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CHAPTER 2

LITERATURE REVIEW

Literature Review

The literature review is divided into four sections: the study of corporate governance, corporate governance and the Asian financial crisis, corporate governance ranking, and the improvement of corporate governance practices after the Asian financial crisis in Thailand.

The Study of Corporate Governance

Jensen and Meckling (1976) show that Agency Problem in companies, also referred to as the separation of ownership and control, arises from conflicts of interest between principals and agents. Conflict between ownership and manager (Managerial Agency) and conflict between management and debtor (Debt Agency) involves issues such as separation of ownership and control, asymmetric information, the free rider, and moral hazard problems.

Problem behaviors include transfer-price at below market prices, executive compensation, and managers entrenching themselves on the job even when they are no longer competent to operate the firm. This entrenchment often leads to managerial expropriation of funds. One way to reduce these behaviors is to monitor the activities of agents. Another way is to grant long-term incentive contracts that can limit divergence from principal interests, such as ownership shares or stock options, in order to align managerial and investor interest. Although Agency Problem can be lessened by incentive contracts, if these contracts are poorly negotiated or drawn up without any involvement from investors, the contract may not be effective in reducing agency problems.

Shleifer and Vishny (1997) was the first to document that corporate governance is a way that suppliers of finance to corporations assure themselves of getting a return on their investment. That survey also concludes that legal protection of investors by regulators and concentration of ownership, for example ownership structure, capital structure, and board responsibilities, are complementary approaches to governance. These governance mechanisms can be used to decrease conflict and align all involved towards the interest of the firms.

Morck et al. (1998) studied ownership structure as a corporate governance mechanism. This empirical analysis investigates the relation between management ownership and market valuation of the firm, as measured by Tobin's Q. Percent shareholding of company boards is divided into three levels: 0-5%, 5-25%, and more than 25%. Results indicate that for companies with management

shareholding in the 0% to 5% and 25% to 30% range, Tobin's Q has a positive relationship with management ownership. On the other hand, Tobin's Q starts to decline with management ownership between 5% and 25%. These results indicate that at the 0% to 5% range of management ownership, management in firms that perform well will receive incentives such as stock remuneration or the right to exercise their stock options. Management ownership between 5% to 25% tend to use their rights for their own benefit and may have enough voting power to destroy the company wealth. With 25-30% ownership, the company board is free to reject any outside challenge. At this range, there is a pure-convergence-of-interest between management decisions that will benefit the company. Another interpretation is that the increasing of Tobin's Q with ownership reflects the convergence of interest between manager and shareholders, while the decline reflects entrenchment of the management.

Jensen (1986) suggests that conflict of interest between shareholders and managers occurs when firms create substantial free cash flow. Jensen finds that managers of firms with large amounts of free cash flow are more likely to aggressively expand the firm by not considering cost of capital, rather than pay dividends to investors. Managers have incentives to enlarge their firms beyond their optimal size because growth increases managerial power by increasing the resources under their control. If firms with excessive free cash flow issue debt, they are bonding to pay out future cash flow as interest. Thus debt can reduce the agency cost of free cash flow by reducing the cash flow available for spending at the discretion of managers.

Classens, Djankov and Lang (2000) focus on the East Asian region. This study examines 2,980 corporations in nine Asian countries and finds clear evidence that the top ten families in each country control between 18% and 58% of the total listed companies. This corporate control is enhanced by a pyramid structure and cross-holdings among firms. The study concludes that wealth concentration might have a negative effect on economic evolution. This supports the theory that the 1997 financial crisis was caused by expropriation of minority shareholders by controlling shareholders with high control rights.

Corporate governance evidence and Asian financial crisis

After the Asian financial crisis, some studies found a relation between corporate governance and the decline of the stock market during the economic crisis. Johnson, Boone, Breach, and Friedman (2000) find that corporate governance variables explain much of the variation in exchange rate depreciation and stock market performance during the Asian crisis. This study uses financial data from summer 1997-1999, factors indicating the level of corporate governance covering 25 emerging

markets, and indicators that represent corporate governance at the country level and firm level. These indicators include the general assessment of legal environment (the judiciary efficiency, corruption, and the rule of law) and the general assessment of corporate governance (shareholder rights, creditor rights, and accounting standards). For stock markets, the International Finance Corporation's Investable Index was used to measure stock market returns for a selected set of companies in U.S. dollars by including the largest and most liquid stocks in each market. This index lessened the problem of illiquid stock prices that were not the real transaction price. To measure the exchange rate, they used data published by the Economist.

The findings suggest that corporate governance played a significant role in the extent of stock market decline and exchange rate depreciation in 1997-1998 while macroeconomic factors were less important. Corporate governance factors were still significant, even with macroeconomic factors added into the regressions.

