Foreign Owned Companies and Financial Performance. A Case Study on Companies Listed on Bucharest Stock Exchange

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**ABSTRACT**
The main objective of this paper is to investigate the relation between the foreign ownership and firm performance. The study was conducted for the companies listed on Bucharest Stock Exchange, in the first, second and third categories. The financial companies and the credit institutions were excluded from the sample. The final sample included 63 companies. Return on Assets and Return on Equity are used for measuring the financial and economic performance of the firm. The foreign ownership is measured by the percentage of shares held by foreign investors. Econometric tools like linear regression analysis are used for analysis. The results of the study suggest that there is no significant link between firm performance and the existence of foreign capital.

1. Introduction

The participation of foreign capital in Romanian companies has increased in the last ten years. According to data provided by the National Trade Register Office in the period 2000-2010 the number of companies with foreign capital participation in Romania increased by 2.3 times and the amount of capital held by foreign investors increased more than 6 times. Changes in capital structure of the Romanian companies are perhaps more profound than any other country. The reasons for this internationalization of the capital of Romanian companies are obvious: access to resources, Romanian market opportunities, adapting products to specific customer preferences and needs of the Romanian production and transaction costs lower.

Dramatic change of capital structure Romanian companies generated heated debates among business people, researchers, politicians and general public. A series of questions appeared, such as: What are the consequences of increasing the share of foreign capital? What happens when a large part of the business is controlled from abroad? Are there any differences between foreign investors and investors? Do foreign investors have different objectives from local investors? Are the foreign controlled companies different? Is there any risk associated with the transfer of income or job knowledge? Examination of how foreign capital affects firm performance has particularly important policy implications for governments worldwide. These governments spend impressive sum of money and resources for programs aimed to attract foreign investment with the hope of collecting the benefits of globalization, as a report of United Nations Conference on Trade and Development (UNCTAD) shows.

According to legislation a firm with foreign participation is a foreign direct investment if at least 10% of equity is owned by a foreign business entity. This threshold is suggested and used for statistical purposes by the International Monetary Fund, UNCTAD, OECD, many OECD countries, including Romania and is common in the literature [9]. The threshold of 10 percent is considered to represent a meaningful stake and effective voice in the management of the firm. The nationality of a firm is determined by the ultimate parent's country of ownership. All firms not meeting this criterion are defined as German owned including firms without ownership information, which is common practice for the database. Subsidiary information, i.e. either name or operating revenue of the subsidiary, is taken as evidence that a German firm is a MNE.

The main objective of this paper is to investigate if the foreign equity is associated with better performance in the case of listed companies on Bucharest Stock Exchange.

2. Literature review

Companies with foreign capital participation are those companies whose capital is wholly or partly formed by contributions subscribed by foreign investors. The term foreign-owned company is often associated with foreign direct investment term. Foreign direct investment is a lasting investment relationship

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between a resident entity and a non-resident entity; it usually implies a significant influence on the management of the investee company.

In developing economies, in transition economies or emerging economies, foreign capital is seen as a source of economic development, modernization, income growth and increasing level of employment. Generally the factors that encourage foreign capital investment in a country are related to the specific characteristics of the target country, such as access to natural resources, geographical location, infrastructure, market size and its development potential, cost of production factors, especially the cost of labor, fiscal policies, price liberalization, institutional development, technological absorptive capacity, quality and soundness of economic policies etc, as Blonigen suggest.

In the case of Romania, foreign investors may take into account that Romania is one of the largest markets in Central and Eastern Europe, with over 22 million people, being in 2nd place after Poland, attractive geographical location, location at the crossroads of traditional trade routes, which facilitates access to the former USSR countries, Middle East and North Africa, rich natural resources, tourism potential, navigation facilities on the Black Sea and the Danube etc.

