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# INTERNAL GOVERNANCE MECHANISMS AND FIRM PERFORMANCE: THE CASE OF VIETNAM

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## Abstract

*Good corporate governance would contribute to the sustainable development of the economy. Better corporate governance is supposed to lead to better corporate performance and expropriation of controlling shareholders is supposed to be prevented. Studies of impacts of corporate governance on organizational performance had started since 1990s. Vietnam is a developing country with an underdeveloped financial market and week regulatory principles. Therefore, an approach of internal mechanism is supposed to be a better way to improve the quality of corporate governance than external mechanisms. Two internal governance mechanisms (IGMs) are examined in the relationship with corporate performance in this study include (1) Ownership structure and (2) Board of Directors. The results shows that largest shareholder, controlled directors and duality have negative impacts on firm performance while family ownership, board of director ownership, institutional ownership and foreign ownership have positive impacts on firm performance. The study makes theoretical and empirical contribution to the understanding for the development of an effective corporate governance framework in Vietnamese market.*

**Keywords**

Ownership Structure, Board Characteristics, Firm Performance, Corporate Governance, Vietnam

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# 1. Introduction

### 1.1 Internal Governance Mechanisms and Firm Performance

In general, there are many different models of corporate governance around the world. These differs are according to the variety of capitalism in which they are embedded. The Anglo-Saxon countries (US & U.K) tend to emphasize the interests of shareholders. The coordinated or multi-stakeholder model associated with Continental Europe (Germany & France) and Japan also recognizes the interests of workers, managers, suppliers, customers, and the community (Allen & Gale, 2002). The corporate governance model of the Anglo-Saxon countries represents the "outsider" system and the model of the Continental Europe, on the other hand, is called "insider" system (Tan & Wang, 2007).

Better corporate governance is supposed to lead to better corporate performance. Expropriation of controlling shareholders is supposed to be prevented. Moreover, better decision-making is expected in these companies (Nam & Nam, 2004).

Studies on influence of corporate governance on performance include studies of some aspects of corporate governance such as board composition, shareholder rights, executive remuneration, insider ownership, takeover defenses (Hermalin & Weisbach, 1998). Studies of country analyses include Gompers et al. (2003), Nam & Nam (2004), Balata et al. (2004), Abdullah & Page (2009), Hu et al. (2009) and more. These studies provide evidence that corporate governance leads to higher value and performances in both US and non-US firms.

Vietnam is a developing country with an underdeveloped financial market and a shortage of regulatory principles. The research of external governance mechanisms would be difficult to be conducted in lacking information environment of Vietnam. Currently, not many studies on influence of corporate governance on Vietnamese companies have been conducted. There are several studies conducted in Vietnamese market to examine the relationship between internal corporate governance aspects and corporate performance. This study would like to provide more comprehensive analysis on the relation between internal governance mechanisms (IGMs) and firm performance in Vietnamese market. IGMs include ownership structure and board of directors.

### 1.2 Research Objective

This study conducts an empirical study to provide an analysis of impacts of IGMs on firm performance. The study makes theoretical and empirical contribution to the understanding for the development of an effective practice of IGMs corporate governance in Vietnamese market.

## 2. Theoretical Framework and Literature Review

### 2.1 Agency Theory

Agency theory has been used in many researches in economics, accounting, marketing, finance, political science, organizational behavior and sociology (Eisenhardt, 1989). Agency theory models the relationship between the principal and the agent. Jensen and Meckling (1976) defined an agency relationship as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent". In the context of the firm, the agent (manager) acts on behalf of the principal (shareholder) (Eisenhardt, 1989; Jensen &Mucking, 1976).

The principal has to use agent because he does not have enough ability to maximize value of his own property. The owner also use agent when he has resources restrictions. As part of this, the principal will delegate some decision-making authority to the agent and the welfare of the principal is affected by the choices of the agent. Therefore, the major issue is the information asymmetry between managers (agents) and shareholders (owners). In this relationship, insiders (managers) have an information advantage. The agent may take unobservability activities to enhance his personal goals (Eisenhardt, 1989; Jensen & Meckling, 1976). Owners therefore could not accurately evaluate and determine the value of decisions made by agents. The contracts between owners and agents therefore are written to address these conflicts. The costs for mitigation these agency problems as a result are huge.

