Journal of Corporate Finance 40 (2016) 1–23

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Executives' horizon, internal governance and stock market liquidity

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ARTICLE INFO

Article history:
Received 18 December 2015
Received in revised form 23 June 2016
Accepted 23 June 2016
Available online 29 June 2016

JEL classification:
G30
G34
G39

Keywords:
Executives' horizon
Internal governance
Corporate governance
Subordinate managers
Liquidity

ABSTRACT

In this article, we examine whether internal governance, the process through which subordinate managers effectively monitor the chief executive officer (CEO), can improve a firm's liquidity. Using the difference in horizons between a CEO and his immediate subordinates to measure internal governance, we show that firms with better internal governance have lower information asymmetry and higher liquidity. Further, we show that internal governance is effective in enhancing liquidity for firms with CEOs close to retirement, firms that require higher firm-specific skills, and firms with experienced subordinate managers. Our results are robust to inclusion of conventional governance measures, alternative model specifications, and different measures of internal governance and liquidity.

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1. Introduction

Internal governance is defined as the process through which subordinate managers can effectively monitor the chief executive officer (CEO) of the firm. It is the bottom-up governance mechanism that hinges upon subordinate executives' incentive and ability to provide checks and balances to affect corporate decisions. Recent literature shows that subordinates can set up a counterpower to self-serving actions of the CEO (Acharya et al., 2011; Cheng et al., 2015; Landier et al., 2009). Our contribution in this article focuses on the effect of "differential horizon" between the CEO and non-CEO executives on the firm's informational environment and liquidity.

Acharya et al. (2011) argue that CEOs with a shorter employment horizon may extract rents at the expense of the shareholders and other stakeholders inside the firm. However, there are several reasons to believe that non-CEO executives have strong incentives to focus on long-term actions. Subordinate executives have the desire to become the next CEO, especially if they are younger and see a sufficient scope for career advancement within the firm.[1] Further, their ability to withdraw their contributions can force the CEO to give in less to his/her personal benefits and act in a more public-spirited and farsighted manner (Acharya et al., 2011). Subordinate non-CEO executives also have more to lose relative to the CEO as they have more remaining

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[1] Acharya et al. (2011) report that about 80% of new CEOs are internally promoted.

http://dx.doi.org/10.1016/j.jcorpfin.2016.06.005
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years of employment, which increases the risk of finding a comparable paying job and the potential loss of income (Cheng et al., 2015). According to Acharya et al. (2011), the differential horizons between the CEO and his/her immediate subordinates and the constraints that each team imposes on the other ensure that the firm can function and survive, even if outside governance is weak.

While the impact of internal governance on investment, firm performance, and profitability has been analyzed (Aggarwal et al., 2013; Landier et al., 2013), how internal governance can improve a firm's information environment and liquidity has received little attention.[2] We hypothesize that a firm with better internal governance has lower information asymmetry and better liquidity. Previous literature contends that the subordinate managers, due to their expertise, are the most important source of private and firm-specific information and possess a great influence on a firm's decision-making process (Fama and Jensen, 1983). In fact, subordinate managers are often directly responsible for compiling value-relevant information for the firm and can foster the use of "objective" information and improve the information-production process inside the firm (Landier et al., 2009). Further, Masulis and Mobbs (2011) empirically document that the existence of non-CEO executives on the board improves internal monitoring because of non-CEO executives' firms-specific knowledge.

Not only do non-CEO executives have incentive to improve the informational environment inside the firm, but they can also leverage on their knowledge to push the CEO to provide more transparent information to the market. Cheng et al. (2015) show that non-CEO executives with longer horizon in the firm tend to provide the market with better financial reporting quality. Using the difference between retirement age and non-CEO executives' ages as a measure of subordinates' horizon, Cheng et al. find that the extent of real earnings management decreases as subordinates' horizon increases. However, subordinate managers' horizon is just one part of the story. For example, Gopalan et al. (2014) find that CEOs with short-term horizon tend to emphasize short-term firm performance. Gopolan et al. also find that the myopic CEOs have incentives to manage short-term earnings and degrade firms' reporting quality. These results pose an interesting empirical question as to how the difference in horizons inside the management team can impact the information quality, and hence, the liquidity, of the firm.

