Corporate Governance and Equity Returns

Shigeru Uchida‡
Sarwar Uddin Ahmed†
Md. Zahidul Islam*

Abstract

This paper analyses the relationship between corporate governance and equity returns from the small investors view point. A primary survey has been conducted to gather the data required to examine the link. Preliminary result of the study shows that the four elements of governance: board structure, transparency, fairness and responsibility are positively related with equity returns.

Keywords: Corporate Governance, Equity returns, Bangladesh, Small Investors

1. Introduction

Corporate governance is the set of procedures by which a firm is controlled for the benefit of the stakeholders. The principal stakeholders are the shareholders, the board of directors, employees, customers, creditors, suppliers, and the community at large. It aims to safeguard the accountability of

‡ Professor, Nagasaki University
† Visiting Professor, McNeese State University & Associate Professor, Independent University, Bangladesh
* Lecturer, University Brunei Darussalam

certain individuals in an organization through mechanisms that try to reduce or eliminate the principal-agent problem. Corporate-governance mechanisms assure investors in corporations that they will receive adequate returns on their investments (Shleifer and Vishny, 1997). If these mechanisms does not exist or function properly, outside investors would not lend to firms or buy their equity securities. In Bangladesh, regulators such as Securities and Exchange Commission (SEC) and Bangladesh Bank (the Central Bank) have taken various initiatives to ensure good governance standards among the public listed companies. This study is an attempt to observe the status of their governance practices by investigating the perception of small investors of the stock market regarding the relationship between governance and equity returns.

2. Literature Review

Before drawing the conceptual framework of the study, we need to conduct a literature survey on prior empirical studies examining the relationship between equity returns and corporate governance.

There are various studies examining this relationship (LaPorta et al., 1999; De Jong et al. 2001; Black, 2001, Gompers et al. 2003; Drobetz et al. 2004; Bauer et al. 2004 and Uchida et al. 2011). One of the earlier studies examining this association by LaPorta et al. (1999) showed that firms with better governance standards have higher valuation. Among the contemporary studies Gompers et al. (2003) analyzed the relationship between corporate governance and equity returns based on the data of US market. The result of their study showed that, well-governed companies can ensure higher equity returns compared to their counterparts. Also De Jong et al.

(2001) on Netherlands, Black (2002) for Russia and Drobetz et al. (2004) on Germany found positive relationship between corporate governance and firm value. Whereas, Bauer et al. (2004) by taking the European market case, surprisingly found negative relationship between firm performance and corporate governance standards.

However, there are very few studies examining this relationship in developing countries. Uchida et al. (2011) found a positive but statistically insignificant relationship between governance and firm performance, measured by ROA, by taking the data of the banking sector of Bangladesh. On this background, this study aims to examine the relationship between governance and equity return performance, from the perspective of the small investors. In doing so we have developed a survey instrument where corporate governance is represented by four elements; viz., board structure, transparency, fairness and responsibility. Whereas, equity returns are proxied by investors market return. The conceptual framework of the study is as shown in Fig. 1.

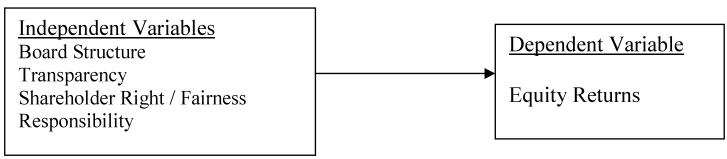

Fig 1: Conceptual Framework

3. Methodology and Survey Instrument

Because of unavailability of secondary data in Bangladesh regarding corporate governance and equity investors return perspective, it was required to conduct a primary investigation. To collect data from primary sources, a set of structured questionnaire having five sections, viz.; Board Structure, Transparency, Shareholder Right / Fairness, Responsibility and Performance (27 questions in total) were distributed among the investors. A 5 point Likert scale was used to determine how strongly respondents agree or disagree with each item (1=strongly disagree and 5=strongly agree). The authors conducted the survey on 75 randomly selected respondents. Among them 55 were complete and eligible for use.

For the analytical purposes respondents were classified into three categories based on their degree of equity return expressed in the questionnaire—lower return (for scores below 2), moderate return (for scores 2 to 4), and high return (for scores of above 4). Then these three categories of return receiving investor groups were related with their governance responses in relation to Board Structure, Transparency, Shareholder Right / Fairness, and Responsibility.

