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Financial accounting information, organizational complexity and corporate governance systems ☆

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Abstract

We posit that limited transparency of firms' operations to outside investors increases demands on governance systems to alleviate moral hazard problems. We investigate how ownership concentration, directors' and executive's incentives, and board structure vary with: (1) earnings timeliness, and (2) organizational complexity measured as geographic and/or product line diversification. We find that ownership concentration, directors' and executives' equity-based incentives, and outside directors' reputations vary inversely with earnings timeliness, and that ownership concentration, and directors' equity-based incentives increase

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with firm complexity. However, board size and the percentage of inside directors do not vary significantly with earnings timeliness or firm complexity.

JEL classification: G30; M41; J33

Keywords: Corporate governance; Corporate transparency; Earnings timeliness; Organizational complexity; Diversification

1. Introduction

In the U.S. and in other economies with strong legal protection of outside shareholders' rights, transparency of a firm's operations and activities to outside investors disciplines managers to act in shareholders' interests.[1] We posit that limited corporate transparency increases demands on corporate governance systems to alleviate moral hazard problems resulting from a more severe information gap between managers and shareholders, ceteris paribus. We consider two factors that limit corporate transparency to varying degrees across large public U.S. companies: (1) relatively uninformative financial accounting systems characterized by the inability of firms' GAAP earnings to explain changes in shareholder value in a timely fashion (low earnings timeliness) and, (2) firm complexity due to extensive geographic and/or line of business diversification.

We develop and test two sets of hypotheses concerning how corporate governance systems vary with the diversification of firms and the timeliness of their earnings. Our first set of hypotheses predicts that corporate governance systems of diversified firms and firms with relatively low earnings timeliness are characterized by a relatively strong link between stock price performance and the wealth of executives and directors, and by high ownership concentration, to provide incentives to increase shareholder value through monitoring and other costly activities. Our second set of hypotheses concerns how the composition of the board of directors varies with the diversification of firms and the timeliness of their earnings. We predict that, in order to enable highly effective board monitoring, the boards of diversified firms and firms with low earnings timeliness have a relatively high percentage of outside directors with (1) a strong reputation as an outside director, and (2) expertise in the firm's main industry. We also explore how board size and the percentage of directors who are insiders vary with diversification and the timeliness of earnings, but make no directional predictions.

Our hypotheses build on prior research concerning the determinants of corporate governance structures. In a seminal paper, Demsetz and Lehn (1985) conjecture that the scope for moral hazard is greater for managers of firms with more volatile operating environments. They document that ownership concentration is increasing

[1] We use the term corporate transparency to refer to the clarity of the activities and performance of the firm to outsiders.