Economic Modelling 33 (2013) 280–291

Contents lists available at SciVerse ScienceDirect

Economic Modelling

journal homepage: www.elsevier.com/locate/ecmod

Corporate governance under asymmetric information: Theory and evidence

Chen-Wen Chen *, Victor W. Liu [1]

Department of Business Management, National Sun Yat-sen University, No. 70, Lienhai Rd., Kaohsiung 804, Taiwan, ROC

ARTICLE INFO

Article history:
Accepted 3 April 2013

JEL classification:
G32
M42

Keywords:
Corporate governance
Asymmetric information
Moral hazard
Audit

ABSTRACT

This paper discusses and explores three situations under asymmetric information. First, companies with a higher level of corporate governance provisions compensate the owner–manager with a higher managerial reward for information disclosed. Second, there are significant and positive relationships between information disclosed and corporate governance provisions, as well as between company value and corporate governance provisions. The higher proportion of a firm held by the largest owner(s) has negative impacts on information disclosed and shareholder rights as outside investors underestimate the companies' performance caused by insufficient effort of the owner–manager or by other factors. Third, audits improve moral hazard when outside investors are informed of bad company performance by underestimating the stock price.

© 2013 Elsevier B.V. All rights reserved.

1. Introduction

The literature has vastly discussed the interaction between owner–managers and outside investors (Bebchuk and Neeman, 2009; Drymiotes, 2008; Fuerst and Kang, 2004; La Porta et al., 1999, 2000a; Tirole, 2001). This paper demonstrates the effects of corporate governance on companies' stock price under three situations where there is asymmetric information between outside investors and the owner–manager. To explore these situations empirically, we use data of the World Bank to prove that a relationship exists between corporate governance and company performance.

Information disclosed about a company is important to corporate governance, in order to get a higher stock price evaluation from outside investors in the stock market. Gompers et al. (2003) proved the positive relationship between corporate governance and company performance through an investigation of shareholder rights and stock price compensation. Cuñat et al. (2012) examined the effect of corporate governance provisions on shareholder value and found that abnormal returns from the stock market are due to shareholder-sponsored governance proposals. Our paper proves that outside investors reward management running companies with different levels of corporate governance provisions through the stock price, especially when corporate governance provisions[2] and the effort to disclose information – voluntary disclosures – are the personal decisions of the owner–manager.

Why is it difficult for outside investors to expect a positive relationship between corporate governance and company performance? Following the research of Gompers et al. (2003), Bauer et al. (2004) found a negative relationship between corporate governance and company performance. Core et al. (2006) failed to support the hypothesis that companies with a lower level of corporate governance provisions have lower stock prices. Larcker and Tayan (2011) pointed out seven myths of corporate governance and considered it unsurprising that the standard and best practice of corporate governance may not exist. Because a company is an organized system, its success is judged by its external conditions and interactive elements, and by the planning and execution process of strategies.

Asymmetric information is one abstract factor adopted herein to explain inefficient corporate governance provisions. To find out the practical meaning about corporate governance provision applicable

* Corresponding author. Tel.: +886 6 258 0771; fax: +886 7 525 4662.
E-mail addresses: salin116@ms54.hinet.net (C.-W. Chen), vwliu@mail.nsysu.edu.tw (V.W. Liu).
[1] Tel.: +886 7 525 2000x4662; fax: +886 7 525 4662.

[2] Based on the implicit assumption of Tirole (2001), corporate governance provisions are drawn as very powerful contracts or laws that force controlling investors to perfectly internalize their welfare so that investors must receive the controlling rights. Taking it a step further, this kind of corporate governance provisions could be the choice of corporate governance arrangements (Bebchuk, 2002), such as providing incentives, performing monitoring or control, and/or setting up legal protection as pointed out by Vives (2000). Corporate governance provisions have been widely discussed in Cuñat et al. (2012) – for example, provisions that protect managers from the external discipline of takeovers (such as poison pills, staggered boards, or golden parachutes) and statutes that insulate managers from the monitoring and control of shareholders (Bebchuk et al., 2009; Gompers et al., 2003).

0264-9993/$ – see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.econmod.2013.04.010

all around the world, we implement indicators of the World Bank for 217 countries in both developed and developing nations. They are four referred proxies of company performance with corporate governance provisions: right (strength of legal rights index, 0 = weak to 10 = strong), share (market capitalization of listed companies, % of GDP), credit (credit depth of information index, 0 = low to 6 = high), and risk (risk premium on lending, prime rate minus treasury bill rate, %).[3] To demonstrate the information-disclosing efforts and incentives of keeping the managerial position, we model possible impacts of corporate governance on a company and examine models with data at the country level from the World Bank.

This paper finds that company performance under corporate governance provisions is affected by the owner–manager. The evidence also shows that information disclosure complements monitoring by improving the asymmetric information (Cormier et al., 2010). From the model derivation and estimated functions of incentive[4] (e.g. incremental stock price), we note that the effort exerted by the owner–manager of a company may be underestimated and shown by a lack of efficient monitoring. This may result from other factors affecting company performance and may lead to moral hazard (Chhaochharia and Grinstein, 2007). The risk of moral hazard is both reflected on corporate governance provisions and managerial reward theoretically. There is evidence of a significant difference between the identities of an owner–manager as the owner and as the manager on information disclosure and corporate governance provisions respectively. Despite some studies in the literature similar to Larcker and Tayan (2011), who pointed out that there is no relationship between managerial reward and company performance, stock price increments may provide incentives to create long-term wealth for shareholders. This paper argues that company value enhanced by increments of the stock price may provide a better background to incentivize the owner–manager by enforcing corporate governance provisions.

