INTERNAL CORPORATE GOVERNANCE MECHANISMS, INVESTORS’ CONFIDENCE AND STOCK PRICE FLUCTUATIONS RISK

Omran Ahmad Al-Ibbini *, Osama Samih Shaban **

* Faculty of Business, Al-Zaytoonah University of Jordan, Amman, Jordan
** Corresponding author, Faculty of Business, Al-Zaytoonah University of Jordan, Amman, Jordan
Contact details: Faculty of Business, Al-Zaytoonah University of Jordan, P.O. Box 130, 11733, Amman, Jordan

Abstract

The primary goal of corporate governance is to create a balance of power-sharing among shareholders, directors, and management to enhance shareholder value and protect the interests of other stakeholders. The main aim of this study is to find out the effect of internal corporate governance in improving the confidence of investors and minimizing stock fluctuations risk. In order to achieve the objectives of the study, a questionnaire has been designed and distributed randomly to 200 traders at the Amman Stock Exchange (ASE). Resolution data were analyzed using the statistical program (Smart PLS), in addition to other statistical methods. The study concluded that there is a significant statistical effect of internal corporate governance mechanisms in improving the confidence of investors and minimizing stock fluctuations risk. Also, the study recommended to maintain the current level of investors’ confidence and to work on developing the legal framework for corporate governance in the light of the proposed development of a conceptual framework, and economic growth.

Keywords: Corporate Governance, Internal Governance Mechanism, Stock Fluctuations Risk, Investors, Board of Directors, Jordan

1. INTRODUCTION

The stability of stock markets is an important indicator of a proper and well-managed financial system and thus promotes the growth of the national economy. But, as a result of successive financial crises such as the recent global financial crisis that led to the collapse of many companies and financial institutions, many governments and regulators resorted to many reforms and corrective measures aiming to stabilize the financial market, raising the efficiency and minimizing risk. The word stable means that the system absorbs the economic shock primarily via self-corrective mechanisms, preventing the adverse events from disrupting the real economy or spreading over to other financial systems. Most of these reforms came in the form of regulations to strengthen corporate governance in these firms and financial institutions (Claessens, 2019).

Corporate governance is a process that is influenced by regulatory and contractual laws, market-based mechanisms, and best practices to create and maximize shareholder value while
protecting the interests of other stakeholders. When a capital structure is concentrated in the hands of a small group of shareholders, corporate governance ensures that the interests of shareholders and minority interests are compatible (Sarra, 2004; Kumar & Zattoni, 2017).

Researchers have shown that corporate governance mechanisms can help non-performing companies increase their efficiency and reduce the associated risks. The risk of fluctuations in stock prices is one of the most important risks that affect the stability and strength of joint-stock companies, as these companies seek to grow and maximize their wealth, and corporate governance is one of the effective tools that can be adapted to enhance performance (Duffy, 2004; Kumar & Zattoni, 2019).

The current study aims to find out the role of internal corporate governance mechanisms (board of directors, ownership concentration, and executive compensation) in improving the confidence of investors and minimizing stock fluctuations risk.

The problem of the study can be noticed through the activities witnessed during the recent period in the Jordanian stock market where huge fluctuations occurred in the volume and prices of trading, for example, the general shares index dropped by 1278.8 points in 2018 compared to 20126.6 points in 2017. It is noted that the reason behind such fluctuations mainly goes for irrational reasons. Jordanian investors narrate that the drop in the financial market sometimes depends on speculation and not on economic foundations, or market opportunities, which affects investor confidence in the financial market and consequently lead to negative effects on stock prices and the economy in general. From this standpoint, the idea of this research paper seeks to answer the following questions to achieve the aims of the study and to find out the effect of internal corporate governance in improving the confidence of investors and minimizing stock fluctuations risk:

- Is the efficiency of the board of directors represented by the following characteristics (independence, size of the board, ownership of board members) have a role in minimizing stock fluctuations risk in Jordanian joint-stock companies?
- Does the ownership concentration have a role in minimizing stock fluctuations risk in Jordanian joint-stock companies?
- Do executive compensations have a role in minimizing stock fluctuations risk in Jordanian joint-stock companies?

