The use of foreign currency derivatives, corporate governance, and firm value around the world

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A B S T R A C T

This paper examines the impact of currency derivatives on firm value using a broad sample of firms from thirty-nine countries with significant exchange-rate exposure. Derivatives can be used for managers’ self-interest, for hedging or for speculative purposes. We hypothesize that investors can appeal to a firm’s internal (firm-level) and external (country-level) corporate governance to draw inferences on a firm’s motive behind the use of derivatives, since well-governed firms are more likely to use derivatives to hedge rather than to speculate or pursue managers’ self-interest. Consistent with this explanation, we find strong evidence that the use of currency derivatives for firms that have strong internal firm-level or external country-level governance is associated with a significant value premium.

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1. Introduction

Risk management theories (e.g., Smith and Stulz (1985), Bessembinder (1991), Froot et al. (1993), and Leland (1998)) suggest that the use of derivatives for risk management purposes adds value to a firm by reducing expected taxes or financial distress costs, by mitigating underinvestment or by allowing a firm to increase its debt capacity and take advantage of debt-tax-shields without an increase in risk. On the other hand, managerial risk aversion motives may lead managers to use derivatives to engage in risk management activities to protect themselves and not necessarily to benefit shareholders (Stulz (1984) and Smith and Stulz (1985)). Finally, firms may also use derivatives to speculate (Geczy et al. (2007)), an activity which we should again not expect to benefit investors on average.

A large part of the previous empirical literature focuses on a firm’s decision to use derivatives and their impact on risk. This literature examines whether the use of derivatives is consistent with existing theories of hedging (e.g., Tufano (1996), Geczy et al. (2007), Haushalter (2000), and Graham and Rogers (2002)), whether derivatives are used for speculative purposes (Geczy et al. (2007)), or whether the use of derivatives impacts risk (e.g., Guay (1999), Allayannis and Ofek (2001), Bartram et al. (2011), and Zhang (2009)). More recently, another stream of research has examined directly the impact of the use of derivatives on firm value (e.g., Allayannis and Weston (2001), Guay and Kothari (2003), Jin and Jorion (2006), Mackay and Moeller (2007), and Bartram, Brown, and Conrad (2011)). Specifically, Allayannis and Weston (2001) find that the use of foreign currency derivatives is positively associated with firm value in a large sample of U.S. nonfinancial firms with exposure to exchange rates, Mackay and Moeller (2007) find a similar effect for the use of derivatives in a sample of oil refiners and Bartram et al. (2011) find a positive valuation effect in a large sample of nonfinancial firms from 47 countries. However, Guay and Kothari (2003) argue that based on the magnitudes of the notional amounts of the derivatives used by U.S. firms, the value implications of their use should be modest. Further, Jin and Jorion (2006) find no value impact for the use of derivatives in a sample of oil and gas producers.

While most of this prior work has focused on the unconditional (average) effect of the use of derivatives on firm value and has found mixed results, in this paper we develop a conditional test which should help clarify the value implications of the use of derivatives. Specifically, we argue that due to information asymmetries (see e.g., Geczy et al. (2007)), investors cannot easily distinguish between the alternative uses of derivatives (for hedging, for speculation, or for managerial benefits), thus making earlier tests noisier and harder to interpret. Further, we argue that investors can appeal to a firm’s corporate governance environment to draw inferences on its motive behind the use of derivatives. Hence, we expect that the use of derivatives should be positively associated with firm value for well-governed firms.

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3 Bartram et al. (2011) also note that the premium they find is sensitive to endogeneity concerns and measured with low precision.

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Using a broad cross-country sample of ADR firms from thirty-nine countries with significant exchange-rate exposure, we exploit differences in internal (firm-level) as well as external (country-level) corporate governance structures across countries and examine their implications for the value of currency derivatives usage. An international setting allows us to obtain a large degree of variation in the corporate governance environment by exploiting the considerable heterogeneity that exists in firm-level and country-level agency problems around the world. Therefore, our setting should make our tests sharper. The main hypothesis we test is that strong corporate governance is both important determinants in the decision to use currency derivatives; however, like previous work with U.S. data, they focus on the unconditional average (value) effect. Previously, Lel (2009) examines that internal and external corporate governance and country-level governance in countries with strong shareholder protection (Pinkowitz et al. (2006) and Kalcheva and Lins (2007)).

Third, we examine how the interaction between firm-level internal governance and country-level external governance influences the effect of derivatives use on firm value. Strong investor protection should reduce managerial agency costs and positively affect the impact of the use of derivatives on firm value. However, the international corporate governance literature emphasizes that investor protection can be established both by country level legal protections as well as by firm level governance structures (e.g., see LLSV (2000), Lins (2003), and Dyck and Zingales (2004)). Therefore, we expect the positive relation between the use of foreign currency derivatives and firm value to be most pronounced when both the firm and country level investor protection environments are strongest.

To compare results with the previous literature we start our analysis by examining the use of currency derivatives without taking into account differences in corporate governance. Similar to Allayannis and Weston (2001), we separate between firms with and without ex-ante exposure to exchange rates through foreign sales. We employ their methodology that uses the Tobin’s Q ratio as a proxy for firm value and a dummy indicating whether a firm uses currency derivatives or not controlling for factors that affect firm value such as size, leverage, and profitability.

We find a positive and significant association between a firm’s use of currency derivatives and value for the sample of firms with exposure, suggesting that on average the use of foreign currency derivatives for foreign firms with exchange-rate exposure adds value. The magnitude of the premium is 10.7% in the baseline OLS specification though it can be higher in some of the other specifications that we employ. While this is undoubtedly large compared to Allayannis and Weston’s (2001) premium of 4.9% for U.S. firms, our sample of foreign firms have twice as large exchange-rate exposure as the sample of U.S. firms employed in Allayannis and Weston (2001). In addition, exchange-rate volatility is higher for currencies in countries outside the U.S. (Domínguez and Tesar (2006)), which should also contribute to a higher premium for foreign firms using FCDs.

Next, we examine the value implications of the use of derivatives conditional on corporate governance. Consistent with our hypothesis that corporate governance should help investors distinguish between the alternative uses of derivatives, we find that firms with strong corporate governance (both at the firm- and country-level) are rewarded with a premium for the use of foreign currency derivatives. The use of derivatives by firms with weak corporate governance does not carry a significant premium but we do not find this activity to be value-destroying either. Our results are robust to the use of several alternative proxies for firms’ internal and external corporate governance environment.

Last, we examine how the interaction of firm-specific internal corporate governance and country-specific external governance impacts the value of currency derivatives usage. We find that the relation between the use of foreign currency derivatives and firm value is more pronounced when both the internal firm level governance and the
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