### 2.2 Corporate Governance in Vietnam

In Vietnam, corporate governance principles have been applied recently and there are not many researches on this kind of topic are conducted. The assessment of corporate governance in Vietnam conducted in May 2006 by the World Bank as part of the Reports on Observance of Standards and Codes Program (ROSC) showed that Vietnam has recently taken important steps to establish its corporate governance Framework. This report indicates some key issues of framework for corporate governance in Vietnam such as a high degree of informality still exists in the corporate sector, an unofficial securities market that is significantly larger than the formal market, and there remains a large presence of state ownership in enterprises (World Bank, 2006). Like most emerging economies, Vietnamese listed companies are characterized by highly concentrated ownership structure. These firms are characterized by family ownership, institutional ownership and state control ownership. External governance mechanism such as competitive markets for corporate control is underdeveloped.

### 2.3 Literature Review and Hypothesis Development

#### 2.3.1 Ownership Structure

The efficacy of ownership concentration is a controversy of monitoring versus expropriation role. In 1980s, concentration ownership is believed to limit agency problem as higher concentration of ownership gives large shareholders stronger incentives and greater power at lower cost to monitor management (Hu & Izumida, 2008). Large shareholders are willing to play an active role in corporate decisions because they could have the benefits from their monitoring effort (Grossman and Hart, 1986). However, interests of large shareholders could be diverged from minority shareholders' benefits (Hu & Izumida, 2008). Controlling shareholders could exploit the interests of minority shareholders via related party transactions as well as falsifications of financial statements (Hu et al., 2008).

Methodologies to measure ownership concentration of almost studies after the research of Demsetz & Lehn (1985) accumulate the ownership five, ten, or twenty largest shareholders. However, Earle et al. (2005) argued that group accumulation could conceal the interactions among large shareholders and the pattern of concentration. These aspects could influence on the effect of concentration on performance. Moreover, there could be the conflict of interests between these block holders (Earle et al., 2005). The approach of measuring ownership concentration by largest block holder is supposed to be better than group measurement.

Hypothesis 1: Ownership of the largest shareholder has an impact on firm performance.

There is a problem of inefficient performance of SOEs. Transition economies, however, has a high degree of state ownership. Many studies have found that state ownership is often linked to low efficiency (Bai et al., 2004; Ding et al., 2007). This could be a result of objectives conflicting between macro-economic benefit and shareholder value. Nee et al. (2007) found that state ownership not only fails to improve firms' financial performance, but actually impacts negatively on various important firm decisions.

Hypothesis 2: State ownership has an impact on firm performance.

Family ownership is popular around the world. In US, Anderson and Reeb (2003) found that family ownership presents in one-third of the S&P 500 firms. Many literatures also investigate into the effects of family-control (Kaserer & Moldenhauer, 2005). Family ownership could be considered as insider ownership as family businesses traditionally attracted a lot of attention given their predominant economic role (Kaserer & Moldenhauer, 2005).

Hypothesis 3: Family ownership has impact on firm performance.

There are two arguments about the efficacy of managerial ownership. The convergence of interest hypothesis believes managerial ownership has positive effect while managerial entrenchment hypothesis has opposed view. Jensen and Meckling (1976) argued that a sufficient high level of managerial ownership aligns the interests of managers and shareholders hence improve the firm performance. A manager's claim on the performance associated with his fraction of the equity increases the probability that the manager devotes significant effort to maximize firm/shareholder value due to his own interests. (Hu & Izumida, 2008)

Hypothesis 4: Ownership of Board members has impact on firm performance.

Large shareholders likely play a crucial role in monitoring and controlling. Chen et al. (2008) argued that there are three benefits with institutional ownership including they are correlated with the higher proportion of the economic profit due to cost effectiveness, cost reduction in coordinating the management, and big institutions will find more difficulties and more expensiveness when it try to sell its big quantity of shares. On the other hands, some evidence of institutions improving corporate governance could be found in U.S (Balata et al., 2004).

Hypothesis 5: Institutional Ownership has an impact on firm performance.

The flows of foreign investment are important sources of finance for developing countries' corporates. Foreign investors from developed markets come with capital and knowledge. They could use their powers to impact to invested companies. Foreign companies transfer advanced technologies and provide access to international capital markets (Caves, 1996, cited Aitkin &Harris ion, 1999). Pfaffermayr & Bellak (2000) argue that affiliating with foreign firms help local companies have access to newer and superior technologies and lead to superior performance.

### 2.3.2 The Board of Directors

Although BOD acts as monitor mechanism to protect benefits for all shareholders including minority shareholders, the negative effects of having controlling directors could outweigh the benefits of their presence. First, controlling directors actively influence on the strategy and objectives of company in line with the interest of controlling shareholders, not necessarily the minority shareholders (Claessens et al., 2000; Young et al., 2008). Second, the presence of controlling directors could potentially weaken the governance role of other directors, making the board less effective (Hu et al., 2009).

Hypothesis 7: The proportion of directors related to largest shareholder on the BOD has an impact on firm performance.