Furthermore, Mitton (2002) studied corporate governance at the firm level and company performance during the East Asian financial crisis. The sample criteria includes having financial data reported in the Worldscope database, having no reported segments in the financial service industry (SIC codes between 6000 and 6999), and inclusion in the International Financial Corporation's (IFC) global index. Mitton defines corporate governance at the firm level to include disclosure quality, ownership structure, and corporate diversification. To measure firm performance during the crisis, Mitton uses stock returns from July 1997 to August 1998.

Results indicate that higher disclosure quality correlated with higher stock prices. Transparency of companies led to low expropriation of firm resources by management and major shareholders. As for ownership structure, the presence of strong blockholders was beneficial during the crisis, due to their incentive and power to prevent expropriation of minority shareholders. Moreover, Mitton differentiates management blockholders from non-management blockholdings. The results indicate that the value of large blockholders is greater during a crisis when those blockholders are not involved with management. This result is consistent with the idea that if blockholders are involved with management, they could have more opportunity or incentive for expropriation of minority shareholders. The results also show that companies with more diversified investment have lower stock prices due to the expropriation of firms' resources through diversified investment in lower return projects.

There is some doubt whether there is enough evidence that good corporate governance plays an important role in investment decisions of institutional investors. McKinsey & Company (2000)

released the "Investor Opinion Survey on Corporate Governance: June 2000", gathered from more than 200 institutional investors in both developed and emerging markets. The survey defines good corporate governance as firms having a majority of truly independent outside directors with a formal director evaluation, high response to investor requests for information, and executive directors who had significant stockholdings with a large proportion of their remuneration in the form of stocks or options.

This survey presents three key findings. To begin with, 75% of respondents rated board practices to be as important as financial performance, especially for firms in emerging markets. Secondly, more than 80% of respondents said they would pay more for shares of a well-governed company as opposed to a poorly-governed one if both companies had comparable financial performance. Finally, this corporate governance premium differed by country. Investors were willing to pay a higher premium to companies with good governance in countries where such practices were lagging.

McKinsey & Company (2002) submitted another survey "Global Investor Opinion: July 2002" which relates corporate governance as an increasingly core component in investment decision-making. This survey is based on responses from over 200 institutional investors from a spectrum of institutions such as pension funds, mutual funds, money managers, private equity firms, and banks. The findings indicate that investors put corporate governance equal to financial indicators when evaluating investment decisions. Moreover, investors are willing to pay a premium for companies exhibiting a high governance standard. The survey concludes that the important factor is disclosure quality of financial information. Institutional investors also support a single unified global accounting standard. They are strongly in favor of expensing stock options in profit and loss statements. In terms of company boards, investors suggest that companies create more independent boards and achieve greater boardroom effectiveness through such steps as director selection, a more disciplined evaluation process, and greater time for board meetings.

In conclusion, corporate governance plays an important role in the investment decisions for institutional investors: they are willing to pay a premium for companies with good governance.

Corporate Governance Rating

Gompers et al (2001) tests the importance of corporate governance to companies. The investigation looks at three areas: stock return, firm value, and agency cost. To build their governance index, the study applies 24 takeover defense provisions to 1500 U.S. companies during 1990-1999.

These provisions measure the balance of power between managers and shareholders. One point was given for every provision that restricts shareholders' rights and increases managerial rights. The summation became the governance index. Unlike most governance indexes, in this study higher index companies gave less protection to investors.

The hypothesis is that if corporate governance is connected to company performance, stock price should quickly adjust to any relevant change in the company's governance. If governance was affected but was not incorporated immediately into stock prices then realized returns on the stock should differ from equivalent securities. This study compares abnormal returns of stock by an investment strategy that purchased shareholder portfolio with a lower governance index with a short management portfolio with a high governance index.

Findings indicate that abnormal returns were lower in companies which provided more rights to managers than to shareholders. To further study company stock returns, the research applied the regressions of return on stock characteristics to separate components of a firms' governance as well as firm characteristics that influenced the firm's stock return. These variables included market capitalization, book to market ratio, and trading volume of the company. The result shows that both raw and industry-adjusted returns are significantly correlated with abnormal returns.

Gompers et al (2001) then studied whether governance and other characteristics such as book value of asset, age, risk, and leverage of the company were related to company value as proxy by Tobin's Q ratio. The result was that Tobin's Q ratio tended to increase as governance index decreased. This means that a company with poor governance had a lower value than a company with good governance. In terms of the relation between governance and agency cost, companies with better governance had higher net profit margins and sales growth and less capital expenditures and corporate acquisitions.

