Earnings informativeness and institutional investors on boards

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A B S T R A C T
We study the role of directors appointed by banks and those appointed by investment funds in the informativeness of accounting earnings in a low investor protection environment with a high presence of institutional directors. Results suggest that the monitoring role of directors appointed by banks and funds improves investor protection and increases market confidence in accounting information. The paper has interesting academic and policy implications for the debate on the proper degree of institutional involvement in corporate governance, noting that when analyzing the role of institutional investors, researchers must take into account investors’ participation in other mechanisms of corporate control such as the board of directors. We contribute to the literature by showing that, in a weak regulatory and low investor protection environment, one of the ways in which institutional investors play a monitoring role is through influencing earnings quality when they are both shareholders and board members.

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Capacidad informativa de los resultados contables e inversores institucionales en las juntas

R E S U M E N
Estudiamos el papel de los consejeros que representan a las entidades bancarias y los fondos de inversión en la capacidad informativa de los resultados contables en un entorno con una baja protección de los inversores y con una alta presencia de consejeros institucionales. Los resultados sugieren que el control ejercido por los consejeros que representan los intereses de las entidades bancarias y de los fondos de inversión mejora la protección de los inversores e incrementa la credibilidad de la información contable divulgada. El artículo posee interesantes implicaciones políticas y académicas en el contexto del debate relativo al nivel de implicación de los inversores institucionales en el gobierno corporativo, apuntando la necesidad de que los investigadores tomen en consideración el papel de los inversores institucionales en otros mecanismos de control corporativo, como es el consejo de administración. Contribuimos a la bibliografía mostrando que, en un entorno de débil protección de los accionistas, una de las formas a través de las cuales los inversores institucionales desempeñan un papel de control es mediante su influencia en la calidad de la información contable cuando son, al mismo tiempo, consejeros y accionistas de la empresa.

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Introduction

Boards of directors can play a significant role in controlling agency problems. From an agency perspective, the ability of the board to act as an effective monitoring mechanism depends on its independence of management (Beasley, 1996). Independent directors do not appear to be really efficient in Communitarian countries, however, and some authors highlight that the supervising role in these environments is not played by independent directors, as UK-and US-based research suggests, but by directors appointed by institutional investors (García-Osma & Gill de Albornoz-Noguer, 2007; López-Iturriaga, García-Meca & Tejerina-Gaite 2015; Sánchez-Ballesta & García-Meca, 2007).

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The presence of directors appointed by institutional investors (we call them institutional directors) on the board is increasing across all OECD countries, and accordingly, institutions are becoming more influential in the corporate governance of bank-dominated countries. Although prior research has provided significant insights into the relationship between institutional investors and reporting quality (Ahmed, Hossain, & Adams, 2006; Bona-Sánchez et al., 2013; Chung, Firth, & Kim, 2002; Lobo & Yang, 2001; Siregar & Utama, 2008), the available evidence is mixed and has failed to consider the role of these shareholders as directors. Nevertheless, directors representing institutional investors make up an important part of the boards in some European countries. Thus, according to (Struggles, 2011), directors appointed by institutional investors account for 40% of directorships in Spain, 22% in France and 13% in Italy. In contrast, they only account for 2% of British firms’ directorships. As this report shows, the presence of institutional directors is also highly different among continental countries, as characterized by the importance of financial intermediaries as resource providers, high ownership concentration and banks as relevant shareholders (e.g., the proportion of institutional directors in German boards is only 8%). Unlike the Anglo-Saxon environment, the role exercised by institutional investors when they are board members enables them to be part of the internal decision-making process (e.g., Weinstein & Yafeh, 1998). Because its institutional investors are simultaneously core shareholders and highly represented directors, Spain represents a unique scenario to analyze how the presence of institutional directors on the board affects the quality of reported earnings. Therefore, we analyze the role of institutional directors in the informativeness of accounting earnings in a sample of Spanish listed firms between 2004 and 2010. In addition, although agency theory has dominated research about board of directors, we use other theoretical approaches such as resource theory, stewardship theory, and resource dependency theory to provide insights regarding the role of institutional directors.