In general, the benefits of foreign capital for the host country, summarized in the literature consist in attracting innovative technology, human capital formation, international trade integration, creating a competitive business environment leading to economic growth and economic growth is the most important poverty eradication tool. The OECD report from 2002 suggest that often, beyond these purely economic benefits, foreign capital helps by improving social and environmental conditions in host countries, for example by transferring "clean" technologies, clean corporate social responsibility policies. However, according to this OECD report, it appears that in less developed countries, foreign capital has smaller effect on growth. To get the maximum benefits of foreign capital a country must have already reached a certain level of education, technological development and infrastructure. Underdeveloped financial markets can minimize foreign capital benefits.

However, despite the mentioned benefits, policies of liberalization of international capital flows have generated heated controversy. Historically, the existence of foreign capital has generated concerns about loss of sovereignty and loss of national identity, since in extreme cases could lead to the control of multinational companies of local authorities. For these reasons, over time governments have imposed restrictions on foreign capital presence. Such restrictions are the limitation of foreign capital in local companies, monitoring and special procedures, proving of the ability to get economic benefits, constraints in terms of employment of foreign personnel or stipulations about the majority on the board of executives.

For example, foreign participation is limited to less than 50% for airlines companies in the EU and North American countries, for telecommunications companies in Japan, for the shipping companies in the United States of America. Other countries have banned foreign participation for the companies which activate in the exploitation of natural resources in order to give citizens access to the benefits associated. For example, according to information provided by the 2011 report of OECD, in Iceland foreign capital is prohibited for companies from fishing sector and energy sector, and in Mexico, is prohibited foreign participation for the companies in oil sector. In recent years the world's governments have reconsidered these restrictions through formal agreements on capital flows.

According to the Romanian law, the establishment or development of a company with foreign capital in Romania does not require any specific approval for the investment. The procedure requires fulfilling certain legal formalities such as obtaining the certificate of a judge, registration in National Trade Registry and registration as tax payer. According to the legislation in Romania, companies with foreign capital participation may be established in all economic sectors.

Since 1991 the Romanian legislation aimed to attract the foreign capital in the economy. Therefore to stimulate the interest of foreign investors and domestic investment in development projects in Romania, the legal framework has changed several times, seeking to identify the most appropriate and effective incentives for economic development.

Foreign investors must comply with national regulations; they had the same rights and obligations as any domestic investor. There is no limit foreign capital participation in the Romanian companies, a foreign investor may establish or acquire a 100% of the shares of a Romanian company in any sector open to private companies, except for national and internationally air transport sectors, where foreign capital participation is limited to a maximum of 49%, as in other EU countries for investors from non-European Economic Area.

The contribution of foreign investors can take many forms, including currency, equipment, services, intellectual property rights, know-how and managerial experience, reinvested profit made from other businesses in Romania.

Romanian legislation provides also cover, and guarantees in case of measures of nationalization, expropriation or similar measures.

The ways of penetration of foreign capital in Romania (by contribution to capital flow of foreign holdings in companies are the following:

- Greenfield: creation of enterprises by or with foreign investors (investment started from zero);
- Mergers and acquisitions: acquisition of all or part of enterprises by foreign investors from residents;
Corporate development: increase in the capital of foreign investors in direct investment enterprises.

Not all differences in performance can be attributed to the origin but capital. There are other factors that influence performance, such as the sector in which the company activate, the company size, the company age, the proportion of financial liabilities in equity, the sales or the increased sales, net profit capitalization, etc.. On international level there is a rich literature based on empirical studies comparing the productivity of companies whose capital comes from abroad with the productivity of the companies with domestic capital. Thus, several studies have investigated the causal link between the existence of foreign capital and operating performance, if the target company is located in an emerging market and investor comes from a developed economy.

In Venezuela, Aitkin and Harrison [1] demonstrated on a sample of Venezuelan firms that the existence of foreign capital is closely linked to productivity improvements, but only for small firms. In Mexico, Perez-Gonzalez [11] demonstrated that controlled subsidiaries of multinational companies have improved the overall productivity of production factors, especially those working in areas that rely on technological innovations, which are transferred by the parent companies. Petkova demonstrated that Indian firms acquired by foreign investors recorded significant growth of productivity in a horizon of three years from the date of acquisition. A similar study was conducted in Indonesia by Arnold and Javorcik [4]. They have shown that Indonesian firms acquired by foreign investors recorded substantial improvements in productivity both in the year of acquisition and in the following years.

