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The International Journal of Accounting 48 (2013) 364 – 389

The International Journal of Accounting

The Impact of Corporate Governance on the Financial Outcomes of Global Diversification

Feras M. Salama[a,*], Karl Putnam[b,1]

[a] *Accounting Department, School of Business and Management, American University of Sharjah, Sharjah, United Arab Emirates*

[b] *Accounting Department, College of Business, University of Texas at El Paso, El Paso, Texas 79968, United States*

Received 7 April 2011

Abstract

The tenets of agency theory suggest that: 1) managers may pursue investment strategies that are at odds with shareholder value, and 2) effective governance mechanisms can improve the quality of managerial decision-making and enhance the outcomes of corporate investment. Accordingly, using an agency theory lens, we hypothesize that the financial outcomes of global diversification are contingent on the quality of the multinational firm's corporate governance: high (poor) quality corporate governance is associated with positive (negative) financial consequences attributable to global diversification. Using a sample of 5985 firm-year observations over the period 2002 through 2006, we find support for our hypothesis. The results are robust to using three different measures of global diversification, three different measures of financial outcomes (one accounting-based and two market-based measures), and two econometric methods to control for the endogeneity of the diversification decision.
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JEL classification: G3
Keywords: Corporate governance; Global diversification

1. Introduction

Despite the growing significance of foreign investment to U.S. firms, research on the financial implications of global diversification is limited and the results are inconclusive. Two

* Corresponding author. Tel.: +971 6 515 2574; fax: +971 6 558 5065.
E-mail addresses: mferas@aus.edu (F.M. Salama), kputnam@utep.edu (K. Putnam).
[1] Tel.: +1 915 747 7740.

0020-7063/$ - see front matter © 2013 University of Illinois. All rights reserved.
http://dx.doi.org/10.1016/j.intacc.2013.07.003

frequently cited studies examining the economic consequences of global diversification are Bodnar, Tang, and Weintrop (1999) and Denis, Denis, and Yost (2002). To begin with, Bodnar et al. suggest that global diversification is beneficial because it provides affirm with greater opportunities to achieve economies of scale of intangible assets such research and development, thereby reducing the overall cost per unit produced. Consistent with their argument, Bodnar et al. find that global diversification is positively associated with firm value. Conversely, Denis et al. argue that the complexity associated with global investment exacerbates agency costs and magnifies the degree of information asymmetry between managers and shareholders. Accordingly, Denis et al. hypothesize and find a negative relationship between global diversification and firm value.

The lack of consensus of prior studies in terms of the economic implications of global diversification implies that 1) global diversification is a corporate strategy that could have positive or negative financial outcomes and 2) there are other factors that moderate (influence) the relationship between global diversification and firm value/performance.[2] In this paper, we suggest that the quality of the firm's system of internal corporate governance is a variable that may affect the financial outcomes of global diversification. Agency theory advocates emphasize that an adequate system of internal governance is a mechanism that works to facilitate efficient monitoring of managerial decisions (e.g., Shleifer & Vishny, 1997).As a result, it plays an important role in restricting managers' ability to pursue corporate strategies that destroy shareholder value (e.g., Hope & Thomas, 2008). In addition, Bushman, Chen, Engel, and Smith (2004) maintain that quality corporate governance alleviates moral hazard problems by assuring that managers are held accountable for their decisions and this would in turn encourage managers to direct firm resources toward positive net present value (NPV) projects.

Accordingly, the purpose of this study is to examine the impact of internal corporate governance structures on the financial outcomes of global diversification. Employing insights obtained from accounting, strategy, and finance literature, we hypothesize that when the quality of corporate governance is high, managers are less able to pursue global diversification strategies that are at odds with shareholder value. Consequently, in this case, the financial outcomes of global diversification are positive. Conversely, when corporate governance quality is poor, self-serving managers are more able to indulge in empire-building global diversification strategies that maximize their own utility and destroy shareholder value. In this case, the financial outcomes of global diversification are negative.

We test our hypothesis using a sample of 5985 firm-year observations for the period 2002–2006. To capture the strength of the firm's internal governance system, we combine a large set of board/committee characteristics which include 1) board of directors' governance quality (e.g., leadership structure, board size, board meetings, board independence, busyness of the board, and board-share ownership), 2) audit committee governance quality (e.g., audit

[2] The arguments and findings of several studies provide support for these two propositions. For example, Morck and Yeung (1991) suggest that international diversification per se does not enhance or destroy firm performance and that the financial ramifications of global diversification are influenced by the degree of intangible assets that the multinational firm possesses before expanding internationally. Other studies find that the outcomes of global diversification are impacted by the type of global diversification strategy pursued by the firm (related vs. unrelated diversification) (e.g., Doukas and Lang, 2003) and the degree of financial leverage (debt) in the firm's capital structure (e.g., Doukas & Kan, 2006).

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