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Weakened outside shareholder rights in dual-class firms and timely loss reporting ☆

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ABSTRACT

In this paper, we examine timely loss reporting for U.S. firms with a dual-class share structure, i.e., firms characterized by a divergence (wedge) between insiders' voting rights and cash flow rights. In our *primary* analysis, we find compelling evidence that the wedge (quantified by excess voting rights) is associated with *less* timely loss reporting for these firms. In our *secondary* analysis, in which we match our sample of dual-class share observations with a sample of single-class share observations, we find similar results. Our paper informs public policy by showing that weakened outside shareholder rights matter, even in the U.S., where, despite a strong investor protection environment, dual-class firms are less timely in recognizing bad news in reported earnings.

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1. Introduction

U.S. policy makers (such as the SEC) are cognizant of the importance of outside shareholder rights in mitigating agency costs. However, prior research has focused largely on firms with a single-class share structure. By contrast, dual-class share structure companies are characterized by a divergence between the control (voting) rights and the ownership (cash flow) rights of managers and insiders. The separation of voting rights and cash flow rights allows insiders to escape the pro rata wealth consequences of their decisions (Gompers et al., 2010). As a result, the wedge (i.e., insiders' excess voting rights) may be expected to aggravate the agency problem by facilitating the diversion of resources (private control benefits) to insiders (Claessens et al., 2002; Lins, 2003; Cronqvist and Nilsson, 2003; Masulis et al., 2009). In this paper, we seek to inform public policy by empirically analyzing the effects of a dual-class structure and the size of the wedge (excess voting rights) on asymmetric timely loss reporting (TLR), i.e., the more timely recognition of economic losses than economic gains into earnings.

Prior research suggests that timely loss reporting is useful in investor protection (the stated goal of the SEC) by addressing agency problems and making timely disclosures of any value-reducing insider activities (Bushman et al., 2004; Francis and Martin, 2010).[1] Stated differently, timely loss recognition requires reported earnings to be contingent

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[1] As an example, the acquisition of plant and equipment requires managers to estimate the asset's useful life and salvage value at the end of its useful life and to select a depreciation method. Subsequently, managers must account for the asset's impairment, if applicable. While extant standards require the asset to be written down when the carrying value exceeds its fair-market value, these standards also provide managers wide latitude in determining the amount as well as the timing of asset impairment write-down (Riedl, 2004). For these reasons, accounting standards notwithstanding, insiders exercise significant discretion over the timing and magnitude of bad news reporting.

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upon the sign (i.e., negative or positive) of the shock to firm value and thus convey information useful in contracting and for mitigating agency costs (Ball et al., 2000). Consequently, firms with more timely loss recognition are less likely to over- or underinvest, suggesting that timely loss recognition can improve managers' capital allocation decisions (Lara et al., 2010). In a similar vein, Francis and Martin (2010) argue that timely loss recognition mitigates agency problems by encouraging managers to limit further value destruction by terminating failing projects promptly rather than deferring decisions to a later generation of managers. Therefore, timely loss reporting alleviates agency problems by mitigating information asymmetry, specifically with respect to insiders' ongoing value-reducing activities through prompt disclosure to outside shareholders. Consistent with this argument, Francis and Martin (2010) find that firms with more timely incorporation of economic losses into earnings make more profitable acquisitions and are less likely to make post-acquisition divestitures.

Our interest in U.S. dual-class share structure firms stems from the fact that separation of control (voting) rights and ownership (cash flow) rights in such firms is relatively transparent. By contrast, non-U.S. firms tend to utilize relatively opaque pyramid and cross-holding structures to separate control and ownership rights and otherwise entrench corporate insiders (Fan and Wong, 2002). Moreover, by focusing on a single country (the U.S.), we are able to hold the regulatory environment constant and examine whether the control-ownership divergence of the controlling shareholders affects timely loss reporting in a country with an established reputation for offering strong protection for investors.[2]

