CORPORATE GOVERNANCE AND STOCK PRICES

LUU THI BICH NGOC[*],
LUU TRONG TUAN[**], LUU HOANG MAI[***]

ABSTRACT

There are more and more evidences of the relation between corporate governance and firm performance. Many governance attributes (e.g. CEO salary structure) can affect firm performance. This research aims to synthesizes some perspectives on corporate governance as well as introduces some tools for measuring corporate governance. The article also explores the linkages between stock price and corporate governance quality via regression analysis. The findings reveal that corporate governance significantly affects the share prices of listed companies and hence is a very important predictor for share price in the stock market.

Keywords: corporate governance, stock price, listed companies, Vietnam.

TÓM TẮT

Quản trị công ti và giá chứng khoán

Ngày càng có nhiều bằng chứng cho thấy mối liên hệ giữa quản trị công ti và hiệu quả hoạt động của công ti. Nhiều thuộc tính quản trị, như cấu trúc lương cho CEO, có tác động đến hiệu quả hoạt động của doanh nghiệp. Bài viết khảo sát mối liên hệ giữa giá chứng khoán và chất lượng quản trị công ti qua phân tích hồi quy. Kết quả nghiên cứu cho thấy quản trị công ti tác động có ý nghĩa đến giá cổ phiếu của các công ti niêm yết và vì thế là yếu tố dự báo quan trọng cho giá cổ phiếu trên thị trường chứng khoán.

Từ khóa: quản trị công ti, giá cổ phiếu, công ti niêm yết, Việt Nam.

1. Introduction

The topic of corporate governance has attained enormous practical importance for at least three reasons. First, the effiency of the existing governance mechanisms in advanced market economies has been the subject of debate. For instance, Jensen (1993) argues that the internal mechanisms of corporate governance in the US corporations have not performed their job. He advocated a move from the current corporate form to a much more highly levered organization, similar to a leveraged buyout (LBO). On the other hand, legal scholars view the US mechanisms and the legal system in a favorable light.

Second, there is an ongoing debate on the relative efficacy of the corporate governance systems in the US and UK (typified by dispersed shareholdings and a prominent role for the secondary market trading of shares) and the corporate governance systems in Japan and Germany (typified by more

[*] MBA., Candidate, Open University Ho Chi Minh City
[**] PhD., Open University Ho Chi Minh City
[***] MA., Saigon Technology University

concentrated shareholdings and a prominent role for banks). With the new and emerging market economies seeking to implement the “right" corporate governance, this debate has attracted serious attention from finance and legal scholars.

Third, there is an apparent departure of the current practice of corporate governance from the legal provisions which accord the board control over management. The basic principle of corporate governance is that the shareholders elect the board of directors who in turn select top management. The common practice, however, is for the board to be elected by the shareholders from the slate approved by the top management.

This paper seeks to synthesize some perspectives on corporate governance and introduce some tools for measuring corporate governance. The paper also explores the linkages between stock prices and corporate governance quality.

2. Literature review

2.1. What is Corporate Governance?

Shleifer and Vishny (1997) view corporate governance as the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. Corporate governance therefore is the system of laws, rules, and factors that control operations at a company. However, researchers generally view corporate governance mechanisms as those internal to companies and those external to companies.

The essence of this relationship is shown in the simple balance sheet model of the firm (Figure 1). The left side of the schema depicts the fundamentals of internal governance. Management, acting as shareholders’ agents, decides which assets to invest in, and how to finance those investments. The Board of Directors, at the zenith of internal control systems, involves in advising and monitoring management and is responsible for hiring, firing, and compensating the senior management team (Jensen, 1993) with high level of corporate social responsibility (Tuan, 2012). The right side of the schema portrays components of external governance arising from firm’s need to mobilize capital. Moreover, it stresses that in the publicly traded firm, there exists a separation between capital providers and those who manage the capital. This separation generates the demand for corporate governance structures.

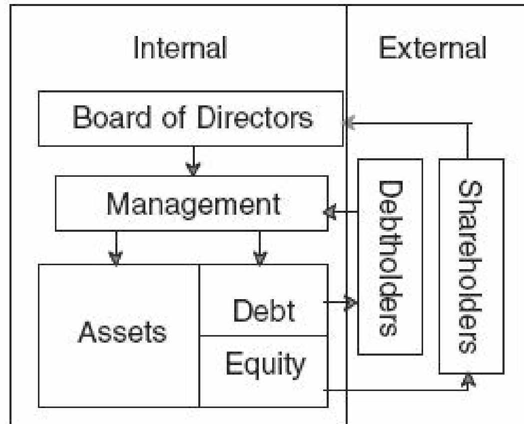

Figure 1. *Corporate governance and the balance sheet model of the firm*
Adapted from PowerPoint slides accompanying Ross et al. (2005)

