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Evidence on complementarity and substitution contingency in monitoring and bonding mechanisms

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ABSTRACT

Using a sample of Canadian firms during 2008–2011, we use multivariate path modeling to explore potential complementarities and contingencies that might occur between two monitoring devices, related to blockholders and institutional investors, and two other bonding devices, namely compensation plans based on EVA and Stock-options. The study reveals that, on one hand, there is a complementary effect between blockholders and EVA implementation; and on the other hand, there is a substitution effect between institutional investors and blockholders themselves, and also between stock-option plans and both kinds of shareholders. Such findings put forward at least three policy implications. First, it is worthwhile implementing EVA as a performance measure when there is many blockholders. Second, institutional investors and blockholders act as substitutes in terms of monitoring. Third, the presence of either institutional or large shareholders reduces the need to rely on bonding schemes based on stock-option plans.

1. Introduction

The influence of control mechanisms on firm performance has been an issue of great interest in a large body of finance literature, spanning more than half a century. Two main arguments may enlighten such a striking interest. First of all, the separation of principals and agents has led to acute agency problems that amazingly deteriorate firm performance. Secondly, there is a wide range of corporate governance mechanisms which intensity and efficacy vary across time, firms and countries. However, little is known about the relationship that exists between corporate governance devices themselves. Agency theory has provided two key devices to deal with agency problems: monitoring and bonding mechanisms. While monitoring mechanisms are used to oversee managers and compel them to respect owners' rights and interests, bonding mechanisms refer to the incentives offered to managers to motivate them to act in the shareholders' sake. There are several monitoring mechanisms including shareholder involvement, ownership concentration, institutional ownership, board leadership and composition, auditing, market control, etc. Bonding mechanisms typically suggest compensation schemes.

Despite extensive related studies, two main debates remain inconclusive: how well these devices work to address agency problems (Walsh and Seward, 1990; Bebchuck and Fried, 2006; Conyon, 2006; Kaplan, 2008; Locke, 2008; Hoskisson et al., 2009; Alves et al., 2016; Dah, 2016); and what kind of relationship exists between them (Westphal and Zajac, 1994; Rediker

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and Seth, 1995; Barkema and Gomez-Mejia, 1998; Coles et al., 2001; Gompers et al., 2003; Klapper and Love, 2004; Lehn et al., 2007; Linck et al., 2008; Bebchuk et al., 2009; Hoskisson et al., 2009; Firth and Rui, 2012).

Relative to the first issue, some studies have argued that both controlling and bonding mechanisms have been ineffective in curtailing agency problems and monitoring managers' self-serving behavior (Walsh and Seward, 1990). On one hand, executive compensation has become irrationally high and has increased much more significantly than firm performance (Bebchuk and Fried, 2006; Kaplan, 2008; Locke, 2008; Alves et al., 2016). This is typically noticeable during economic downturns which enable managers to hidden their opportunistic behavior and extract higher private benefits; what cuts down the firm value (Dah, 2016). On the other hand, monitoring has become ever more intense in response to new requirements of best practices of corporate governance; and hence their costs have become increasingly expensive (Conyon, 2006; Hoskisson et al., 2009). Actually, firms aim to apply good governance practices so as to get higher credit ratings, and thus to afford cheaper and larger funding (Aman and Nguyen, 2013). Consistently with the findings of Williamson (1986, 1987), the magnitude of the monitoring cost is expected to increase with the number and the quality of corporate devices to be implemented.

Relative to the second issue, many recent studies provide a contingent view of the firm and argue that monitoring and bonding mechanisms are interrelated. Some researchers have focused on the possible substitution between governance mechanisms and find that the positive effect of these controlling mechanisms on performance disappear when jointly considered (Rediker and Seth, 1995; Firth and Rui, 2012). Other researchers address the possible linkage between bonding and controlling devices and suggest that when executives are given appropriate incentives that align their interests to owners ones, controlling is needed to a lesser extent (Westphal and Zajac, 1994; Barkema and Gomez-Mejia, 1998). There is therefore a systematic balance between these governance mechanisms; and the selection of a specific corporate governance structure reveals a trade-off between costs and benefits (Linck et al., 2008; Firth and Rui, 2012). However, controlling and bonding mechanisms may work as complements rather than substitutes. This is typically true in the long term (Hoskisson et al., 2009). In fact, as long as monitoring becomes more thorough, higher payment is needed to compensate the risks borne by managers that dramatically increase in turn.

The main contribution of this paper is to focus on both sides of interdependence, namely substitution and complementarity, which might occur between monitoring and compensation devices, through the multivariate path modeling. Most previous studies either use OLS regressions (Rediker and Seth, 1995; Barkema and Gomez-Mejia, 1998; Coles et al., 2001; Gompers et al., 2003; Klapper and Love, 2004; Lehn et al., 2007; Linck et al., 2008; Bebchuk et al., 2009) or apply simultaneous equation estimations (Jensen et al., 1992; Bathala et al., 1994; Agrawal and Knoeber, 1996; Firth and Rui, 2012). This new sophisticated econometric approach allows estimating simultaneously multiple regressions including several dependent and independent variables with various natures. But above all, this technique puts in evidence potential complementarities and contingencies between the dependent variables, themselves; what allows us to draw relevant conclusions regarding the overall efficacy of corporate governance structure.

To shed some light on the issue, we would investigate a concentrated-ownership economy, namely Canadian firms, rather than a dispersed-ownership context such as American and British counterparts to which a large bulk of research has been devoted (La Porta et al., 1999; Morck et al., 2000). Our sample consists of publicly traded companies in Toronto Stock Exchange over the period 2008–2011, which provides us with a total of 424 observations. We specifically address the following issues: (1) the interdependence among controlling and bonding mechanisms; and (2) the determinants of these corporate governance devices.

The remainder of paper is organized as follows. Section 2 briefly reviews related literature. Section 3 provides data and describes empirical methodology. Results are summarized and discussed in Section 4. A conclusion follows and points out directions for future research.

2. Related literature

Within a contractual theoretical framework, there is necessarily a divergence of self-objective and interest between principal and agent; what thereby leads to agency costs and hence a welfare loss. There are at least three sources of such a divergence: managers' desire to remain in power, managerial risk aversion and free cash flow (Denis, 2001). Agency theory provides several mechanisms to reduce such a loss and to address agency problems (Jensen and Meckling, 1976). Charreaux (1997) defines corporate governance as a set of organizational devices that shape and monitor managerial discretion for the sake of the firm. These corporate governance mechanisms are no longer considered as isolated best practices devices.

In line with the contingency hypothesis of the firm, these devices may interact and complement each other; and that is the interaction of their effects or clustering of their features that make them more or less effective (Agrawal and Knoeber, 1996; Ernst, 2002; Aguilera and Jackson, 2003; Schmidt and Spindler, 2004; Lehn et al., 2007; Aguilera et al., 2008). Firms are thus argued to select among different governance mechanisms those which are most suitable and appropriate to enhance their performance given their specific characteristics and the requirements of the environment in which they operate (Coles et al., 2001; Lehn et al., 2007; Firth and Rui, 2012). Each corporate governance structure would reveal a trade-off between costs and benefits of several bonding and controlling devices (Linck et al., 2008). Complementarity arises when two or more governance devices strengthen each other in their respective contribution to achieve a specific aim while substitution stresses that the presence of once governance device is sufficient to reach such an aim.