

Corporate Governance, Information, and Investor Confidence

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Corporate governance has a major impact on investors' confidence that self-interested managers and controlling shareholders will not divert their investment to non-productive ends (Shleifer and Vishny, 1997; Claessens, 2002). Maintaining this confidence is critical for public firms because the resources and capital provided by outside investors is the life-blood of their growth and even survival. In their seminal work on the modern corporation, Berle and Means (1932) pointed out the disadvantaged situation of outside investors. In particular, shareholders in corporations do not have the expertise and/or the resources to monitor individually insiders' actions or access insiders' information on the future prospects of the firms. Building on this, the vast and influential literature on agency costs (Jensen and Meckling, 1976) highlights the consequences of asymmetric information between insiders and investors. More broadly, there are large literatures on ameliorating agency conflicts through incentive contracts (Hart, 1995) and the transmission of information by insiders to outside investors through signaling with dividends and share repurchases (Bhattacharya, 1979; Vermaelen, 1981) and disclosure through financial statements (Dye, 2001). However, the role of corporate governance is considered only implicitly in these papers.

Research on the explicit effects of corporate governance on insiders' moral hazard and information transmission is only now emerging. In particular, we have looked for research that examines the interaction of the quality of corporate governance with empirically important aspects of insiders' behavior and information transmission choices. Moreover, there has been a need to study this role of corporate governance in diverse international contexts. The studies published in this issue of CGIR move the literature significantly forward in these areas.

As we mentioned above, a major concern for outside investors is that resources can be diverted by managers for perquisite consumption (Grossman & Hart 1988), or tunneled by

controlling shareholders for their pecuniary benefit (Johnson et al., 2000; Cheung et al., 2006). In particular, the risk of tunneling has received substantial attention in the recent literature (Aslan and Kumar, 2012, 2014; Huyghebaert & Wang, 2012; Shan, 2013). The fast growing literature on tunneling has examined both theoretically and empirically the consequences of tunneling for both minority shareholders and creditors. However, the role of management in tunneling by controlling shareholders has received little attention. This is a significant gap in the literature. After all, the agency literature is largely devoted to understanding the implications of the managerial power and prerogatives. In the first paper of this issue, Zhang et al. study controlling shareholder-manager collusion in tunneling, using data from Chinese listed companies. Zhang et al. find support for the hypothesis that there is collusion between controlling shareholders and managers. While the earlier literature shows that the deviation between control and cash flow rights of dominant shareholders facilitates tunneling, this study shows that this deviation is negatively related to the pay- and turnover-performance sensitivity of managers. This is one of the first empirical analyses of the relation of controlling shareholder moral hazard (as measured by the deviation between control and cash flow rights) and managerial incentives. They also find evidence of rent sharing between controlling shareholders and management, suggesting that the collusion between them has negative consequences for investors beyond the weakening of managerial performance incentives. Furthermore, Zhang and et al. use their data to examine the variations in the controlling shareholder-manager nexus. They find that this nexus, resulting in weak performance incentives, is more pronounced in firms with lower profits and poorer economic prospects. This is an especially interesting result because it suggests a form of ‘vicious cycle,’ whereby collusion between controlling shareholders and management leads to poor economic performance that further exacerbates the incentives for rent sharing (through tunneling and otherwise depleting the resources of the firm). Analyzing these dynamics theoretically and empirically is a highly important area for future international corporate governance research

The second paper in the issue, by Luo and Salterio, examines the interaction of corporate governance with firms' choices of their information disclosure regimes. As the authors note, nearly all countries with corporate governance related regulations follow a "comply or explain" approach, wherein regulators prescribe a 'best practices' code of conduct for public firms; firms must either comply with the prescribed practices or explain any deviations thereof (Zattoni and Cuomo, 2008). This approach has wide appeal because it forces a 'disciplining framework' on the disclosures of governance practices and deviations from norms, allowing outside investors to make more reliable assessments of the implications of deviations from non-compliance based on the explanations provided by the firm. For the firm, however, this regulatory framework presents an interesting trade off (see, e.g., Adams et al., 2010). Compliance with the generalized norms and best practices may not create value and in fact may impose net costs of maintaining a non-optimal governance structure. On the other hand, deviation may also impose costs. In particular, to avoid negative investor reaction from non-compliance the firm may have to incur additional monitoring costs.