As implied by Shleifer and Vishny (1997), the suppliers of finance employ corporate governance to make certain that they will get a return on their investment. The schema also denotes the link between shareholders and the board. Shareholders, the residual claimants, elect board members and boards, as established in state law, owe a fiduciary obligation to shareholders. Firms, in fact, are more than just boards, managers, shareholders, and debtholders. Figure 2 shows a more comprehensive perspective of the firm and its corporate governance. The figure describes other participants in the corporate structure in, including employees, suppliers, and customers. By incorporating the community in which firms operate, the political environment, laws and regulations, and more generally the markets in which firms are involved, Figure 2 also reflects a stakeholder perspective on the firm (Jensen, 2001) which is reflected in corporate social responsibility activities (Tuan, 2012) and high level of emotional intelligence (Tuan, 2013), as well as the realities of the governance environment.

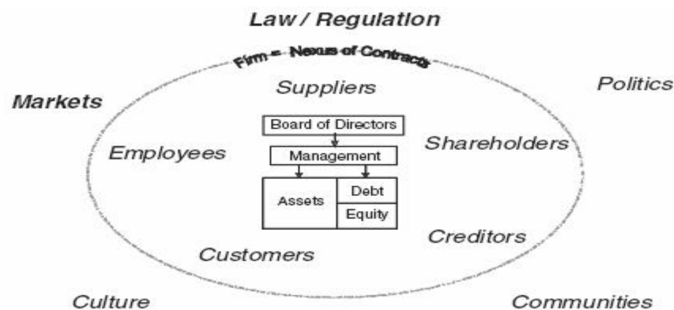

Figure 2. *Corporate governance: beyond the balance sheet model*

A broader set of governance impacts incorporates elements that many may not traditionally see as being part of corporate governance structures per se. Nevertheless, they are aspects of the environment that, at a minimum, influence corporate governance. The central Governance node splits into two broad classifications – Internal Governance and External Governance. Internal Governance is divided into 5 fundamental categories: 1) The Board of Directors (and their role, structure, and incentives), 2) Managerial Incentives, 3) Capital Structure, 4) Bylaw and Charter Provisions (or antitakeover measures), and 5) Internal Control Systems. Internal Governance relates to corporate social responsibility (Tuan, 2012). Likewise, External Governance is divided into 5 groups: 1) Law and Regulation, specifically federal law, self regulatory organizations, and state law; 2) Markets 1 (including capital markets, the market for corporate control, labor markets, and product markets); 3) Markets 2, highlighting providers of capital market information (such as that provided by credit, equity, and governance analysts); 4) Markets 3 – focusing on accounting, financial and legal services from parties external to the firm (including auditing, directors' and officers' liability insurance, and investment banking advice); and 5) Private Sources of External Oversight, especially the media and external lawsuits.

2.2. Corporate disclosures by family firms

Firms which are managed or controlled by founding families are referred to as family firms. In their literature survey on corporate governance, Shleifer and Vishny (1997) highlight the significance of exploring the traits of such firms to better understand the economic efficiency of different corporate governance mechanisms.

Compared to non-family firms, family firms in the US confront less severe agency problems arising from the separation of ownership and management (Type I agency problems). Nevertheless, they are characterized by more severe agency problems arising between controlling and non-controlling shareholders (Type II agency problems). Overall they cope with less severe agency problems than non-family firms. Less severe agency problems lead to less manipulation of earnings for opportunistic reasons and thereby higher earnings quality (Ali et al., 2007).

Ali et al. (2007) also find that compared to non-family firms, family firms make less voluntary disclosure about corporate governance practices in their regulatory filings. Family firms have incentive to reduce the transparency of corporate governance practices to facilitate getting family members on boards without interference from non-family shareholders.

Another finding from Ali et al.'s (2007) research is that family firms with founder CEO, rather than family firms with descendent CEO, are chiefly responsible for family firms exhibiting better disclosure practices and disclosure-related consequences as compared to non-family firms. The authors also discover that family firms without dual class shares, rather than family firms with dual class shares, are primarily responsible for family firms exhibiting better disclosure practices and disclosure-related consequences as compared to non-family firms. Family firms with founder CEO as compared to those with descendent CEO and family firms without dual class shares as compared to those with dual class shares have less severe agency problems. Thus, the difference in the severity of agency problems is a likely reason for the difference in disclosure practices Ali et al. observe across family and non-family firms.