Another set of studies were conducted in countries with developed economy. For example, Doms and Jensen in the U.S. [9] showed that U.S. firms with foreign capital are more productive than companies with domestic capital, but on average are less productive than U.S. multinationals. Girma [19] in the years 2005, 2006, and 2007 found for U.S. firms substantial growth rates immediately after their acquisition by a non-American investor. But these studies did not take into account the foreign investor’s home country, if it comes from an emerging economy country or a country with developed economy. Antkiewicz and Whalley [3] highlighted the tendency of Chinese firms to acquire companies in the OECD. This trend is dictated by facilitated access to resources, new technologies and distribution networks in target countries. Greenaway, Guariglia-Yu [12] conducted a study on a sample of 21,582 Chinese firms during 2000-2005 and they concluded that the most profitable companies are joint ventures companies, compared with firms that have full Chinese capital or with firm that have full foreign capital. In essence the study suggests that a minimum domestic capital is required to ensure local optimum performance.

In the most of the cases the literature suggests that firms with foreign capital have certain advantages over domestic capital firms, leading to superior performance of firms with foreign capital [7]. Dunning suggests that the superior performance of foreign-owned companies is the result of the ability of the foreign investors to exploit economies of scale and superior system of governance. All these views on the superior performance of foreign capital are based on arguments and assumptions of Hymer [12]. He believe that multinational companies have intangible productive assets such as know-how, superior system of governance, quality relationships with trading partners, coordinated export business contacts that are able to exploit them to gain competitive advantages. These things are available in developed countries. On the other hand, in countries with transition economies or developing economies some empirical studies contradict the hypothesis that foreign capital generates superior performance. For example Barbosa and Lourie [5] in a comparative study conducted in Greece and Portugal have not found differences in terms of return on assets between domestic and multinational companies. Similarly, Pfaffermayr and Bellak [17, 18] showed that differences in performance between companies with domestic capital and foreign capital are not explained by foreign capital itself. There is a category of studies that examined the effect of foreign capital origin on performance. Ford, Rorke and Elmslie [10] showed that country of origin of the capital generates productivity differences between domestic firms and those owned by foreign capital. Bilyk (2009) in Ukraine, has shown that differences in performance between domestic owned firms and foreign owned are explained by origin of the capital. Capital from developed countries positively influences the performance of companies and capital from less developed countries adversely affect firm's performance.

3. General characteristics of Romanian capital market

Bucharest Stock Exchange (BSE) was first created in 1882 but was closed during the communist regime. BSE was reopened on April 1, 1995, having as main activity the administration of financial market activity. Currently, BSE has declared that its mission is to serve as capital market and to support entrepreneurial activity in Romania. BSE manages three segments: regulated market (BSE) and RASDAQ and ATS market. While RASDAQ offers general framework for trading shares and preferential rights, regulated market – BSE provides the general framework for trading the five categories of financial instruments: equities, bonds, shares and units of collective investment undertakings, structured products and derivatives. Equity securities and debt securities listed on both BSE and RASDAQ are grouped into three categories. In the case of BSE, the main regulated market, listing requirement for companies is to assign a certain level of capitalization. There are three levels of capitalization, 1 million, 2 million and 30 million for the three categories of regulated
market. In addition, the companies from the first category must meet the dispersion requirement of shareholders (over 2,000 different shareholders), financial performance requirements and strategic management requirements. Bucharest Stock Exchange is still far away from its vision of becoming the best performing equity market in the region. At the end of 2010, BSE is ranked in 5th position out of 9 in the capital market in terms of market capitalization region and in the 6th position in terms of turnover.