This study acquires its importance as it can provide Jordanian joint-stock companies with empirical evidence on the relationship between corporate governance and minimizing stock fluctuations risk, which will contribute to strengthening the governance mechanisms in those companies. Also, decision-makers can benefit from this study by identifying the most important mechanisms and methods that can help management in managing risk, and fluctuations of stock price and thus helping in setting or amending appropriate policies and mechanisms to support the governance mechanisms that help on the growth of Jordanian joint-stock companies. On the other hand, previous studies dealt with the issues of internal governance and risk management in advanced economies only, while previous studies in developing economies focused on studying the impact of internal governance mechanisms on the performance of joint-stock companies only and ignoring the role of governance mechanisms in managing the risk of fluctuations in share prices.

The structure of the paper starts with the introduction. Section 2 presents the existing literature on this subject. Section 3 describes the methodology. Section 4 represents research results and Section 5 summarizes the conclusions.

2. LITERATURE REVIEW

The stock market is a barometer or a mirror of a country’s economic conditions. It reflects current economic performance as well as an index of this performance. However, nowadays, the stock market has its own dynamics, as players within the market decide daily fluctuations.

In Jordan, we have seen certain boom years at the Amman Stock Exchange (ASE) and unfortunately, after 2017, there was a significant drop in volume and stock price index, and a number of companies also moved elsewhere, which led to the downgrading of the ASE from an emerging market to a frontier market.

This alienated large pension funds and institutional investors that only invest in emerging markets and above. Many investors in Jordan avoid investment in a stock portfolio, and they opt for investment in government securities as it is more profitable and tax-free (J. Anani, personal communication, December 21, 2019). So, what should be done to attract investment and boost confidence in the ASE? First of all, the government should abolish the recent tax on trade and speculation in the market, and then, it should work on seeking long-term investments. However, if this is the case, we will not get any money because speculation is an integral part of the investment (Hashim & Amrah, 2016). It is also important for monetary policy in terms of open market operations (J. Anani, personal communication, December 21, 2019). One cannot have an open market without the presence of government securities as it is more profitable and tax-free (J. Anani, personal communication, December 21, 2019). An open market is also important for investing and boosting confidence in the ASE. In general, the stock market is a barometer or a mirror of a country’s economic conditions. It reflects current economic conditions. It is also important for monetary policy in terms of open market operations (J. Anani, personal communication, December 21, 2019). It is also important for monetary policy in terms of open market operations (J. Anani, personal communication, December 21, 2019).

There is no single reason for share price fluctuations, and it is also difficult to measure it accordingly. Due to large and overlapping elements that affect the movement of markets, there are sometimes events, conditions, and news that theoretically moves stock prices up or down, and in general, this change depends on supply and demand factors, and supply and demand depend on many factors and influences. One of the major factors is speculation in the market, and then, it should work on seeking long-term investments. However, if this is the case, we will not get any money because speculation is an integral part of the investment (Hashim & Amrah, 2016). It is also important for monetary policy in terms of open market operations (J. Anani, personal communication, December 21, 2019). One cannot have an open market without the presence of government securities as it is more profitable and tax-free (J. Anani, personal communication, December 21, 2019). An open market is also important for investing and boosting confidence in the ASE. In general, the stock market is a barometer or a mirror of a country’s economic conditions. It reflects current economic conditions. It is also important for monetary policy in terms of open market operations (J. Anani, personal communication, December 21, 2019).
Corporate governance, at least theoretically, this will lead to better performance among companies and vice-versa (Aljifri & Moustafa, 2007).