No previous study has considered how directors appointed by institutional investors affect the properties of accounting earnings in a low investor protection environment with a high presence of institutional directors. Therefore, our paper seeks to fill this gap in the literature by studying the influence of directors appointed by different types of institutional investors on earnings informativeness. Accordingly, we make a distinction between directors appointed by banks and those appointed by investment funds. We think that they may have differences in their incentives and an ability to monitor managers and alleviate asymmetric information problems, and that these differences may have an effect on the properties of accounting earnings.

In this respect, institutional investors should not be considered as a homogeneous group, because they can have different levels of influence and ability to exercise control in corporate decision making (Almazan, Hartzell, & Starks, 2005; Chen, Elder, & Hsieh, 2007; López-Iturriaga et al., 2016). According to the literature, depending on their investment horizons and business ties, institutional investors can either encourage short-term managerial behavior (Bhide, 1993; Froot, Scharfstein, & Stein, 1992) or actively monitor firms, thus constraining managerial discretion (Bushee, 1998). The literature also underlines that some institutional investors choose to monitor firms and exert influence on managers, whereas others focus on information gathering and short-term trading profits (Elyasiani, Jia, & Mao, 2010).

The results in this paper suggest that directors appointed by banks and funds improve investor protection and increase market confidence in accounting information.

Our study contributes to the literature on the effect of board composition on earnings quality in several ways. First, we provide evidence of the link between directors appointed by institutional investors and earnings quality in a way that is difficult to capture in the US or UK context, where this type of director is less prevalent. The higher number of institutional directors in countries as Spain allows us to examine their effects on financial and economic variables and even to study differences between them according to their objectives. Second, the results do not support differences between both types of directors regarding objectives, stability, scrutiny and visibility, suggesting that in institutionally controlled firms both types of directors representing banks and funds improve earnings quality. Overall, our results confirm that board characteristics have an important influence on earnings informativeness, and cover a relevant research question, due to the lack of previous evidence and the important role of institutional investors in Spanish boards. The findings also support the importance of the monitoring function of non-executive directors on the board, with no distinctions.

Institutional setting

Spain is a civil-law country with a bank-oriented financial system in which banks play an active role regarding the markets. Spanish companies are characterized by a one-tier board system, where there is a distinction between three main categories of directors: internal directors (executive) and external directors (institutional and independent). These institutional directors (called consejeros dominicales) represent a significant proportion of the board and are usually large banks and investment funds (Heidrick & Struggles, 2011). Therefore, in Spain there are controlling shareholders who usually sit on boards to represent the interests of institutional investors and who have an important role as controlling shareholders, members of their boards and creditors. The high proportion of these institutional directors on boards, explained by the high ownership concentration of Spanish firms, favors a sense of board stability that gives institutional directors large opportunities to engage in financial decisions (Elyasiani et al., 2010). Additionally, these directors play an outstanding role and maintain close ties with the governance of non-financial firms, maintaining frequent involvement in management decisions (Bona et al., 2013).

As in other Continental European countries, these controlling shareholders mitigate the conflict between management and minority shareholders, but lead to other conflicts between controlling shareholders and minority shareholders. This is due to large controlling shareholders frequently own substantially more control rights than cash flow rights, what gives them a high expropriation potential (López-Iturriaga and Tejerina Gaite, 2014).

In Spain there are several codes of Corporate Governance that recommend the compliance of corporate governance regulations. The first official Code of Good Governance (the Olivencia Code) was issued in Spain in 1998. After the Aldama report (2002), in 2006 the Unified Code of Corporate Governance (CUBG, 2006) was issued, whose main purpose was to improve business management and return transparency to the Spanish system. This code was confined to companies whose shares are traded on the Stock Exchanges, and under the “comply or explain” principle, these companies had to state their degree of compliance with the Code’s 58 recommendations, indicating whether they comply or not with them. Recently, in 2015, the Good Governance Code was issued and introduced several improvements, especially regarding new recommendations concerning corporate social responsibility issues and more transparency regarding board compensation.

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