2.3. Metrics for corporate governance ratings

The most commonly used services that provide metrics that rank the quality of a firm's corporate governance system are the institutional shareholder services (the ISS), Standard and Poor's (S&P, discontinued 2005), Governance Metric International (GMI), and The Corporate Library (TCL). The ISS includes a composite of 225 variables based on 61 rating criteria across eight governance topics. It rates the corporate governance of over 5200 U.S. companies and 2300 international companies and provides ratings based on a percentage scale. The S&P includes four categories and it provides scores on a range from 1 to 10; however, the list is not currently published. The GMI includes 600 variables based on seven categories; it provides scores based on a range from 1 to 10 and provides ratings for nearly 3400 U.S. and international companies. The TCL includes approximately 120 variables based on six categories, provides letter scores ranging from an A to an F and provides ratings for over 2000 U.S. companies. When deciding on which rating service to use, researchers and firms must be cautious as each service has its advantages and disadvantages.

The ISS database appears to be the most recently developed rating service and one that is currently the most widely used in corporate governance research literature. The ISS database is used to create a summary index called "Gov-Score" and this index is a broad measure of governance and one that is positively linked to both return on equity and return on assets. An evaluation of corporate governance must include a wide variety of factors in order to capture the real value of the board. The categories included in the ISS database are board characteristics, audit characteristics, charter/bylaws, antitakeover practices, executive and director compensation, progressive practices, ownership and

director education. Within each of the ISS categories are various subsets resulting in a total of 225 corporate governance variables.

3. Research methodology

Sample

94 listed companies were selected as a sample from the population at the Ho Chi Minh City Stock Exchange (HOSE) in Vietnam.

Data Source

The annual reports of the 2010-2011 period from the selected companies and their stock prices were collated.

Instruments

The variables for the purpose of study encompass stock price (dependent variable) and corporate governance score (independent variable).

Stock price: Daily average stock price of each company was computed. The formula used for calculating daily average share price is the average of the intraday high and intraday low price.

Daily average stock price = (Intraday high + Intraday low)/2

Annual average stock price = Sum of daily average stock price/number of days stock is traded.

Corporate governance was measured using Sawicki's (2009) questionnaire which consists of nine questions as regards board independence, expertise of audit committee, remuneration committee, nomination committee, CEO duality, existence of audit committee, frequency of audit committee meeting, big audit firm and shareholder ownership.

4. Empirical findings

Cross-sectional regression analysis using SPSS 15 was conducted for this study. Our correlation results show that corporate governance has 0.702 correlations at sig level .000 with stock prices which means 70.2% correlation with each other. A correlation of above 0.5 implies that the two variables have high correlation and hence are dependent upon each other (Samontaray, 2010). Under such circumstances the p-value must be less than 0.05.

Then whether the model is fit or not was investigated. 'R' is the multiple correlation coefficients, that is, the correlation between the observed and predicted values of the dependent variable. A high 'R' value indicates stronger relationship. On the other hand, R squared is the proportion of variation in the dependent variable explained by the regression model. Also, adjusted R squared endeavours to correct R squared to more closely reflect the goodness of fit of the model in the population. Both R squared and adjusted R squared must be close each other high for better model fit. In our research, it was found that R squared value was more than 0.5 and adjusted R square value was close to R square value. This proves that data is fit to be utilized and the model that has been chosen for it is equally fit. Our model summary takes the total score of corporate governance as independent variable while stock prices as dependent

variable. Main variable corporate governance has R squared 0.618 which means that corporate governance has 63.8% impact on stock prices and Adjusted R squared value is 0.572 which is close to R squared value. This level of predictability is low but stock prices are also affected by many variables. However, this analysis takes only corporate governance excessively. So this level of predictability is sufficient. Component wise analysis has R squared value of 0.718 and adjusted R squared value as 0.649.

***Table 1**. Regression analysis*

Model Summary[b]

Model	R	R Squared Value	Adjusted R Squared Value	Std. Error of the Estimate	Change Statistics			Durbin-Watson
					R Squared Change	F Change	Sig. F Change	
1	0.702[a]	0.618	0.572	65.15457	.517	48.716	.000	2.147

a. Predictors: (Constant), Corporate Governance Score

b. Dependent Variable: Stock Prices

***Table 2.** Component wise regression analysis*

Model Summary[b]

Model	R	R Squared Value	Adjusted R Squared Value	Std. Error of the Estimate	Change Statistics			Durbin-Watson
					R Squared Change	F Change	Sig. F Change	
1	0.775[a]	0.718	0.649	62.31125	.617	59.908	.000	2.329

a. Predictors: (Constant), Board Independence, Expertise of Audit Committee, Remuneration Committee, Nomination Committee, CEO Duality, Existence of Audit Committee, Frequency of Audit Committee Meeting, Big Audit Firm, Shareholder Ownership.

b. Dependent Variable: Stock Prices

5. Discussion and conclusion

Black and Khanna (2007) conducted a study on share price fluctuations of companies associated with regulations, which concluded that while midsized companies reacted in a speedy manner, faster growing firms which need external equity capital placed a greater emphasis on governance rules and benefited relatively more. The results of the current research reveal that corporate governance has significantly affected the stock prices of these listed companies and hence has been a very important predictor for their stock price value. These results are consistent with those of previous studies.