Core et al. (2006) offered another explanation for why a company with a lower level of corporate governance provisions may suffer from a lower stock price. It could be that outside investors expect the stock price of a company with a lower level of corporate governance provisions to plummet due to agency costs, such as managerial shirking, over-investments, and perquisite consumption. Corporate governance in this situation may not result in any relationship among stock-based compensation, shareholders' rights, and future cash flow. Another question is why an owner–manager in a company with a higher level of corporate governance provisions still enjoys stock-based compensation and complements monitoring by only keeping the same level of corporate governance provisions and information-disclosure (Cormier et al., 2010). The reason is that in practice, the efficiency of enforcing corporate governance is difficult to observe by outside investors and is often estimated by several methods, such as by providing incentives, performing monitoring or control, and/or setting up legal protection (Vives, 2000). This paper searches to understand the effects of managerial reward and audits – mandatory disclosures – on corporate governance through both theoretical and empirical models.

Kurihama (2007) viewed companies as public institutions to discuss asymmetric information existing between shareholders and owner–managers. Independent auditing and monitoring the owner–manager enhance the credibility of financial reports used to control the operating activities of owner–managers. Ghosh (2007) directly pointed out that the external monitoring of auditors improves the problem of moral hazard generated from high managerial ownership. Audits are positively correlated with company performance, which is in turn improved by external monitoring. However, the function of an audit on corporate governance differs among companies and lacks country-level data. This paper only derives models to find if audits can indeed improve the problem of moral hazard for outside investors. The results of OLS regression states that when information disclosed improves shareholders rights through the positive relationship between company value and shareholders rights, an audit does improve information disclosed and company risk.

The paper is organized as follows. Section 2 reviews the related literature. Section 3 proves theoretically how outside investors reflect company value on a stock price for companies with different levels of corporate governance provisions. Furthermore, the effects of incentives and audits on companies with different levels of corporate governance provisions after the occurrence of moral hazard are also discussed. Section 4 considers two robustness checks. Section 5 tries to empirically prove the moral hazard that different owner–managers may face by maintaining corporate governance provisions with incentives and audits. Section 6 concludes the analysis.

2. Literature review

This paper discusses the problems of asymmetric information generated from the process in which owner–managers[5] enhance stock prices through corporate governance. Prior to the now-famous Enron case, the promise of protecting minority shareholders made by owner–managers had been proven to enhance stock prices.[6] Lately, however, scholars have proposed and recommended the importance of corporate governance. We discuss corporate governance associated with two strands of the literature: incentive and audit as internal monitoring and external monitoring, respectively. When outside investors notice the information released from the investment market to avoid loss, owner–managers, as directors of their companies, have incentives to enforce corporate governance and disclose information.

Suppose now that an owner–manager of a public company operates it for outside investors in the market. Grenadier and Wang (2005) analyzed how an owner delegates the execution decision to an owner–manager by the real option method. When the owner–manager is the only person to know the future value of an investment, the timing to execute options determines the reward for the owner–manager who makes an effort to disclose information. If the

[3] Strength of legal rights index (0 = weak to 10 = strong) measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending. The index ranges from 0 to 10, with higher scores indicating that these laws are better designed to expand access to credit. Market capitalization of listed companies (% of GDP) (also known as market value) is the share price times the number of shares outstanding. Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at the end of the year. Listed companies do not include investment companies, mutual funds, or other collective investment vehicles. Credit depth of information index (0 = low to 6 = high) measures rules affecting the scope, accessibility, and quality of credit information available through public or private credit registries. The index ranges from 0 to 6, with higher values indicating the availability of more credit information, from either a public registry or a private bureau, to facilitate lending decisions. Risk premium on lending is the interest rate charged by banks on loans to private sector customers minus the "risk-free" treasury bill interest rate at which short-term government securities are issued or traded in the market. In some countries this spread may be negative, indicating that the market considers its best corporate clients to be lower risk than the government. The terms and conditions attached to lending rates differ by country, however, limiting their comparability.

[4] The theory is proposed by Laffont and Martimort (2002).

[5] Perez-Gonzalez (2006) found that publicly-traded companies ruled by family heirs, whereby the incoming chief executive is related by blood or marriage to the departing CEO, underperform versus those not having family successions despite the family background. It is because minority investors are unable to share in the private benefits of control that comes from the company.

[6] Gomes (2000) modeled the agency problem between controlling shareholders and minority shareholders as a stochastic game with incomplete information. Situations exist where the corporate governance structure insulates large shareholders and when the legal system does not protect minority shareholders due to poor laws or poor enforcement of laws. Thus, the owner–manager's actions depend on the costs of extracting private benefits that only he knows, although outside investors recognize the probability distributions of owner–manager types. Gomes (2000) showed his argument that companies can sell shares to minority shareholders without any explicit mechanism of governance, because managers are able to commit implicitly to not expropriating shareholders, which enhances the stock price.

دریافت فوری ← متن کامل مقاله

ISIArticles
مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات