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Corporate governance, violations and market reactions☆

Roy Kouwenberg [a,b,*], Visit Phunnarungsi [c,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

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ABSTRACT

We test the relation between firm-level corporate governance and the market reaction to announcements of violations of rules and regulations by Thai listed firms. We find no significant difference in market reaction when firms with high and low governance scores commit violations. We do find a larger negative abnormal return when firms with low past violation records violate the rules. The market reaction is especially strong, −8.1% on average, when firms with low past violations and low governance scores commit violations. The evidence suggests that investors rely on a combination of observed behavior (violations) and the firm's formal governance policies to learn about the firm's true governance practices.

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

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* 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).

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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,