In this paper, we argue that timely loss reporting can play a useful role in dual-class firms by alerting outside shareholders to ongoing value-reducing activities and by promoting early intervention.[3] Prior research suggests that the wedge between control (voting) rights and cash flow rights enables insiders to extract private benefits through self-dealing, excess compensation and perquisites, outright theft, or simply the pursuit of the "quiet life," without having to bear the full financial consequences of their choices (Bertrand and Mullainathan, 2003; Faccio and Lang, 2002). Recent empirical evidence (e.g., Masulis et al., 2009) also suggests that the greater the wedge, the greater the extraction of private control benefits by insiders in the form of higher CEO compensation and more frequent value-destroying acquisitions. Understandably, this type of behavior motivates insiders to operate in greater secrecy, publicly disclose as little private information as possible, exercise tighter control over information, and lower the quality of reported earnings. The argument is that insiders have an incentive to lower the timeliness of loss reporting as a means of making it harder for outside investors to monitor the performance of the firm, i.e., as a means of keeping them in the dark (uninformed) about ongoing extraction of private control benefits and other value-reducing activities that expropriate wealth away from outside shareholders.

While the prediction of a negative relation between dual-class share structure and timely loss recognition is intuitively appealing, it is plausible that no such relation exists. Insiders, by virtue of their entrenched position and relative immunity to hostile takeovers, may be less concerned about short-term adverse stock price performance and thus better positioned to focus on building longer-term enterprise value for shareholders. In other words, insiders in dual-class firms may be less subject to capital market pressures and have a reduced incentive to lower TLR.

Given these conflicting views, we attempt to shed empirical light on the relation between dual-class share structure and timely loss recognition. Specifically, we measure timely loss reporting based on Basu's (1997) model, which reflects the asymmetric timeliness in the recognition (incorporation) of economic losses in accounting income, i.e., the more timely recognition of economic losses than economic gains in current-period reported earnings. We also use Basu's (1997) time-series measure of asymmetric persistence of losses and gains as an alternative measure of timely loss reporting.

Consistent with Masulis et al. (2009) who utilize only dual-class firms in their analysis, our *primary* analysis is based only on dual-class firms. We utilize a sample of 2797 firm-year dual-class share observations from 1995 through 2002 and find that the wedge (excess voting rights) is associated with *less* timely loss reporting, i.e., *less* asymmetric timeliness in the recognition of economic losses in accounting income. This result holds even after controlling for several firm characteristics that have been identified by prior research to be relevant in understanding the variation in timely loss reporting across firms. Because firms may self-select into a dual-class share structure, we also conduct a two-stage regression analysis that controls for potential endogeneity in a firm's decision to select into a dual-class share structure. Our results are robust to Heckman, 1979 correction for sample selection bias and to the inclusion of controls for dividends (as an alternative measure of performance for dual-class firms, as suggested by Francis et al., 2005) and various corporate governance mechanisms. Our results also hold (1) for alternative measures of timely loss reporting used in prior research, and (2) when we control for whether

[2] Using data from a single country allows us to address Wysocki's (2004) criticism that, while important, cross-country studies suffer from omitted country-specific legal and institutional factors. Separately, prior research suggests that investor protection matters, i.e., stronger investor protection contributes to lower private control benefits, better matching between growth opportunities and actual investments, better firm performance, and higher firm valuation. By focusing on the U.S., we hold constant the legal and institutional environment.

[3] As noted by Gompers et al. (2010), the diversion of resources (private benefits of control) can be pecuniary or nonpecuniary. Thus, while some insiders may prefer empire building (such as pursuing value-destroying "trophy" acquisitions or "pet" negative net present value projects), others may prefer to simply enjoy a "quiet life" by avoiding difficult decisions or buying peace through higher compensation for employees (Bertrand and Mullainathan, 2003). Consistent with the notion of diversion of resources (private control benefits), some studies (e.g., Gompers et al., 2010) suggest that dual-class firms underperform single-class firms.

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