An effective governance structure improves investor confidence, ensures company accountability, enhances reliability, and reduces the risk of equity fluctuations (Shailer, 2004). Better performance among companies depends on a set of rules and relationship guidelines called corporate governance. Corporate governance is one of the most important and comprehensive terms that have spread globally over the past two decades. Attention to governance has increased in most emerging and advanced economies due to its association with organizational, accounting, financial, economic, social, and environmental aspects, and the concept of corporate governance is a modern concept that began to emerge after the emergence of agency theory. Corporate governance has been defined by specialists, researchers, and international bodies with many definitions, and here we mention some of them for the sake of mentioning but not limiting it. The Organization for Economic Cooperation and Development (OECD) has defined corporate governance as the set of relationships between the owners of the company (shareholders) and its boards of directors and shareholders and other related parties that have an interest in the facility, as it shows the mechanism by which it explains the goals of the facility and the means to achieve those goals and monitor their achievement, and thus, effective corporate governance is what provides both the board of directors and the executive management with appropriate incentives to reach goals that are in the interest of the company, and facilitates the establishment of an effective monitoring process, and thus helps the company to use its resources efficiently (OECD, 2004).

Corporate governance is also defined as, the set of systems and processes that exist within the company, which sets goals and works to monitor their achievement in line with the company’s values and leads to doing business in a better way which leads to improving the company’s relationships with its shareholders, improving administrative quality, encouraging long-term thinking and emphasizing stakeholders of information, and ensuring that executive managers are well monitored while performing their job (Hashim & Amrah, 2016).

Corporate governance is also the set of mechanisms, processes, and relationships by which companies are controlled and operated (Shailer, 2004). These mechanisms can be divided into two categories, one external and the other internal. External mechanisms are controlled by those outside the organization and serve the goals and objectives of entities such as regulatory bodies, governments, unions, and financial institutions.

These objectives include adequate debt management and legal compliance. External mechanisms are often imposed on organizations by external stakeholders in the form of union contracts or regulatory guidelines. External organizations, such as industry associations, may propose best-practice guidelines, and companies can choose to follow or ignore them. Firms usually report the strength of management and legal compliance (Florackis, 2019). Organizations and regulatory authorities require mechanisms to external stakeholders (Aljifri & Moustafa, 2007).

The company’s most important control groups come from its internal mechanisms. These controls monitor the progress and activities of the organization and take corrective action when the work is derailed. Maintaining the larger fabric of internal control for the company serves the company’s internal goals and internal stakeholders, including employees, managers, and owners. These goals include management oversight, auditing, board structure to levels of responsibility, independent internal segregation of control, and policy development (Florackis, 2005; La Rosa, Cacerio, & Berrini, 2019).

Corporate governance differs from corporate governance in that corporate governance is primarily concerned with protecting businesses, while management focuses on its development. Governance refers to the policies and procedures put in place to ensure that we operate within the law and in the interest of all stakeholders. Management refers to the technologies that executives use to help a company operate and thrive (Ashe-Edmunds, 2019). The importance of corporate governance arises in preserving financial stability in particular, and in maintaining the stability of the national economy in general. The importance of governance has increased as a result of companies from emerging and advanced economies to shift to free economic systems and adopt the idea of moving towards a free economy market and liberalization to enable companies to turn into an independent form of ownership from management (Hoffmann, 2014).

Froum et al. (2016), Zaloom et al. (2019), personal communication, December 21, 2019, and many researchers have agreed that corporate governance is not an objective in itself, as it is not related to procedural or formal controls and it does not present a strict commitment to limited guidance, observation, or observance of specific administrative behaviors. Rather, in fact, it aims to improve a corporation’s performance and ensuring that they have access to funds at a reasonable cost. As there is a direct relationship between the quality of governance and the degree of economic corporation performance, therefore, corporations that have efficient governance controls consequently will have high levels of confidence in their management, and it will deal transparently with the stakeholders and other clients which will increase common confidence and work on reducing investment risks, as well as reducing the cost of capital (Zaloom, 2013).