One of the vital roles of BOD is independence. The independence is to provide defense against the exploitative behavior by the controlling shareholders and other directors. Independent directors are expected to be active and effective monitoring role than executive (inside) directors (Fama & Jensen, 1983).

Hypothesis 8: The proportion of non-executive directors on the board has an impact on firm performance.

Hypothesis 8b: The proportion of independent directors on the board has an impact on firm performance.

Jensen (1993) argues that the BOD is often ineffective because the role of chairperson is combined with CEO position. The separation of two roles has both costs and a benefit as there could be an implicit rivalry between two roles as well as it is difficult to isolate responsibility for poor performance (Balabat et al., 2004).

Hypothesis 9: The duality has an impact on firm performance.

## 3. Data and Methodology

### 3.1 Model and Variables

The Model of the study is suggested from study of Hu et al. (2009) with supplement from study of Kaserer & Moldenhauer (2005) &Balata et al. (2004).

Firm’s performance = f(Ownership Structure, Board of Directors)

Firm’s performance is measured by Tobin’s Q.

Ownership structure and Board of Directors are independent variables and are measured as below table

**Table 1:** *Variables Definitions*

| Variable Name | Measurement |
|---|---|
| State Controlled | Dummy variable: 1 if the state is the controlling shareholder<br>Threshold is 20% |
| Family Controlled | Dummy variable: 1 if the company is the family-owned.<br>To be considered a family firm an individual or a family must be the largest shareholder and hold at least 20% of ultimate voting rights (La Porta et al., 1999) |
| Largest Ownership | The percentage of company shares owned by the largest shareholder of the listed company |
| State Ownership | The percentage of company shares owned by the State |
| BOD Ownership | The percentage of company shares owned by the BOD and their families |
| Supervisory Ownership | The percentage of company shares owned by former BOD and their families |
| Institutional Ownership | The percentage of company shares owned by institutional investors |
| Foreign Ownership | The percentage of company shares owned by foreign investors |
| Controlling Directors | The proportion of controlling directors on the board of directors. Directors who are full-time employees of or have relationship with the major shareholder of the listed company |
| Non-Executive Directors | The proportion of non-executive directors on the total of board members |
| Independent directors | The proportion of independent directors on the board of directors |
| Dual leadership | Dummy variable: 1 if the company has the combination of the roles of Chairman and CEO. |
| Firm size | The natural logarithm of total assets |
| Board size | The total number of directors on a board of directors |
| Supervisory board size | The total number of supervisors on a supervisory board |

### 3.2 Data Collection

Data for this study would be extracted from Annual Reports for listed firm in HSX and HNX for 5 years from 2009 to 2013.

## 4. Results

### 4.1 Descriptive Statistics

Data is retrieved from companies listed on the Ho Chi Minh Stock Exchange (HSX) and the Stock Exchange Hanoi (HNX) before 31/12/2008 excluding financial institutions.

**Table 2:** *Descriptive Statistics of Independent Variables*

| Variable | Observation | Mean | Stand. Dev | Min | Max |
|---|---|---|---|---|---|
| Largest Ownership | 1230 | 0.379117 | 0.176919 | 0.0053 | 0.8746 |
| State Ownership | 1230 | 0.3010518 | 0.226078 | 0 | 0.7969 |
| BOD Ownership | 1230 | 0.4360413 | 0.188078 | 0.0032 | 0.890743 |
| Supervisory Ownership | 1230 | 0.0123457 | 0.036347 | 0 | 0.5187 |
| Institutional Ownership | 1230 | 0.4693005 | 0.244245 | 0 | 0.9975 |
| Foreign Ownership | 1230 | 0.1147606 | 0.160443 | 0 | 0.9354 |
| Controlling Directors | 1230 | 0.3921138 | 0.252594 | 0 | 1 |
| Non-Executive Directors | 1230 | 0.5358159 | 0.209036 | 0 | 1 |
| Independent directors | 1230 | 0.1319243 | 0.16836 | 0 | 0.7142857 |
| Duality | 1230 | 0.6284553 | 0.483414 | 0 | 1 |
| Board Size | 1230 | 5.621951 | 1.189597 | 3 | 11 |
| Supervisory Board Size | 1230 | 3.05935 | 0.389725 | 2 | 5 |