There are, of course, two different effects of the "comply and explain" approach. In the good outcome, firms can choose a tailored approach and increase value by avoiding unnecessary costs and by increasing monitoring. In the bad outcome, firms do not take advantage of the flexibility and avoid making serious improvements in governance. Bringing empirical evidence to bear on these two possible outcomes is important with obvious implications of corporate governance regulation design (the choice between flexible and strictly prescriptive regulation, for example). However, the literature is sparse on this issue. Luo and Saltiero develop a unique and innovative approach by taking seriously the value-adding potential of "deviate and explain" option. Using the Canadian "comply or explain" regime, they construct a novel board score measure based on firms' posture towards 47 'best governance practices' embedded in the Canadian governance regulations. In particular, the highest score for each governance dimensions is given to the "explain" option while the lowest is given to "non-compliance." The results are illuminating and thought provoking on several fronts. We learn about the governance dimensions that firms are most likely to drop (i.e., be

in non-compliance). The authors find a striking significant and positive relation between their unique score and firm value; that is, firms that used the “or explain” option were able to create value, which is consistent with the positive outcome of the flexible “comply or explain” framework.

In the third paper, Han et al. examine the role of corporate governance in the information transmitted through stock repurchases by firms. Stock repurchases play an increasingly important economic role in countries across the world. In the U.S., they have surpassed dividends and in 2013 represented 60% of cash payouts to shareholders (Economist, 2014). In addition, there have recently been conflicts between large activist shareholders and management regarding using cash reserves for share repurchases. The basic issue is whether stock purchases are done for benefitting equity investors. A well know argument in favor of repurchases is that they signal management’s private information on good economic prospects, that is, communicate that share prices are undervalued. However, the literature has also raised the possibility of misuse of asymmetric information – the false signaling hypothesis (see Baker et al., 2011) – where informed managers use frequent stock repurchase to send false signals on undervaluation. However, the literature has not clarified the motivation behind frequent stock repurchases. Han et al. posit that deliberate false signaling from frequent stock repurchases may reflect agency costs from asymmetric information and hence corporate governance may be directly implicated. They use a unique repurchase database from South Korea to test this interesting hypothesis. An appealing feature of their data is that Korean regulations require managers to choose among a set of possible motivations for stock repurchasing. Hence, signaling intent can be more cleanly identified compared with, say, U.S. data where the signaling intent has to be inferred and stock repurchases may be connected with other motivations.

The paper presents a number of novel findings that will move the literature forward. There is evidence that frequent stock repurchases reflect false signaling intent. The frequency of stock repurchases is related to agency costs in the predicted direction. Moreover, stronger corporate governance mitigates the false signaling from stock repurchases that are driven by agency costs. Apart from the substantial interest of its results, the study also demonstrates the empirical power of

using international data, reflecting a variety of regulatory regimes, that enhances identification and helps resolve important issues relating to corporate governance.

In the final paper, Zhang et al. analyze the moderation or mediating effects of R&D investment, the most widely used proxy for technological innovation, between corporate governance and firm performance. While the previous literature has examined the mediating effects of other firm related variables, such as refocusing strategy or mergers and acquisitions strategy, the impact of R&D has not been examined even though innovation is a fundamental driver of value creation. Conceptually, this is an important issue because it is not clear whether from the perspective of technological innovation corporate governance has direct or indirect effects on firm performance? In particular, do corporate governance mechanisms (ownership structure, managerial incentive compensation etc.) have indirect effects on performance through their relationship with R&D investment? The answer to these questions can improve our understanding of the role played by technological innovation on agency costs. Using Data from the Chinese information technology (IT) industry, Zhang et al. find that corporate governance mechanisms have indirect effects on firm performance through the mediating role of R&D investment. However, their analysis does not support the hypothesis that R&D moderates the relation of corporate governance to firm performance.

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