Corporate governance is also important for potential shareholders and investors. Corporate governance provides a guarantee with an appropriate degree of reassurance to shareholders and potential investors in achieving an adequate return on their investments and preserving their rights, especially minority rights, in light of the agency problem arising from the separation of company ownership from its management (J. Anani, personal communication, December 21, 2019). Corporate governance works in bridging the gap between all stakeholders, as each party desire to adopt its own practices to achieve their interest, while ignoring the interest of shareholders (Froum, 2016).

As for risk management, it is an integrated and comprehensive system to create the appropriate environment and appropriate tools to identify, measure and study potential risks, determine their potential impact on the company’s business, assets, and revenues, and then develop appropriate plans to
avoid these risks, or to control them, or to mitigate their effects (Talluri, Kull, Yildiz, & Yoon, 2013). Risk management is also defined as the process of systematic selection of cost-effective methods in order to minimize the impact of a particular threat on an organization or institution. It is a process related to the principle of business continuity. It is the process of measuring and evaluating risks and devising strategies to manage them. These strategies include transferring risks to another entity, avoiding them, minimizing their negative effects, and accepting some or all of their consequences (Williams, Smith, & Young, 1995). As for types of risk management, they can be classified according to two criteria, as follows (Freeman, 1993):

1. **Conventional risk management**: Traditional risk management focuses on risks arising from physical or legal causes (for example natural disasters or fires, accidents and deaths, and lawsuits).

2. **Financial risk management**: It is a form of risk management that focuses on those risks that can be managed using barter financial instruments and major environmental banks.

3. **Optimal risk management**: Optimal risk management focuses on prioritizing so that risks with higher losses and a higher likelihood of occurrence are addressed first, while risks with fewer losses and less likelihood of occurrence are addressed later.

Regardless of the type of risk management, all major companies and small businesses have their own risk management team. While risk management is used to avoid losses as much as possible, business continuity planning is found to address the outcome of residual risks. The importance of risk management stems from events that are unlikely to occur and that would happen, if there was sufficient time for them to occur (Froom, 2016; Hashim & Amrah, 2016).

Risk management and business continuity planning are two related processes that are linked together and cannot be separated. The risk management process provides many inputs to the business continuity planning process such as assets, impact assessment, cost estimate, etc. Therefore, risk management covers a broad and important area required in the business continuity planning process. The risk management process provides many inputs to the business continuity planning process (Talluri et al., 2013; Williams et al., 1995; Kumar & Zattoni, 2015).

Risk-based decision-making is the process of relying on the results of risk assessment, business analysis, risk management, strategies, and tactics (risk reduction, risk transfer, risk avoidance, and/or risk acceptance). The risk-based decision-making is a decision-making process that is based on dialogue with stakeholders, monitoring and adjustment in light of the economic and public relations and the political implications of the decisions to be implemented. The risk-based decision-making process requires consideration of the following questions (Kandil, 2005; Pennock & Haimes, 2002; National Research Council, 2005; Chepkoech & Rotich, 2017; Urbański, Haque, & Oino, 2019):
- Can the risk be reduced?
- What are the controls available to reduce risk?
- What combination of control makes sense (economic, social, political)?

Risk assessment is the process of data, analysis, and presentation of potential risks and weaknesses that may affect current business and potential controls that can reduce risk. Risk assessment requires consideration of the following questions:
- What could go wrong?
- What is the probability of an error?
- What are the consequences?
- What controls are currently in place?

Business area analysis is the process of examination and understanding of business functions, sub-jobs, processes, and interdependencies between them. Business area analysis requires consideration of the following questions:
- What are our business functions and sub-functions and processes?
- Which are critical to the continuity of our business?

Risk communication is the process of exchanging information related to risks, fears, perceptions, and preferences within the organization and between the organization and its external environment that links the comprehensive management of institutions with the risk management function. Risk communication requires consideration of the following questions:
- To whom do we communicate about risk?
- What do we communicate about risk?
- How do we communicate about risk?

Risk planning is the final step which is based on the results of risk management and within the overall context of enterprise management, plans, policies, and procedures are developed to address the physical and commercial consequences of residual risks that exceed the level of acceptance of the company, and its assets and its stakeholders. The plans may be stand-alone or standardized, but they must be integrated. Risk planning may include crisis management planning, business continuity, disaster management planning, communication planning, business continuity planning, business recovery planning, business restoration, and transition planning.