Gompers et al. (2003) demonstrate that weak shareholder rights, defined by a large number of anti-takeover provisions, significantly reduce firm value, as well as subsequent share returns. Core et al.

(2005) came up with different results in their comparative investigation between stock returns and operating performance with strong and weak shareholder rights, an extension of the study by Gompers et al. (2003). They provided evidence that firm with weak shareholders rights subsequently have lower operating performance.

Contrary to the results of Gompers et al. (2003), but in line with Core et al. (2005), Aman and Nguyen (2007) find that risk-adjusted returns are insignificant across all five governance-based portfolios. In fact, firms with lower governance ratings achieve higher returns, but this is explained by their higher exposure to the book-to-market risk factor. In other words, firms with lower governance ratings deliver higher returns essentially due to their higher risk, while firms with higher governance ratings generate lower subsequent returns because of their lower risk.

Implications can be made as regards the relationship between corporate governance and stock prices from the research findings. First, that firm-level corporate governance can serve as a value driver is to a certain extent justified by what the study findings imply. Second, not only does the firm generate value for itself in the course of sustaining firm-level corporate governance, it also returns this value to its shareholders as governance mechanisms act as a dynamic force for firms to surpass the mark set by market expectations.

Note nonetheless that all above notions may not apply to firms in other countries including Vietnam. There are many institutional differences across countries that need to be considered. For instance, the legal rules covering protection of shareholders and the quality of their enforcement vary considerably across countries. Thus, further discussions and research are needed to shape the effective path for corporate governance practice in Vietnam which can start with corporate social responsibility (Tuan, 2012), emotional intelligence (Tuan, 2013), and trust (Tuan, 2012).

REFERENCES

1. Ali, A., Chen, T.Y., Radhakrishnan, S. (2007), "Corporate disclosures by family firms", *Journal of Accounting and Economics* 44 (2007) 238–286.
2. Aman, H., Nguyen, P. (2008), "Do Stock Prices Reflect The Corporate Governance Quality Of Japanese Firms?", *Journal of The Japanese and International Economies.*
3. Black, B.S., Khanna, V.S. (2007), "Can corporate governance reforms increase firms' market values: evidence from India", Law Working Paper No. XX/2007, European Corporate Governance Institute, pp. 1-41.
4. Core, J.E., Guay, W.R., & Rusticus, T.O. (2005), "Does weak governance causeweak stock returns? An examination of firm operating performance aninvestors'

expectations" (Working Paper Series), Retrieved November 15th, 2009 from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=533582.

5. Gompers, P., Ishii, J., Metrick, A. (2003), "Corporate governance and equity prices", *Quarterly Journal of Economics* 118, 107-155.
6. Jensen, M. (1993). "The modern industrial revolution, exit, and the failure of internal control systems", *Journal of Finance* 48, 831–880.
7. Jensen, M.C. (2001), "Value maximization, stakeholder theory, and the corporate objective function", In Chew, D.H., Gillan, S. L. (Eds.) (2005), *Corporate Governance at the Crossroads: A Book of Readings,* New York: McGraw-Hill.
8. Ross, S.A., Westerfield, R.W., Jaffe, J. (2005), *Corporate Finance*, 7th edition. New York: McGraw Hill Irwin.
9. Samontaray, D.P. (2010), "Impact of Corporate Governance on the Stock Prices of the Nifty 50 Broad Index Listed Companies", *International Research Journal of Finance and Economics*, Vol. 41, pp. 7-18.
10. Sawicki, J. (2009), "Corporate governance and dividend policy in Southeast Asia pre- and post-crisis", *European Journal of Finance*, Vol. 15, No. 2, pp. 211-230.
11. Shleifer, A., Vishny, R. (1997), "A survey of corporate governance", *Journal of Finance* 52, 737–775.
12. Tuan, L. T. (2012), "Corporate social responsibility, ethics, and corporate governance", *Social Responsibility Journal*, 8(4), 547-560.
13. Tuan, L.T. (2013), "Emotional intelligence as the departure of the path to corporate governance", *Corporate Governance*, 13(2), 148-168.

(*Received: 06-12-2012; Revised: 15-02-2013; Accepted: 20-5-2013)*