response to the external pressures for governance reform. When a new system is introduced, most firms accept this

system to acquire social legitimacy (Myere and Rowan 1977). However, to be competitive, firms must develop their own resources and capabilities for this new system. In our paper, we have found internal inertia related with large shareholders and firm competitiveness and external pressures related with firm size and debt ratios. In future studies of outside directors, we need to find out a way to use outside directors effectively in Korean companies.

This research, in itself, faces certain limitations. First, it may be too early to test empirically outside directors in Korean companies, because it has only been three and a half years since their introduction. More empirical tests about the effects of outside directors must be conducted in the future. The importance of this study is to investigate the effect of outside directors in the early stages.

Second, this research is limited in analyzing the internal mechanism of outside directors. In the future research, the relationship between external factors and internal factors of outside directors should be analyzed. Analysis that identifies internal factors is more important for other contingencies.

From the existing literature and this study, it is revealed that companies hold a very passive attitude toward governance mechanisms. Many companies regard governance mechanisms as a repair tool to be used after problems are already realized. Companies need to, instead, have a more positive attitude and use governance mechanisms as an early warning system to eliminate the possibilities of poor performance.

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