Table 1. 2010 rankings of Central and East European capital markets according to capitalization and turnover

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Warsaw Stock Exchange</td>
<td>142,272</td>
<td>1</td>
<td>Warsaw Stock Exchange</td>
<td>59,727</td>
</tr>
<tr>
<td>2</td>
<td>Athens Exchange</td>
<td>50,379</td>
<td>2</td>
<td>Athens Exchange</td>
<td>34,754</td>
</tr>
<tr>
<td>3</td>
<td>CEESEG - Prague</td>
<td>31,922</td>
<td>3</td>
<td>CEESEG - Budapest</td>
<td>20,002</td>
</tr>
<tr>
<td>4</td>
<td>CEESEG - Budapest</td>
<td>20,624</td>
<td>4</td>
<td>CEESEG - Prague</td>
<td>15,391</td>
</tr>
<tr>
<td>5</td>
<td>Bucharest Stock Exchange</td>
<td>8,402</td>
<td>5</td>
<td>Cyprus Stock Exchange</td>
<td>838</td>
</tr>
<tr>
<td>6</td>
<td>CEESEG - Ljubljana</td>
<td>7,028</td>
<td>6</td>
<td>Bucharest Stock Exchange</td>
<td>704</td>
</tr>
<tr>
<td>7</td>
<td>Cyprus Stock Exchange</td>
<td>5,094</td>
<td>7</td>
<td>CEESEG - Ljubljana</td>
<td>361</td>
</tr>
<tr>
<td>8</td>
<td>Bulgarian Stock Exchange</td>
<td>5,498</td>
<td>8</td>
<td>Bulgarian Stock Exchange</td>
<td>281</td>
</tr>
<tr>
<td>9</td>
<td>Bratislava Stock Exchange</td>
<td>3,380</td>
<td>9</td>
<td>Bratislava Stock Exchange</td>
<td>231</td>
</tr>
</tbody>
</table>

Source: Federation of European Securities Exchanges http://www.fese.be

The number of listed companies has increased continuously in the last years, but the market capitalization has fluctuated under the influence of the evolution of world financial markets. Thus, after an increase in 2007, market capitalization dropped more than 60% to 6,474 billion EUR in 2008, the peak of the economic crisis. The value has slowly increased in 2009 and 2010 on the background of a timid recovering economy.

Regarding the sectors of activity of listed companies, the biggest three sectors that dominate the distribution, account together almost 95% of the market capitalization on the exchange. They are, in order, financial intermediation, mining and quarrying and manufacturing.

4. Methodology of research

The present paper tries to find whether foreign ownership is associated with better financial performance for the companies listed on Bucharest Stock Exchange during the financial crises.

Information used for empirical analysis of the relationship between the foreign capital and the performance of listed companies concern only non-financial companies listed on BSE. In the present on regulated sector of BSE are listed 76 companies. From this group I eliminated the financial companies (financial investment companies, credit institutions and the insurances companies). Elimination of the banks and financial investment companies has ensured that companies included in the sample follow the same set of accounting regulations. Financial information was obtained from financial statements prepared on 31 December 2010, available on BSE website. Information about capital structure in terms of origin was collected from the Central Depository website, adjacent institution of BSE.
The result is therefore a sample of 63 firms observed in 2010 and 2006. Most of the companies included in the sample belong to manufacturing industry, 44 companies representing 69.8% of the total. The remaining companies included in the analysis belong to the construction industry (5 companies - 7.9%), retail (4 companies - 6.3%), hotels and restaurants, the extractive industry, transport and storage of each of these areas being represented of three companies (4.8%) and a company of production and supply of electricity and heat (1.6%).

Sample structure followed the orientation of foreign direct investment.