Although there are many studies of the importance of corporate governance on companies in the US, the only study about governance in Asia is the CLSA (2001), Credit Lyonnais Securities Asia. CLSA ranks corporate governance of companies across emerging markets, including Asian markets. Governance scores are based on how companies perform on 57 issues within seven main governance categories. These categories include the compliance of management with regulations and policy; the timeliness, accuracy and integrity of disclosure procedures to outside investors; independence, whether mechanisms such as outside directors or auditors monitoring can decrease conflict of interest in company; accountability; responsibility; fairness; and social responsibility. The first six criteria were given an equal weight of 15% and the last, social responsibility was given a lower weight of

10%. The study links the level of corporate governance in firms with stock prices in emerging markets.

The CLSA study ranks the corporate governance standards of 495 companies from 25 different emerging markets across 18 main sectors. Sample selection is based on two criteria- firm size and investor interest. Using binary answers (yes/no), a "Yes" adds one point to the governance score and "No" adds zero. About 70% of the questions were based on objective facts and the remaining questions represent analysts' opinions. Two concerns of the study are that bias from reliance on analysts' opinion could come from past performance of that company; also the sample companies could not count the companies that were no longer covered by CLSA in their portfolio after the crisis.

The results of the CLSA survey show that in 2000, among the largest 100 companies, ROCE of companies in the top quartile of good governance was significantly higher than average, as well as ROE and Economic Value Added (EVA). Over 1 year, 3 years, and 5 years P/B ratios and share price of firms within the top quartile outperformed average total return. The principal findings of this report suggest a strong correlation between higher corporate governance ranking, superior financial return ratios, and higher valuations (P/B ratios) and medium-term share price outperformance. These findings are premised on the relationship between corporate governance and EVA, as higher-ranking companies tend to be greater value creators. Across the CLSA rating, higher ranked companies had better social awareness and fairness, but poorer accountability and discipline. This indicates that the greater problems are in accountability of management to the board and the ability of the company to correct for mismanagement.

The CLSA report was subsequently elaborated on by Klapper and Love (2002), which uses two main performance measures: Tobin's Q as a measure of firm market valuation and return on asset (ROA) as a measure of operating performance. The study tests the correlation between firm governance and equity valuation. They add some variables that might cause increasing market valuation, such as log sales, sale growth, and the ratios of fixed capital to sales. The findings indicate that firms with better corporate governance have higher market valuation. The study tests the correlation between firm governance and firm performance, with estimation by ROA and finds that firms with good governance had relatively high profits. These results are consistent with the previous study in the U.S. market.

The next study rated corporate governance of Thai companies. The Strengthening Corporate Governance Practices in Thailand (2002) report was a collaboration between the Thai Institute of Directors (Thai IOD) and McKinsey & Company Thailand to look at the current corporate governance

practices of Thai companies. This report shows a correlation between good corporate governance and company performance. The evaluation relies on publicly available information from annual reports, SET and SEC records and disclosures, and individual public company sources. This survey focuses on the top 100 listed companies on the average market capitalization from January to December 2000 and also includes a sample of companies in the food and electronics sectors. The evaluation uses both international standards of governance and the recently published SET guidelines. The research evaluates company governance practices in five key areas and each category is given separate weight:

- Rights of shareholders (20%)
- Equitable treatment of shareholders (20%)
- Role of stakeholders (10%)
- Disclosure and transparency (25%)
- Board responsibilities (25%)

This survey finds that improving governance practices might benefit stock performance. Companies with higher corporate governance scores tend to have higher market-to-book ratio. These results are in line with the McKinsey & Company Investor Opinion Survey 2000 which found that investors were willing to pay a premium for well-governed companies. The Thai IOD survey shows that Thai companies are strong in the areas of protecting the rights of shareholders and in board responsibilities, but weak in the equitable treatment of shareholders, transparency and disclosure, and protecting stakeholder rights in corporate governance. This survey also finds a disparity in the quality of corporate governance practices in the survey companies.

The Improvement of Corporate Governance Practices after the Asian Financial Crisis

Ananchai Kongchan (2001) presents a survey of board responsibilities and the role of shareholders and external auditors in improving corporate governance in Thailand after the Asian financial crisis. The survey finds that in most companies, the most important role of the board is in appointing a managing director or CEO as well as selecting a firm auditor and occasionally participating in long term or strategic planning. Further findings suggest that minority shareholders still get less attention in corporate governance, though they have been most affected by the financial crisis. The findings show that minority shareholders do not attend the annual ordinary shareholder meeting, or attend but do not participate. Follow up information tended to be used for short-term investment. The auditor's role did not change much after the financial crisis, however an important change involved the changing of regulations and standards practice of the SEC.

Some studies have emphasized problems on the company level due to a lack of good governance. Some have examined country level problems. More studies have looked at governance in the U.S. while less research has been done in Thailand. As governance continues to improve, this is a good opportunity to study whether corporate governance benefits investors. This thesis focuses on ranking corporate governance levels in Thai listed companies as well as looking at the correlation between the level of a companies' corporate governance (governance index) and its stock return.