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Independent director reputation incentives and stock price informativeness

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ABSTRACT

We link the reputation incentives of independent directors to the informativeness of stock prices. We show that when more independent directors rank a directorship high, the firm-specific information content in a firm's stock price increases. Further, independent directors with high reputation incentives serve firms that voluntarily disclose more information and display lower crash risk. We find similar results when using plausibly exogenous shocks to the reputation incentives of independent directors. Our results therefore support a causal interpretation of the positive influence that independent directors with reputation incentives exert on corporate transparency.

1. Introduction

A key function of financial markets is the production and aggregation of information into market prices. Information contained in securities prices guides important decisions by managers, investors and other participants in the real economy. However, information asymmetries between managers and outside investors prevent investors from pricing firm-specific information accurately. Therefore, understanding how firms can facilitate and maintain high levels of corporate transparency is an important issue.

Independent directors monitor managers and lower the information advantages that managers have over outside investors. Consistent with this, studies show that boards with a greater proportion of independent directors increase the quality of financial reporting and improve a firm's information environment (Chen et al. 2015; Armstrong et al. 2014; Beekes et al. 2004). However, what motivates independent directors to improve corporate transparency is largely unknown and is the focus of our study. In this paper, we link the reputation concerns of independent directors to firm transparency. We show that the stronger the reputation concerns of independent directors, the higher the firm-specific information content in stock prices.

Our reputation measure is from Masulis and Mobbs (2014) and is based on the size of a firm relative to other firms that an independent director also serves. Masulis and Mobbs rank the directorships of individual directors by market value and argue firms confer higher reputation benefits to independent directors when more independent directors rank a directorship high (defined as the firm's market capitalization being at least 10% larger than their smallest directorship) relative to other independent directorships they hold.

The rationale behind this measure is straightforward. Independent directors have incentives to maintain and enhance their reputation as effective monitors (Fama and Jensen 1983), and large firms offer greater opportunities for reputation building

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(Adams and Ferreira 2008), higher visibility (Shivdasani 1993) and higher compensation (Ryan and Wiggins 2004). Various previous studies present results consistent with the notion that firm size is a proxy for reputation incentives and that independent directors allocate more effort to larger firms (Masulis and Mobbs 2014; Knyazeva et al. 2013; Fahlenbrach et al. 2010; Adams and Ferreira 2008).[1]

We argue that independent directors with strong reputation incentives improve firm transparency. This is because independent directors rely on a transparent information environment and accurate firm-specific information to monitor and advise effectively (Adams and Ferreira 2007; Kaplan and Reishus 1990). The need for firm-specific information means that independent directors with reputation incentives will be wary of private information volunteered by managers since managers may be hesitant to disclose information that could be used to discipline them (Jin and Myers 2006; Jensen 1993). When facing higher reputation incentives, publicly available information – that is subject to scrutiny by analysts, auditors, regulators, and the media (Armstrong et al. 2014; Miller 2006) – will become more important to independent directors. Therefore, independent directors will elicit greater corporate transparency as their reputation incentives increase.

We test these propositions using an unbalanced panel of US firms between 1996 and 2012. Our findings confirm a positive link between the reputation incentives of independent directors and firm transparency. We show that the proportion of independent directors who rank a directorship high relative to the other independent directorships they hold is positively associated with stock price informativeness. By the same token, the proportion of independent directors for whom the directorship is of relatively low rank is negatively associated with stock price informativeness. These effects on price informativeness are economically meaningful. For instance, a 10% increase in our directorship rankings measure (approximately the same as one additional director on a nine-person board ranking the directorship high) is associated with a 3.43% increase in stock price informativeness.

Importantly, our results are not explained by the presence of independent directors. The presence of independent directors with high reputation incentives, but not the proportion of independent directors, explains variation in stock price informativeness. Our results are robust to alternative measures for reputation incentives, alternative measures for stock price informativeness, and additional board characteristics (including measures for the expertise, diversity and social ties of board members) that could explain the relationship between director appointments and a firm's information environment.

Establishing a causal relationship between reputation incentives and stock informativeness is challenging. Our results could be driven by firm-level unobservables that correlate with the information environment and board characteristics. To address this, we exploit a plausibly exogenous change in our reputation incentive variable. Following Masulis and Mobbs (2014), we identify a group of treatment firms in which at least one director experiences an increase in her directorship ranking that is due to a decrease in the value of *other* firms in their directorship portfolio. The reduction in firm size is due to reasons that are specific to other firms (e.g. poor performance or divestitures) and therefore unrelated to the firm under investigation.

We match treatment firms with a group of control firms that are in the same industry and are nearest to our treatment firms in terms of size.[2] We then carry out a difference-in-difference analysis with firm-level fixed effects. Our empirical set-up captures the average change in price informativeness *within* treatment firms compared to the average change in price informativeness within control firms. This set-up alleviates concerns that our results are influenced by unobserved between-firm heterogeneity or by firm size (since treatment and control firms are matched on size). We find that, following an increase in the directorship ranking that is caused by a decrease in the size of other firms, treatment firms experience an increase in the level of price informativeness relative to our matched control firms. This supports a causal interpretation of the effect that changes in the reputation incentives of independent directors have on firm transparency.

We also rule out that our results are due to a workload effect, where independent directors devote more time to larger firms because larger firms are more complex. We exploit shocks to the reputation incentives of individual directors that result when mergers cause independent directors to lose one of their *other* directorships. Our results indicate that the termination of other directorships only leads to an improvement in price informativeness if the merger causes an improvement in reputation incentives. We do not find any effect when mergers lower director workloads without an increase in reputation incentives. We interpret this as evidence that reputation incentives and not director workloads explain our results.

In the final part of our paper, we provide direct evidence on how reputation incentives improve transparency. We first show that the more independent directors rank a directorship high, the more information firms disclose to investors on a voluntary basis. Following Carter and Soo (1999) and Gul et al. (2011), we focus on category #8 ('other events') of 8-K regulatory filings. We show that when independent directors with strong reputation incentives serve firms in weak information environments (proxied by fewer stock analysts covering a firm, greater analyst disagreements regarding the future performance of a firm, or less arbitrage-based trading), the number of voluntary disclosures made by these firms increases. Specifically, for firms operating in a weak information environment, an increase in the reputation incentives of one independent director is associated with a 20% increase in the number of category #8 filings over the next three years.

[1] Specifically, Adams and Ferreira (2008) find that the likelihood that a director exhibits attendance problems decreases with firm size, which suggests that directors care more about attending meetings in larger firms. Fahlenbrach et al. (2010) suggest that CEOs see prestigious boards as those of 'firms of similar or larger size relative to their own'. Knyazeva et al. (2013) argue that directors are more willing to accept non-local board appointments if the firm is large because board seats in larger firms offer 'greater reputation benefits, career building opportunities, and networking benefits'. Masulis and Mobbs (2014) show that independent directors with multiple appointments put more effort—in the form of higher attendance and more board committee memberships—into the largest firms in their portfolio of directorships.

[2] Specifically, we use nearest neighbor matching with replacement and require that our treatment and control firms are in the same industry (based on two-digit SIC code) and are nearest in market capitalization. Additionally, we stipulate that firms in the control group do not employ independent directors who also serve firms in our treatment group. We also exclude firms from our control group that experience a substantial (>10%) change in market valuation in the treatment year and firms in which any independent director gains or loses a directorship in a given year.