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Managerial discretion, net operating assets and the cross-section of stock returns: Evidence from European countries ☆

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ABSTRACT

We show that firms with higher NOA (net operating assets) subsequently experience lower stock returns in at least nine out of sixteen European countries, consistent with the U.S. evidence. This negative relation between NOA and future returns is strongly linked with cross-country variation in factors capturing managerial discretion. However, once we adjust for risk, the effect of NOA on stock returns is substantially attenuated and becomes significant only in three European countries. Overall, our findings suggest that optimal investment by executives in response to discount rate changes could be an underlying source of return predictability attributable to NOA in Europe.

1. Introduction

The effect of managerial discretion on firm performance is an important topic of research in strategic and international management. At the same time, in market-based accounting research the concept of managerial discretion is used to interpret predictable returns associated with various accounting figures. In this paper, we combine these two lines of research in the context of return predictability associated with net operating assets in an international setting.

The level of net operating assets is an important accounting figure: it is equal to the difference between operating assets and operating liabilities, while it also represents the cumulation over time of the difference between net operating income and free cash flow (see Penman, 2007). Thus, the level of net operating assets serves as a measure of past and current operating performance (i.e., a measure of balance sheet bloat). At the same time, operating asset/liability accounts are more subject to managerial discretion than other accounts constituting a firms' net financial asset position. Both the level of net operating assets and the level of various operating asset/liability accounts, have informational content for future profitability and stock price performance (see Hirshleifer et al., 2004; Papanastasopoulos et al., 2011).

Hirshleifer et al. (2004) show a strong negative relation between the level of net operating assets scaled by lagged total assets (NOA, hereafter) and future stock returns. As suggested by the literature, managerial discretion drives this relation. Hirshleifer et al. (2004) and Papanastasopoulos et al. (2011) attribute the relation between NOA and subsequent returns to misunderstanding of earnings management and/or overinvestment, while Wu et al. (2010) to optimal investment by

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executives in response to discount rate reduction. The sample in these studies is, however, limited on firms in the U.S. capital market.

Hambrick and Finkelstein (1987) conceptualize managerial discretion, as latitude of action, in an effort to reconcile the long-running discussion in the literature about the influence of executives over the performance of their firms. Before the seminal work of Hambrick and Finkelstein (1987), economists relied on Williamson (1963) and used the term of managerial discretion to define how much leeway executives have in the pursuit of their personal objectives versus the objectives of the stakeholders of their firms. Shen and Cho (2005) integrated both points of view concerning discretion into a single framework, while recently Finkelstein and Peteraf (2007) point out that they address similar antecedents.

Hambrick and Finkelstein (1987) argue that managerial discretion originates from three levels: individual, organizational and environmental. Research on environmental determinants of discretion is primarily conducted in terms of industry-level factors (e.g., Hambrick and Abrahamson, 1995). Possible national sources of variation in discretion are largely ignored, although the literature clearly suggests that the environment within the country where firms operate has a substantial impact on their strategies and performance (e.g., Makino et al., 2004).

The recent studies by Crossland and Hambrick (2007) and Crossland and Hambrick (2011) constitute the first systematic attempt in the literature that explores the determinants of managerial discretion at the country-level. Both studies indicate that certain formal and informal national institutions – culture, ownership structure, legal origin, employer flexibility – greatly influence managerial discretion, and in turn the effects by firm executives on corporate performance. In the context of our work their findings are very important since they provide a mediating role for managerial discretion on firm performance in an international setting.

Following up on studies about managerial discretion at the industry level, Zhang (2006) shows that within the U.S. stock market, both the cross industry and the within industry components of NOA are strong negative predictors for future stock returns. Nevertheless, to the best of our knowledge, we are not aware of any study investigating the possible influence of cross-country variation in managerial discretion on the relation between NOA and stock returns. This issue forms our essential motivation to examine two research questions: (1) whether the negative relation between NOA and subsequent stock returns generalizes to other countries; (2) whether the occurrence of the negative relation between NOA and subsequent stock returns is associated with differences in important country-level factors capturing managerial discretion.

In addressing the first research question, we conduct our work on a sample of fifteen countries of the European Union (EU) prior to its enlargement in 2004, plus Switzerland, that are developed economies with a code-law tradition. In doing so, we can assess whether return predictability attributable to NOA constitutes a more pervasive asset pricing regularity or just a "freak" occurrence in the U.S.; a developed economy, but with common-law tradition and different accounting standards with those in EU (before and after IFRS adoption). At the same time, by conducting our analysis in European equity markets that enjoy some homogeneity regarding the status of the economy and legal origin we intend to eliminate any effects arising from disparities in this respect and to focus more on effects arising from variation in managerial discretion. In our work, we also control for other well-known determinants of stock returns in the cross section and take into account cross-country variation in transaction costs.

In addressing the second research question, we blend blending the work of Crossland and Hambrick (2007, 2011) with the strand of literature dealing with implications of managerial discretion on accounting puzzles. Based on Crossland and Hambrick (2011), EU countries face systematically different degrees of constraint on firm executives (see Table 1, p. 806). Institutional theory suggests that both informal institutions (i.e., enforced by the society) and formal institutions (i.e., enforced by the state) can be related with the extent of leeway that firm executives possess. In our work, we investigate the impact of factors that are associated with cultural environment (individualism), equity-market setting (market development, ownership structure), productivity and growth potential (competitiveness), and accounting regimes (quality of accounting standards). We also directly investigate the impact of the national level of managerial discretion over earnings on the relation of NOA and future returns. In this regard, we seek to gain insights on the rationale of the relation between NOA and stock returns.

The remainder of the paper is organized as follows. In the next we develop our hypotheses, while in Section 3 we provide details about the research design. Section 4 describes the data and variable measurement. Section 5 provides our empirical results. Section 6 summarizes and concludes the paper.

2. Theory and hypothesis development

A substantial stream of the literature in strategy investigates how, whether and when managerial discretion has effect on corporate performance. Another body of literature in accounting interprets the operating and stock price performance attributable to accounting figures as a consequence of executive activities and decision making behavior. We interconnect these two lines of research, by investigating the role of managerial discretion on return predictability associated with NOA in an international setting.