Corporate governance, violations and market reactions

Roy Kouwenberga,b,⁎, Visit Phunnarungsic,a

a Mahidol University, College of Management, Bangkok, Thailand
b Erasmus University Rotterdam, Erasmus School of Economics, Rotterdam, The Netherlands
c Assumption University of Thailand, Martin de Tours School of Management and Economics, Bangkok, Thailand

Article info

Abstract

Article history:
Received 19 August 2011
Accepted 21 June 2012
Available online 30 June 2012

JEL classifications:
G30
G14

Keywords:
Corporate governance
Violations
Event study
Market reaction

1. Introduction

In this paper we test whether the market reacts differently when firms with good and poor governance commit violations of the listing rules. In theory corporate governance should decrease the firm’s discount rate and increase firm value, as governance mechanisms are designed to mitigate agency conflicts and prevent expropriation by managers and controlling shareholders. However, in practice minority shareholders typically face a severe asymmetric information problem when assessing a firm’s corporate governance practices. The problem for outside investors is to determine whether the adoption of formal good governance policies is a sign of good governance practices, or window-dressing to improve a firm’s external image.

Violations of listing rules by firms can provide new information to the market about whether firms implement governance policies substantively or not. If governance policies are fully discounted in stock

☆ Financial support from the Capital Market Research Institute of the Stock Exchange of Thailand is gratefully acknowledged.
⁎ Corresponding author at: Mahidol University, College of Management, 69 Vipawadee Rangsit Road, 10400, Bangkok, Thailand.
Tel.: +66 22062017.
E-mail address: roy.kou@mahidol.ac.th (R. Kouwenberg).

0927-538X/$ – see front matter © 2012 Elsevier B.V. All rights reserved.
doi:10.1016/j.pacfin.2012.06.006
prices, we expect that the market reacts more negatively when firms with high governance scores violate the listing rules, compared to firms with low governance scores. Violations by a firm with a high governance score can reveal that the firm window dresses corporate governance, leading to a negative surprise and a higher discount rate, whereas expectations are lower to begin with for firms with low governance scores. Failure to detect a significant difference between market reactions to violations between firms with low and high governance scores would lead to doubts about whether governance scores provide relevant information to the market about substantive governance practices that is reflected in firm-level discount rates.

We use a short-window event study of firms listed on the Thai stock exchange to uncover the relation between governance and market reactions to violations. We sort listed firms into two groups based on a score for the adoption of good governance policies. The governance policies include having a high proportion of independent directors, separation of the positions of chairman and CEO and the establishment of a remuneration committee, among others. We test whether the market reacts differently when firms with high and low governance scores violate the listing rules. As a benchmark for comparison, we also sort firms based on past violations into good firms (with a record of low past violations) and bad firms (with high past violations). If a firm’s historical violation record affects the discount rate, announcements of violations by good firms should lead to a stronger marker reaction than new violations by bad firms.

We find that violation announcements are bad news for investors: the average abnormal return market reaction is $-2.2\%$ during the three-day event window around the announcement (days $-1, 0, +1$). The market reaction is especially negative when firms commit violations classified as severe: $-4.1\%$. Surprisingly, we find no significant difference in the market reaction to violations between firms with high and low CG scores: the average abnormal return is $-1.1\%$ for high CG firms and $-2.7\%$ for low CG firms, but the difference is not significant. In contrast, we do find a significant difference in market reaction between firms with low and high past violation records. The average abnormal return is $-4.4\%$ for good firms (low past violations), while for bad firms the market reaction is $-1.3\%$.

Closer inspection reveals that the market reaction is especially negative when firms with a good track record and low governance scores commit violations: the average abnormal is $-8.1\%$ for good firms with low CG. In stark contrast, the average market reaction to violations is only $-0.3\%$ for good firms with high CG. This result suggests that the market scrutinizes and discounts a good firm’s governance policies once violations occur, leading to a strong negative reaction for good firms with low CG. On the other hand, for firms with a bad track record governance problems appear already discounted, as the market reaction is not different between bad high CG firms and bad low CG firms ($-1.6\%$ vs. $-1.1\%$). In sum, the results suggest investors gradually learn about a firm's substantive governance practices by observing both the firm’s behavior (violations) and its formal governance policies. Formal governance policies (e.g., having independent directors) may not provide sufficient information when considered in isolation, as bad firms can try to window-dress governance and not all good firms may be willing to bear the costs of improved governance policies.

We test our hypothesis in an emerging market with relatively weak legal setting, Thailand. Existing studies on the relation between market reactions to violations and corporate governance are rare, and mainly conducted in the U.S., a market with strong investor protection. Carcello et al. (2011) find that the market reaction to restatements is less negative when the firm has a fully independent audit committee, but only if the CEO is less involved in the director selection process. Lisic et al. (2011) find that the market reaction to restatements is less negative for firms with at least one financial expert on the audit committee, but this effect is reduced when CEO power is high. We find that the market reaction to violations of good firms in Thailand is less negative when the positions of CEO and Chairman are separated (lower CEO power) and when the audit committee is chaired by an independent director.

To the best of our knowledge, the only related study in an emerging market is a recent working paper by Cumming, Hou and Lee (2011) who find that the market reaction to fraud announcements in China is less negative for state-owned enterprises, while firm-level governance (board independence and CEO duality) has no significant impact. In contrast to our paper, Cumming, Hou and Lee (2011) do not provide explicit hypotheses or an explanation for the insignificant effect of governance on fraud announcement returns, as their study mainly focuses on the role of financial analysts in deterring fraud. Further, as China’s capital market is unique due to widespread state ownership of firms and special listing requirements,
دریافت فوری متن کامل مقاله

امکان دانلود نسخه تمام متن مقالات انگلیسی
امکان دانلود نسخه ترجمه شده مقالات
پذیرش سفارش ترجمه تخصصی
امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
امکان دانلود رایگان ۲ صفحه اول هر مقاله
امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
دانلود فوری مقاله پس از پرداخت آنلاین
پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات