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Does good corporate governance reduce information asymmetry around quarterly earnings announcements?

Kiridaran Kanagaretnam [a,1], Gerald J. Lobo [b,*], Dennis J. Whalen [c,2]

[a] *DeGroote School of Business, McMaster University, Hamilton, Ontario, Canada L8S 4M4*

[b] *Bauer College of Business, University of Houston, Houston, TX 77204, United States*

[c] *Department of Business, Otterbein College, Westerville, OH 43081, United States*

Abstract

We examine the relationship between the quality of corporate governance and information asymmetry in the equity market around quarterly earnings announcements. We use the change in market liquidity (i.e., bid–ask spreads and depths) around the announcements as a proxy for information asymmetry. We use principal components analysis to identify three factors, board independence, board structure and board activity, that capture the information in the eight individual corporate governance variables we examine. We then use ordinary least squares and two-stage least squares to estimate the relations between market liquidity changes and the following four explanatory variables: directors' and officers' percentage stock holdings, board

* Corresponding author. Tel.: +1 713 743 4838.

E-mail addresses: giri@mcmaster.ca (K. Kanagaretnam), gjlobo@uh.edu (G.J. Lobo), dwhalen@otterbein.edu (D.J. Whalen).

[1] Tel.: +1 905 525 9140.

[2] Tel.: +1 614 823 1161.

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independence, board structure, and board activity. Our results indicate that changes in bid–ask spreads at the time of earnings announcements are significantly negatively related to board independence, board activity, and the percentage stock holdings of directors and officers. We also find that depth changes are significantly positively related to board structure, board activity, and directors' and officers' percentage stock holdings. Our results are consistent with the hypothesis that firms with higher levels of corporate governance have lower information asymmetry around quarterly earnings announcements.
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Keywords: Corporate governance; Information asymmetry; Market liquidity; Bid–ask spread; Depth

1. Introduction

We examine the relationship between the quality of corporate governance and changes in information asymmetry in the equity market around quarterly earnings announcements. Prior research finds that more effective boards increase the quality and quantity of information disclosed by the firm, thereby reducing information asymmetry. The market microstructure literature indicates that market liquidity increases as information asymmetry is reduced. Based on the findings of these two streams of research, we hypothesize that increases in information asymmetry at earnings announcements are smaller for firms with stronger corporate governance.

Corporate governance encompasses the controls and procedures that exist to ensure that management acts in the interest of shareholders. In addition to reducing the likelihood that management, acting in its self-interest, takes actions that deviate from maximizing the value of the firm, corporate governance mechanisms also affect the information disclosed by the firm to its shareholders. These mechanisms make it less likely that management, acting in its self-interest, does not fully disclose relevant information to shareholders or discloses information that is less than credible.

A sizable body of prior research indicates that boards that do a more effective job of monitoring management enhance the quality and the frequency of information released by management (Ajinkya et al., 2005; Karamanou and Vafeas, 2005; Klein, 2002a). These information releases include not only actual reported earnings but also voluntary disclosures such as management forecasts and other information releases. Diamond (1985) and Verrecchia (2001) demonstrate that, in addition to reducing the precision of private information relative to the precision of public information, increased disclosure reduces the incentive for private information search. This suggests that information asymmetry, on average, is lower for firms whose boards are more effective.

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