### 4.2 Regression Analysis and Hypothesis Testing

**Table 3:** *Regression Estimates*

| Variable | Coefficient | Standard Error | t | $P_{value}$ | [95% Conf. Interval] | |
|---|---|---|---|---|---|---|
| Largest Ownership | -0.31832 | 0.105156 | -3.03 | 0.003*** | -0.52462 | -0.11201 |
| State Ownership | 0.117168 | 0.083307 | 1.41 | 0.160 | -0.04627 | 0.28061 |
| Family Controlled | 0.096146 | 0.035729 | 2.69 | 0.007*** | 0.026049 | 0.166243 |
| BOD Ownership | 0.170245 | 0.087276 | 1.95 | 0.051* | -0.00098 | 0.341474 |
| Supervisory Ownership | 0.444945 | 0.347538 | 1.28 | 0.201 | -0.2369 | 1.126789 |
| Institutional Ownership | 0.375577 | 0.06645 | 5.65 | 0.000*** | 0.245208 | 0.505946 |
| Foreign Ownership | 0.477287 | 0.119393 | 4 | 0.000*** | 0.243046 | 0.711528 |
| Controlling Directors | -0.1416 | 0.041995 | -3.37 | 0.001*** | -0.22399 | -0.05921 |
| Non-Executive Directors | -0.04974 | 0.04538 | -1.1 | 0.273 | -0.13877 | 0.039291 |
| Independent directors | -0.04235 | 0.069798 | -0.61 | 0.544 | -0.17929 | 0.094591 |
| Duality | -0.04799 | 0.028084 | -1.71 | 0.088* | -0.10309 | 0.00711 |
| Board Size | -0.01565 | 0.011006 | -1.42 | 0.155 | -0.03725 | 0.005941 |
| Supervisory Board Size | -0.01983 | 0.03516 | -0.56 | 0.573 | -0.08881 | 0.049153 |
| HSX listed | 0.065576 | 0.020976 | 3.13 | 0.002*** | 0.024423 | 0.106728 |
| Size | 0.010779 | 0.005031 | 2.14 | 0.032** | 0.000909 | 0.02065 |
| year | | | | | | |
| 2010 | -0.20328 | 0.035203 | -5.77 | 0.000*** | -0.27234 | -0.13421 |
| 2011 | -0.46051 | 0.033093 | -13.92 | 0.000*** | -0.52544 | -0.39559 |
| 2012 | -0.43106 | 0.034586 | -12.46 | 0.000*** | -0.49891 | -0.3632 |
| 2013 | -0.34612 | 0.036987 | -9.36 | 0.000*** | -0.41869 | -0.27355 |

| | | | | | | |
|---|---|---|---|---|---|---|
| _cons | 1.001089 | 0.168564 | 5.94 | 0.000*** | 0.670379 | 1.331799 |

Notes: R-square: 0.293, Adjusted R-square: 0.28, F=20.36, Fig. = 0.000, N = 247, * significant at 10%, ** significant at 5%, *** significant at 1%

Largest Ownership has negative impact on firm performance at 1% significant level. It means that the largest shareholder owns more share, the performance of firm would be worse. This result supports expropriation theory in which interests of large shareholders could be diverged from minority shareholders' benefits (Hu & Izumida, 2008). Controlling shareholders could exploit the interests of minority shareholders via related party transactions (Hu et al., 2008). H1 is supported.

Family Controlled has positive significant impacts on firm performance at 1% significant level. The result is contradicted with the assumption that family ownership concentration could increase the expropriation of non-family minority shareholders or the assumption that in family companies, unqualified members could be appointed to key positions without competition (Claessens et al., 2000) and family managers are less to be monitored (Young et al, 2008). H3 is supported.

BOD Ownership has positive impact on firm performance at 10% significant level. It supports the convergence of interest hypothesis in which managerial ownership has positive effect. Jensen and Meckling (1976) argued that a sufficient high level of managerial ownership aligns the interests of managers and shareholders hence improve the firm performance. A manager's claim on the performance associated with his fraction of the equity increases the probability that the manager devotes significant effort to maximize firm/shareholder value due to his own interests. (Hu & Izumida, 2008) Higher managerial ownership lowers agency costs, hence could imply better firm performance (Balatbatet al., 2004). H4 is supported.

Institutional ownership has positively significant impact on firm performance. It is compatible with the assumption that institutional investors has crucial role in monitoring and controlling and they have positive impact on firm performance. Like Balata et al., (2004) found evidence of institutions improving corporate governance in U.S, the result of Vietnam consolidates the hypothesis that institutional ownership has positive impact on firm performance. H5 is supported.

Foreign ownership has positively impact on firm performance. It totally compatible with the assumption that foreign investors from developed markets come with capital and knowledge.

They could use their powers to impact to invested companies. H6 is supported.