### 3. RESEARCH METHODOLOGY

To achieve the objectives of the study, a questionnaire was prepared and distributed to 200 stock market traders in the ASE during the year 2019. The retrieved questionnaires were analyzed using the statistical program Smart PLS. Below are the research model and the hypotheses that were built on it. Quantitative data were collected in which the traders were asked to state the likelihood (on a 5-point scale: 1 - strongly agree; 4 - agree; 3 - neutral; 2 - disagree; 1 - strongly disagree). 186 copies of the questionnaire were retrieved (percentage of 93%); and also were valid for analysis.

Figure 1 represents the research model. A research model is formed out of three elements that constitute the main factors of the internal corporate governance mechanism. These elements are the main hypothesis of the study.
Figure 1. Research model

Study hypotheses are provided below:

**H1:** There is no statistical effect for ownership concentration on minimizing stock's fluctuations risk.

**H2:** There is no statistical effect for the efficiency of the board of directors on minimizing stock's fluctuations risk.

**H3:** There is no statistical effect for the executive compensations on minimizing stock's fluctuations risk.

The study community is formed out of the traders in the ASE market as they form the potential investors in the public sector. 200 copies of the questionnaire were delivered by hand to the respondents, 186 copies were retrieved. Table 1 shows these results.

**Table 1. Study community**

<table>
<thead>
<tr>
<th>Items</th>
<th>No.</th>
<th>Percentages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Questionnaires distributed</td>
<td>200</td>
<td>100%</td>
</tr>
<tr>
<td>Questionnaires recovered</td>
<td>186</td>
<td>93%</td>
</tr>
</tbody>
</table>

### 4. RESEARCH RESULTS

Many statistical measures were used to analyze the questionnaire, such as arithmetic mean, standard deviation, frequencies, for the purposes of description and analysis of the study data. The statistical methods used can be summarized as follows:

1. **Descriptive analysis:** Arithmetic mean, standard deviation, and percentages.

2. **Cronbach’s alpha:** This measure was used to test the reliability and credibility of the study.

As Sekaran and Bougie (2016) explained, the internal reliability coefficient between answers that statistically acceptable, if the value for this measure is 70% or more.

The result showed that the reliability coefficient is high, which indicates that, the questionnaire is reliable. The total reliability coefficient values (internal consistency) using Cronbach’s alpha equals 73.9%, which is an acceptable value, and suitable for the objectives of the study.

**Table 2. Study demographic variables**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Group</th>
<th>Frequencies</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sex</td>
<td>Male</td>
<td>155</td>
<td>83</td>
</tr>
<tr>
<td></td>
<td>Female</td>
<td>45</td>
<td>27</td>
</tr>
</tbody>
</table>
| Total                     |                              | 186         | 100%
| Age                       | Less than 25 years           | 12          | 11|
|                           | From 25 years -35 years      | 49          | 47|
|                           | More than 35 years of 45 years | 74       | 25|
|                           | More than 45 years           | 63          | 31|
| Total                     |                              | 186         | 100%
| Professional certificate  | CMA                          | 6           | 3 |
|                           | CFA                          | 27          | 15|
|                           | CPA                          | 2           | 1 |
|                           | CPA (Jordanian CPA)          | 24          | 13|
|                           | Other                        | 127         | 68|
| Total                     |                              | 186         | 100%
| Job title                 | Head of investing department | 35          | 18|
|                           | Officer in an investing department | 29      | 16|
|                           | Broker                       | 68          | 37|
|                           | No title                     | 54          | 29|
| Total                     |                              | 186         | 100%
| Experiences               | Less than 5 years            | 21          | 14|
|                           | From 5 years - 10 years      | 46          | 39|
|                           | More than 10 years - 15 years | 72         | 25|
|                           | More than 15 years           | 47          | 22|
| Total                     |                              | 186         | 100%
When examining the results of path coefficients, and through the numbers that appear in Table 3, we were able to determine that the members of the board of directors have the strongest influence on minimizing stock fluctuations risk by 0.943, followed by ownership concentration 0.679, and finally, executive compensations at a rate of 0.519. Table 3 illustrates the path coefficients results.