It is well recognized that better information quality and lower information asymmetry are highly correlated with improving the liquidity of a firm's shares (Bardos, 2011; Verrecchia, 2001). Liquidity is negatively related to the level of information asymmetry that results from some traders having informational advantage over others (Glosten and Milgrom, 1985; Kyle, 1985). Firms can improve stock market liquidity by adopting corporate governance standards that mitigate informational asymmetries between firms' insiders and external shareholders (Chung et al., 2010).[3] In addition, institutional investors can exert governance through trading, which increases both stocks' liquidity and price informativeness (Gallagher et al., 2013).[4]

Our analysis is divided into three main sections. First, we provide evidence on the relation between internal governance and stock market liquidity. To infer the executive horizons in a firm, we follow extant literature and measure CEO and non-CEO executive horizons using their ages (Acharya et al., 2011; Brickley et al., 1999; Dechow and Sloan, 1991; Gibbons and Murphy, 1992; Matějka et al., 2009).[5] To capture the degree of internal governance or the difference in horizons between the CEO and non-CEO executives, we use the age difference between the CEO and other top four executives as a proxy for the difference in horizons within the firm and thus, the level of internal governance. Using various liquidity measures such as turnover, percentage spread, and Gibbs estimate, we show that internal governance generally improves firms' liquidity.[6] We further show that the reduction in information asymmetry serves as a channel through which internal governance affects liquidity. Our analysis employs the Sobel (1982) mediation test and the (Amihud, 2002; Brennan et al., 2013) price impact as a proxy of information content to show that internal governance significantly increases the informativeness of stock prices and hence, the liquidity of the firm.

Measuring the level of internal governance empirically is quite challenging. Recognizing the inherent limitation of a broadly defined, multidimensional measure of horizons such as relative age difference, we also use different alternative measures of internal governance to corroborate the inference from the main analysis. Motivated by recent literature that relies on executive options grants to capture a CEO's horizon in the firm (Edmans et al., 2016; Gopalan et al., 2014), we introduce an alternative measure of internal governance based on the unexercised exercisable options of subordinates relative to that of CEOs (options ratio).[7] The options ratio allows us to compute the difference in horizons between a CEO and his/her subordinates. In addition, we also use an alternative internal governance measure that accounts for the difference in team composition across different industries. We

[2] A handful of studies echo the impact of internal governance on investment, firm performance, and profitability. For example, Aggarwal et al. (2013) empirically document that internal governance mitigates the underinvestment problem and thereby improves firm value. In addition, Aggarwal et al. find that firms with more independent executives from the CEO exhibit a higher level of profitability and higher shareholder returns following large acquisitions.

[3] According to Chung et al. (2010), the governance index that is relevant to stocks' liquidity includes governance standards mainly related to board, audit, and corporate charter that help improve firms' financial and operational transparency. Chung et al. (2010) suggest that improving financial and operational transparency decreases information asymmetries between insiders and outside investors, as well as among outside investors. Poor transparency insulates and impedes the ability of traders to discern the extent to which management can expropriate firm value through shirking, empire building, risk aversion, and prerequisites (Bebchuk et al., 2009; Gompers et al., 2003). Further, providing reliable and accurate information facilitates resource-allocation decision and enforcement of contracts for investors.

[4] Shareholders can vote with their feet through trading, even if they face barriers to voice (Admati and Pfleiderer, 2009; Edmans, 2009; Edmans and Manso, 2011). Using trading as a governance mechanism is desirable because it improves the value of the firm and leads to a more liquid trading (Edmans, 2009).

[5] The model in Acharya et al. (2011) is constructed based on a single CEO and a single subordinate. Empirical implications from their model are applied in the current study to include one single subordinate (highest paid non-CEO executive) as well as multiple subordinates.

[6] In a few model specifications, two out of the three liquidity measures are highly significant.

[7] Both Edmans et al. (2016) and Gopalan et al. (2014) use the Equilar data set that includes the vesting schedule for executives of Russell 3000 firms. We do not have access to the Equilar data set.

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