4. Findings

4.1 Governance and Returns

Investor respondents are plotted against their respective responses

Table 1: Board Structure

	Higher Return	**Moderate Return**	**Lower Return**
Sample Size (valid N)	19	23	13
Mean	2.47	3.13	3.71
Variance	1.37	0.26	0.14
F-test		9.85	
P—value		0.00	
Decision: Reject the null hypothesis			

Table 2: Transparency

	Higher Return	Moderate Return	Lower Return
Sample Size (valid N)	19	23	13
Mean	2.08	3.10	4.18
Variance	1.01	0.28	0.48
F-test		29.48	
P—value		0.00	
Decision: Reject the null hypothesis			

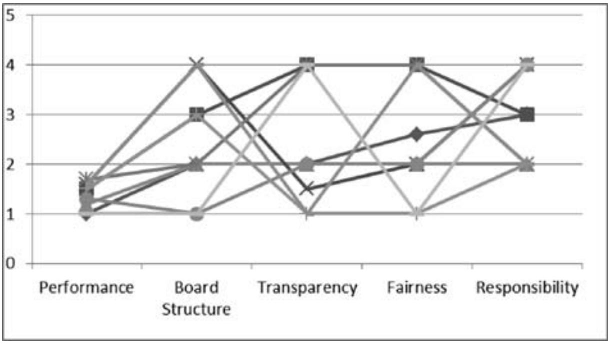

Fig. 2 Scales for Low Return Respondents

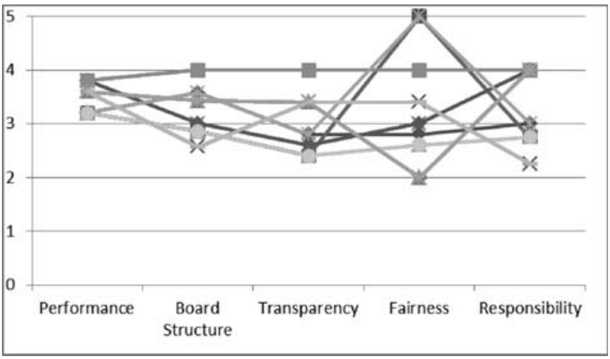

Fig. 3 Scales for Moderate Return Respondents

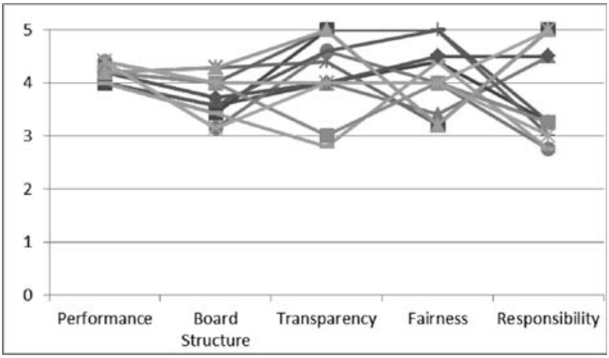

Fig.4 Scales for High Return Respondents

Table 3: Fairness

	Higher Return	**Moderate Return**	**Lower Return**
Sample Size (valid N)	19	23	13
Mean	2.11	2.98	4.02
Variance	0.88	1.23	0.40
F-test		15.42	
P—value		0.00	
Decision: Reject the null hypothesis			

Table 4: Responsibility

	Higher Return	**Moderate Return**	**Lower Return**
Sample Size (valid N)	19	23	13
Mean	3.31	3.32	3.88
Variance	15.85	76.05	28.01
F-test		1.87	
P—value		0.16	
Decision: Do not reject the null hypothesis			

regarding governance components and performance by dividing them into three categories; viz., low return, moderate return and high return (see Figs. 2-4). From the figures we can see that, low return respondents responses are clustered around 1-4 in a five point scale (see Fig. 2). Moderate return respondents replies are gathered around 2 to 4, except few extreme cases (Fig. 3). Whereas, high return respondents responses are clustered around 3 to 5 (see Fig. 4). This indicates that, respondents are reporting positive relationship between equity returns and governance compliance status.

4.2 F Test

In order to prove that the hypothesis of equality of all the average returns against the alternative are not true, the parametric *F-test* (H_o: $\mu 1 = \mu 2 = \mu 3$) has been conducted. We have found difference in mean values among responses in all four elements of governance: Board Structure, Transparency, Fairness and Responsibility (see Table 1 to 4). These are also statistically significant except for responsibility element (see Table 4).

5. Discussion

With the objective to test whether good governance leads toward higher equity returns, we have conducted an empirical study. The result of this can be concluded and summarized as follows:

1. A significant portion of the respondents believe that the firms are having poor governance standards (see Fig. 2). Also as reported by Uchida et al. (2010), there is a discrepancy between reported and actual governance compliance among the listed firms in Bangladesh. More

strict measures should be taken by regulators to ensure good governance.

2. Significant difference has been found in this study among the low and high equity return receiving respondents with respect to governance elements such as board structure, transparency and fairness. This indicates that, investors think governance to be important in ensuring higher equity returns.
3. Insignificant difference of average score among the three categories of respondents with respect to responsibility element implies that, the firms in Bangladesh should put more emphasis on discharging their social responsibility. This result is also consistent with the findings of Ahmed et al. (2011), which reported lower corporate social performance of the Bangladeshi firms.

Though this study has limitation such as small sample size, the results are encouraging in the sense that the investors are looking at good governance as a tool to ensure higher return. This will motivate the researchers to conduct further study in a broader scale with larger sample size.

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