Table 3. The path coefficients of the variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Path coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of directors</td>
<td>0.943</td>
</tr>
<tr>
<td>Ownership concentration</td>
<td>0.679</td>
</tr>
<tr>
<td>Executive compensations</td>
<td>0.519</td>
</tr>
</tbody>
</table>

Based on path coefficient scores, the results show that the relationship between the three variables is statistically significant. It appears that the influence of board of directors, ownership concentration, and executive compensations on minimizing stock fluctuations risk is significant, as the findings of Smart PLS rules explain that the path coefficient is significant if it is above 0.015.

The three combinations also show that the R-squared ($R^2$) for the endogenous latent construct of the board of directors is 88.9%, the endogenous latent construct rate $R^2$ for the ownership concentration is 62.4% and the endogenous latent construct of executive compensations $R^2 = 60.8%$. Table 4 illustrates the $R^2$ results.

Table 4. The $R^2$ of the variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>$R^2$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of directors</td>
<td>0.889</td>
</tr>
<tr>
<td>Ownership concentration</td>
<td>0.624</td>
</tr>
<tr>
<td>Executive compensations</td>
<td>0.508</td>
</tr>
</tbody>
</table>

The convergent validity assessment is associated with the Average Variance Estimated (AVE) value. The evaluation of validity criterion in Table 4 illustrates that the AVE values of board of directors, ownership concentration, and executive compensations respectively are 0.578, 0.535, and 0.517. All these variables are above the cutoff point of 0.50. Therefore, all reflective constructs demonstrate high levels of convergent validity (Fornell & Larcker, 1981). Table 5 illustrates the AVE values.

Table 5. The AVE values

<table>
<thead>
<tr>
<th>Variables</th>
<th>AVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of directors</td>
<td>0.578</td>
</tr>
<tr>
<td>Ownership concentration</td>
<td>0.535</td>
</tr>
<tr>
<td>Executive compensations</td>
<td>0.517</td>
</tr>
</tbody>
</table>

5. CONCLUSION

The results of the study can be summarized as follows:

- There is a statistically significant effect of board of directors on minimizing stock fluctuations risk in the Jordanian joint-stock companies.
- There is a statistically significant effect of ownership concentration on minimizing stock fluctuations risk in the Jordanian joint-stock companies.
- There is a statistically significant effect of the executive compensations on minimizing stock fluctuations risk in the Jordanian joint-stock companies.
- There is a statistically significant effect of internal corporate governance mechanisms on minimizing stock fluctuations risk and improving investors’ confidence in the Jordanian joint-stock companies.

Based on the above results of the study, the study may recommend the following:

- Companies should work on to find stable governance mechanisms that govern relevant parties, including investors and companies.
- Companies should work on maintaining the current degree of investor confidence and working to develop legal and legislative frameworks for corporate governance in light of the proposed developments to encourage investment and economic growth.
- Companies should work on holding specialized conferences in the field of corporate governance and its impact on encouraging investment.
- Companies should work in encouraging thinkers and researchers to cover other aspects that help in minimizing stock fluctuations risk.

Similar to any academic endeavor, this study also suffers from certain limitations, and as such the findings of the study should be evaluated in light of those limitations. However, these limitations also provide opportunities for further research in this area.

- This study is conducted in the Jordanian environment, so caution should be exercised in generalizing the findings of this study.
- This study is examining the effect of internal corporate governance mechanisms on minimizing stock fluctuations risk, and improving investors’ confidence in the Jordanian joint-stock companies and the results of this research could be attributed to other factors affecting the stock fluctuations risk, so additional research should be done in this field.

REFERENCES