![Figure 1. Structure of the sample](image)

The following model type has been constructed:

\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon_i \]

- \( Y \) - return on equity (ROE) / return on assets (ROA)
- \( X_1 \) - the percent of foreign equity in total equity of the company
- \( X_2 \) - growth of sales
- \( X_3 \) - company size measured as logarithm of total assets
- \( X_4 \) - degree of indebtedness expressed as a ratio between debt and equity

In order to estimate the relationship between foreign capital and business performance first is necessary to establish the most appropriate performance indicators. The performance measures used in most of the literature to compare the performance of foreign capital with the performance of domestic capital are mostly indicators calculated on the basis of financial statement, such as return on equity, return on assets and return on sales. Another measure frequently used in some literature is Tobin’s q. This is a ratio between company’s market value (capitalization) and its book value. The indicator was developed by James Tobin and the company’s capitalization is calculated by dividing the replacement value of its assets. In general, the literature considers that the assessment of performance based on accounting information does not take into account the company’s future prospects as the case of indicators based on market values determined. However, the high volatility of the market gives us sufficient reason to doubt the effectiveness of the Romanian capital market. Among the financial ratios, the most commonly used candidates for performance measures are return on assets (ROA), return on sales (ROS), and return on equity (ROE). Return on assets as the ratio of net profit to firm’s assets gives an idea as to how efficient management is at using its assets to generate earnings. Return on sales is the ratio of yearly sales to assets and captures company’s operational efficiency and growth opportunities. Return on equity (ROE), the ratio of net profit to equity, captures firm’s efficiency at generating profits from shareholders' equity.

In general, the existing literature documents the appropriateness of these financial ratios as performance measures in transition context. However, there are potential problems with the usage of the above-mentioned ratios. ROE is subject to the most serious accounting distortions. The problem is that the positive ROE does not always witnesses that a company is profitable. If the corporation incurs losses during several accounting periods, accumulated losses appear in the equity section and may result in negative value of equity. Therefore, positive values of ROE may occur as the ratio of two negative entries, loss to equity. It may turn out that loss-maker has a positive return on equity. As to the remaining ratios, ROA and ROS, they may also suffer from the accounting errors (both random and intended), missing values in financial reports that cause the bias in estimation. However, they can be mitigated by applying screening procedures, as many researchers do. The magnitude of possible distortions in measuring ROA and ROS is therefore much smaller than in case of ROE and these profitability ratios are considered to be appropriate performance measures. In general, it is reasonable to refer to several performance measures rather than to the single indicator in order to compensate for individual shortcomings.
The main variables used are described in the following:
- **Dependent variables** - in this study is considered as dependent variables the return on equity (ROE) and Return on Assets (ROA). The returns were calculated based on financial statements of 2010.
- **Independent variable** – the main independent variable is the percent of foreign equity in total equity of the company (X1).
- **Control variables** - are other factors besides the foreign origin of capital that can affect the performance of a company and whose effect we want to control. To take into account the influence of these factors in the analysis I introduced a set of control variables. Thus it can be checked the certainty of the relationship between the dependent variable and independent variable. The most important control variables found in the literature and used in this study are: growth of sales (X2), company size (X3 - measured as logarithm of total assets), and degree of indebtedness (X4 - debt /equity).

5. Results and interpretation

Testing hypotheses on the effects of foreign capital on financial performance, expressed by return on equity (ROE) and on economic performance expressed by return on assets (ROA) are the following:
- **H0**: Between financial performance/economic performance and foreign equity there is no linear connection;
- **H1**: Between financial performance/economic performance and foreign equity there is a linear connection;

In table no. 3 are presented the results of regression for the dependent variables, return on equity and return on assets for 2010. Coefficients for control variables are also presented in table no. 3. As we can see in Table 3, the null hypothesis is accepted, Sig represents the probability that the null hypothesis is accepted and t represents the calculated value of t-test.