Controlled director's ratio has negative impact on firm performance. As many arguments that presence of controlling directors on board could relate to the conflicts between controlling and minority shareholders. Although BOD acts as monitor mechanism to protect benefits for all shareholders including minority shareholders, the negative effects of having controlling directors could outweigh the benefits of their presence. First, controlling directors actively influence on the strategy and objectives of company in line with the interest of controlling shareholders, not necessarily the minority shareholders (Claessens et al., 2000; Young et al., 2008). Second, the presence of controlling directors could potentially weaken the governance role of other directors, making the board less effective (Hu et al., 2009). It is compatible with assumption that the more controlled directors represent in BOD, the worse performance of company has. H7 is supported.

The duality has a negative impact on firm performance. Although the sign of impact is hypothesized to be positive as the separation between two roles is expected to prevent the abuse of power, the result is vice versa. It is compatible with study of VO and Nguyen (2014). H9 is supported.

The firm size (SIZE) controlled variable has positive significant impact on firm performance. This result is compatible with other studies in which firm size positive affects to the Tobin's Q.The controlled variable of HSX represents the listed companies on Ho Chi Minh Stock Exchange has positive impact. Companies listed on HSX have better performance.The controlled year (YEAR) variableis also has impact on firm performance. Maybe the testing period fall into the recession period after financial crisis of 2008 and recovery phase later so the firm performance was affected differently in different years. The impact was also different for different industries.

## 5. Conclusion

The result shows that IGMs have impacts on firm performance in the case of Vietnam. The findings contribute to the consolidation of agency theory and corporate governance practice in Vietnam.

Largest Ownership has negative impact on firm performance. This result supports expropriation theory in which interests of large shareholders could be diverged from minority shareholders' benefit. Controlling shareholders could exploit the interests of minority shareholders via related party transactions. This requires policy makers have to build up solutions to control for the concentration ownership to protect minority shareholders. The requirements could be more requirements of the transparency belonged to large shareholders' transactions.

Family Controlled has positive significant impacts on firm performance. The result is contradicted with the assumption that family ownership concentration could increase the expropriation of non-family minority shareholders. In Vietnam, companies owned by family have better performance. This is a surprised result. However, it is also a positive signal. It demonstrates that family-owned companies in Vietnam aware of good corporate governance.

BOD Ownership has positive impact on firm performance at level. It supports the convergence of interest hypothesis in which managerial ownership has positive effect. A sufficient high level of managerial ownership aligns the interests of managers and shareholders hence improve the firm performance. However, it is conflicted with largest shareholder's result because largest shareholder could present in BOD. This could be other directors exclude largest shareholder have positive actions to prevent expropriation from controlling shareholder. This is a suggestion for regulator to build up policies to support the role of independent directors. Institutional ownership has positively significant impact on firm performance. It is compatible with the assumption that institutional investors has crucial role in monitoring and controlling and they have positive impact on firm performance. Besides, foreign ownership has positively impact on firm performance. It totally compatible with the assumption that foreign investors from developed markets come with capital and knowledge. They could use their powers to impact to invested companies. Investors and shareholders could also require the Board to find foreign partners or issue shares to increase the percentage holding of foreign investors and in turn these foreign investors have pressures on BOD. The individual shareholders could also delegate to foreign investors to increase voice. Policy makers, moreover, could create more open mechanism for foreign ownership to attract foreign investors. The same situation could be applied for the institutional ownership.

Controlled directors' ratio has negative impact on firm performance. As many arguments that presence of controlling directors on board could relate to the conflicts between controlling and minority shareholders. Although BOD acts as monitor mechanism to protect benefits for all shareholders including minority shareholders, the negative effects of having controlling directors could outweigh the benefits of their presence. First, controlling directors actively influence on the strategy and objectives of company in line with the interest of controlling shareholders, not necessarily the minority shareholders. Second, the presence of controlling directors could potentially weaken the governance role of other directors, making the board less effective. It is compatible with assumption that the more controlled directors represent in BOD, the worse performance of company has. This requires regulators have more mechanisms to protect minority shareholders from expropriation from controlling shareholders. It could be more requirements of the transparency belonged to large shareholders' transactions or increase the independent directors.

The duality has a negative impact on firm performance. Although the sign of impact is hypothesized to be positive as the separation between two roles is expected to prevent the abuse of power, the result is vice versa. This result shows that duality in Vietnam truly is not effective. There should be more detail requirements all well as standards for Chairman and CEO positions.

This study has several limitations. First, there is not separation between individual and institution largest shareholder. Actions of these two entities could be different. The deeper analysis could suggest more understanding about the role of largest shareholders. Second, ownership of state is not separated between state-owned holding companies and other state-owned. The impact of these two kinds of state-owned could provide more details about the role of state ownership on firm performance.

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