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The choice between private and public capital markets: The importance of disclosure standards and auditor discipline to countries divesting state-owned enterprises

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ABSTRACT

For a sample of 1866 privatizations from 37 countries, we estimate the impact of disclosure standards and legal institutions that discipline auditors on the method chosen to divest state-owned enterprises. The agency conflict between minority and controlling shareholders can impede a government from privatizing by selling its stake to diffuse investors in the public capital market with a share-issue privatization (SIP) that typically generates important spillover economic benefits, rather than an asset sale to a small group of buyers. However, prior research implies that accounting transparency plays a natural role in preventing controlling shareholders from siphoning corporate resources by helping minority investors identify any diversionary practices. After controlling for firm-level and other country-level characteristics, we find that SIPs become more likely when countries mandate strict disclosure standards, although this result is sensitive to model specification. In comparison, we provide strong, robust evidence that SIPs are more likely in jurisdictions that relax the burden of proof in civil lawsuits and criminal prosecutions against auditors, leading to more credible financial statements. From a policy perspective, our cross-country research suggests that investors value reforms that subject auditors to more severe private and public enforcement over several other legal determinants, including enhancing disclosure standards.

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1. Introduction

In cross-country research, we estimate the importance of several determinants of accounting transparency to the choice between public versus private capital markets' financing. More specifically, we rely on the high information asymmetry environment of the privatization of state-owned enterprises (SOEs) to analyze whether better disclosure standards and legal institutions that discipline auditors in the event of financial reporting failure facilitate privatizing with a share issue, rather than an asset sale to a small set of investors.[1] Governments typically prefer share-issue privatizations (SIPs), which can involve millions of domestic investors, to generate major spillover benefits for their economies.[2] In the interest of developing their capital markets by enhancing liquidity and broadening equity ownership, privatizing governments often gladly sacrifice some proceeds from the transaction by underpricing these securities. For example, Boutchkova and Megginson (2000) report evidence that large-scale privatization programs were instrumental in stimulating financial markets worldwide, particularly for governments with the political objective of cultivating an "equity culture" by persuading individuals and institutions to actively trade in those markets. McLindon (1996) and Subrahmanyam and Titman (1999) argue that SIPs can precipitate a snowball effect with countries enjoying impressive growth as the greater stock market liquidity and efficiency becomes a catalyst for firms to go public.

However, consistent with Megginson et al.'s (2004) evidence, Dyck (2001, p. 77) explains that countries are routinely forced to resort to: "...asset sales rather than share issues in privatization programs when formal governance chains are weak. Asset sales are usually associated with the sale of a majority stake to a single investor or to a consortium of investors that have been approved under some pre-qualification screening process...Among countries with relatively weak formal protections, very few countries use share issues for a large proportion of privatizations." Smaller investors may refuse to participate in SIPs when they sensibly anticipate that insiders have strong incentives to exploit their positions to divert resources, which they hide by manipulating financial statements to suppress information about underlying firm performance. Dyck and Zingales (2004) find that in countries with large private benefits, measured by the premium paid in control transactions, governments tend to divest state-owned enterprises by negotiating asset sales instead of floating a SIP. Similarly, Megginson et al. (2004) show that a strong legal tradition and good protection of minority shareholders raises the likelihood that the government will elect to privatize through a SIP.

We focus on the choice between share issues and asset sales to analyze whether outside investors value country-level institutions that strengthen accounting transparency given that the siphoning of corporate resources requires self-dealing dominant shareholders to conceal their diversionary practices by distorting the financial statements (La Porta et al., 1998; Dyck and Zingales, 2004). The major role that reliable financial reporting plays during the transition from state to private ownership is well known. For example, Hingorani et al. (1997) provide evidence from the first round of the Czech Republic's mass privatization in 1991 that even highly imperfect financial statements were informative to minority investors. In his influential discussion on the steps a government should take before proceeding with a privatization, Gibbon (1997) stresses the importance of providing investors with credible accounting data on the SOE being divested. Bushman et al. (2004) document in country-level regressions that financial transparency suffers when government share ownership is higher, reinforcing that information asymmetry is worse in these situations. After highlighting the governance gap between

[1] For expositional convenience, we always refer to the sale of state-owned enterprises to a small number of buyers as "asset sales", although these transactions are also known as "private sales".

[2] However, in some situations, governments may resort to asset sales to ensure concentrated ownership when the firm that emerges after privatization requires close monitoring of management. In contrast to diffuse ownership where atomistic shareholders have minimal incentives to actively monitor, shareholders with large equity stakes have both the incentive and ability to protect their interests by controlling management (Jensen and Meckling, 1976; La Porta et al., 1998). In fact, there is some evidence that newly privatized firms are more profitable when ownership concentration is higher (e.g., Claessens and Djankov, 1999), although other evidence runs in the opposite direction; e.g., Frydman et al. (1999). In firms outside the US and the UK, highly concentrated ownership is responsible for the major equity conflict between dominant controlling shareholders and minority investors (Shleifer and Vishny, 1997); i.e., large shareholders can deprive other shareholders by exploiting their power to extract private benefits. In this paper, we use "insiders" and "controlling shareholders" synonymously.