### Table 3. The results of regression for return on equity

<table>
<thead>
<tr>
<th></th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>0.288</td>
<td>0.634</td>
<td>0.454</td>
<td>0.652</td>
</tr>
<tr>
<td>Foreign capital</td>
<td>-0.103</td>
<td>0.137</td>
<td>-0.061</td>
<td>-0.755</td>
</tr>
<tr>
<td>Growth rate of sales</td>
<td>0.186</td>
<td>0.138</td>
<td>0.105</td>
<td>1.352</td>
</tr>
<tr>
<td>Degree of indebtedness</td>
<td>-0.195</td>
<td>0.019</td>
<td>-0.812</td>
<td>-10.225</td>
</tr>
<tr>
<td>Size of the company</td>
<td>-0.018</td>
<td>0.077</td>
<td>-0.018</td>
<td>-0.228</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>0.076</td>
<td>0.123</td>
<td>0.616</td>
<td>0.540</td>
</tr>
<tr>
<td>Foreign capital</td>
<td>0.003</td>
<td>0.026</td>
<td>0.014</td>
<td>0.118</td>
</tr>
<tr>
<td>Growth rate of sales</td>
<td>0.069</td>
<td>0.027</td>
<td>0.291</td>
<td>2.603</td>
</tr>
<tr>
<td>Degree of indebtedness</td>
<td>-0.017</td>
<td>0.004</td>
<td>-0.530</td>
<td>-4.644</td>
</tr>
<tr>
<td>Size of the company</td>
<td>-0.007</td>
<td>0.015</td>
<td>-0.052</td>
<td>-0.459</td>
</tr>
</tbody>
</table>

Analyzing data from the table we see that the explanatory variables are not positively and significantly correlated with the any of measure of performance when the other variables are constant. This does not mean that domestic capital firms perform better. For testing the significance of multiple linear regressions model I used Fisher statistic. The table no. 4 shows the results for modeling.

### Table 4. The results of the regression

<table>
<thead>
<tr>
<th></th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>15,489</td>
<td>4</td>
<td>3,872</td>
<td>28,585</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>7,857</td>
<td>58</td>
<td>0,135</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>23,346</td>
<td>62</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Regression</td>
<td>0,129</td>
<td>4</td>
<td>0,032</td>
<td>6,402</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>0,293</td>
<td>58</td>
<td>0,005</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0,423</td>
<td>62</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), size of the company, degree of indebtedness, growth rate of sales, foreign capital.
The results show us that there is a probability of 95% percent that the models are statistically significant. The dependent variable "return on equity" and "return on assets" are significant influenced by the simultaneously variation of independent variables: foreign capital, size of the company, degree of indebtedness, growth rate of sales.

Estimated value of the determinative factor is 0.663 which means that 66.3% of variation of return on equity is explained by simultaneously variation of four dependent variables. In the case of ROA estimated value of the determinative factor is 0.306 which means that 30.6% of variation of return on assets is explained by simultaneously variation of four dependent variables.

6. Concluding remarks

Companies with foreign capital participation are the main form of foreign direct investment in the country. They are generally perceived as a source of development, modernization and growth. Numerous research studies in the literature converge to the idea of "higher productivity of foreign-owned firms, compared to domestic owned firms". The benefits of foreign capital for the host country, summarized in the literature consist in attracting innovative technology, human capital formation, international trade integration, creating a competitive business environment.

In the study I analyzed the financial and economic performance of Romanian companies listed on a regulated market, Bucharest Stock Exchange, in correspondence with foreign capital participation. The results suggest that there is no positive and direct link between the two variables. This finding should be interpreted in the current economic situation.

The analysis was performed for 2010, a year of recession, characterized by poor performance for most listed companies, regardless of capital. On the other hand, most firms in the sample belong to manufacturing industry, one of the areas worst affected by the crisis. This period was marked by a global collapse in corporate profits and therefore reinvested profits. For Romania, this meant the decline of the demand due to weaker industrial production, with direct effects on performance indicators, regardless of capital. Also most of the foreign capital before 2007, was not directed to those sectors of the economy that produce sustainable economic growth, but the speculative sectors such as retail and real estate, two areas affected by the crisis.

Romanian capital market is far from being a barometer of the Romanian economy, taking into account the small number of companies listed on stock exchange. So the sample used for this study could not be representative for Romanian business environment.

In conclusion, in terms of economic crisis, the positive effect of foreign capital and direct the performance indicators is not felt.

Future research directions may consist in extension of the study to the companies not listed in the Bucharest Stock Exchange. This extension may change the conclusions drawn in this paper and could be more consistent with the existent literature in this field.

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