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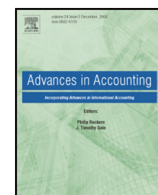

The association between voluntary disclosure and corporate governance in the presence of severe agency conflicts

Ana Gisbert *, Begoña Navallas

Universidad Autónoma de Madrid, Faculty of Economics, Accounting Department, Avda. Francisco Tomás y Valiente, 5, 28049 Madrid, Spain

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A B S T R A C T

Agency conflicts between different types of investors are particularly severe in the presence of high family and block-holder ownership. By focusing on a setting characterised by high ownership concentration, we study the role of independent directors in promoting transparency through increased disclosure. In our tests, we use a sample of Spanish firms and, consistent with prior work, show that the presence of these directors is strongly associated with increased voluntary disclosure. Additionally, we find that when an executive director takes on Chair responsibilities the level of voluntary information is reduced, creating potential conflicts with the role of independent directors. Our results suggest that a strong legal framework holds firm-level clashes of interest in check. We conclude that this regulatory environment can create sufficient incentives to bring together the interests of minority and majority shareholders and guarantee an efficient monitoring role of independent directors. However, results suggest that other mechanisms should be reinforced in order to improve the role of governance control on agency relationships, particularly in the case of the concentration of Chair and executive responsibilities.

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1. Introduction

There is an ongoing debate on the joint role of high quality financial information and corporate governance provisions in reducing information asymmetries and ameliorating agency conflicts. Recent work puts forward arguments suggesting that these mechanisms are both substitutes (Bushman, Chen, Engel, & Smith, 2004) and complements (Ahmed & Duellman, 2007). In our paper, we contribute to this literature in two specific ways. First, we study the relationship between corporate governance and information quality from a broader perspective by focusing on voluntary disclosures. Second, we take into account that the performance of these mechanisms is greatly influenced by the legal and institutional setting in which firms operate. There is little prior evidence on how institutional factors may moderate the link between information quality and corporate governance mechanisms.

Our aim is to shed additional light on this association by focusing on a setting typified by high ownership concentration, and consequently, serious agency conflicts between controlling and minority shareholders (Shleifer & Vishny, 1997). We specifically look at the role of independent directors as a way to enhance information transparency through increased voluntary disclosure. The decision to increase this disclosure (and transparency) is predicted to act as a safeguard to the interests of minority shareholders.

Against this backdrop, we test the hypothesis that the presence of independent directors increases voluntary disclosure of information, thus protecting minority shareholders, even when there is high ownership concentration. Additionally, we look at whether the presence of a significant block-holder affects the role of independent directors. Finally, we test whether the legal framework plays a decisive role in guaranteeing the appointment of truly independent professional directors and in promoting positive complementarities between these control mechanisms.

Fama (1980) and Fama and Jensen (1983) identify outside independent directors as being essential to the effective monitoring and advising role of corporate boards. This monitoring role can be exercised in multiple ways. One method is by enhancing corporate transparency and accountability through alternative reporting devices, such as management forecasts, press releases or additional disclosures in the annual report, all of which reduce the costs inherent to the agency relationship (Healy & Palepu, 2001). The current mandatory financial disclosure model is considered imperfect as it does not always provide the information demanded by users. It is precisely these perceived short-comings in the current business model that have led professional accounting organizations and regulators to increase voluntarily disclosed information in annual reports (Beattie, McInnes, & Fearnley, 2004).

The monitoring role of independent directors may be either enhanced or compromised by certain institutional and firm-specific characteristics. The presence of a majority shareholder can prevent independent directors from performing their control role properly due to, among other reasons, the risk of collusion between the majority shareholder and the independent director (Patelli & Prencipe, 2007). As Cheng and Jaggi (2000) argue, the appointment of independent directors in family-controlled firms may be influenced by personal ties that affect

* Corresponding author. Tel.: +34 91 4974687; fax: +34 91 4978598.
E-mail addresses: ana.gisbert@uam.es (A. Gisbert), b.navallas@uam.es (B. Navallas).

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their independence and in turn, their ability to improve disclosure and effective monitoring. However, it can also be argued that companies with either a high concentration of outside ownership or those that are family-controlled are more likely to appoint highly respected independent professionals to improve transparency and the firm's reputation in order to reduce the costs of the agency relationship that exists between majority and minority shareholders (Shleifer & Vishny, 1997). In any case, we expect the legal framework and enforcement mechanisms protecting minority shareholders to play a significant part in this relationship, guaranteeing the appointment of highly qualified independent professionals and creating mechanisms that make information more transparent in firms with high ownership concentration.

Most of the prior empirical literature in this area has looked at either Anglo-Saxon or Asian countries. Little research has been done on other continental European countries (Babio & Muiño, 2005; Patelli & Prencipe, 2007) where institutional differences, particularly in ownership structures and legal enforcement mechanisms, may lead to significant variations in the reported complementarities between corporate boards and information disclosures in the governance process.

Spain is an interesting framework in which to test these complementarities, because it is characterised by high ownership concentration and a significant proportion of listed family-controlled firms (Faccio & Lang, 2002). Family block-ownerships and "dominant" shareholders are commonly present in listed Spanish firms, where the latter control an average of 30% of the share capital. At the same time, the recent change[1] in this legal framework has not only promoted transparency in listed firms but also guaranteed the presence and independence of non-executive directors. In addition, in line with the idea that agency conflicts are particularly severe in the chosen setting, prior evidence on the effectiveness of independent directors in Spain has offered mixed results, suggesting that independent boards may have fallen short in their monitoring role (García Osma & Gill de Albornoz, 2004).

Spain is therefore in a good position to contribute to the debate on whether the independent directors' monitoring role is impaired or enhanced in the context of high ownership concentration (Patelli & Prencipe, 2007). Detailed information on a firm's ownership and governance structures can be manually collected through the Spanish Corporate Governance Code (CGC henceforward) which requires the identification of non-executive directors in two separate categories: gray[2] and independent directors. Additionally, financial disclosure requirements have been traditionally less specific than in other countries (i.e. the UK or the US[3]) allowing firms more discretion and the freedom to identify the main determinants of disclosure.

Based on a sample of 62 listed Spanish firms, we create an unweighted hand-collected voluntary disclosure index based on 76 items related to the information disclosed in the annual reports. The reduced size of the Spanish capital market allows us to create a self-constructed index, thus avoiding sample selection bias related to analysts' disclosure indexes. Following prior work, together with the proportion of independent directors we control for other governance variables: the size of the board of directors, the doubling up of executive and Chair responsibilities, the degree of ownership concentration and the existence of a significant block-ownership. We also look into other relevant firm-specific determinants of voluntary disclosure.

Empirical results confirm that even in a context of high ownership concentration, with a relatively significant presence of blockholder share capital, independent directors affect the quantity of voluntary information disclosed among listed firms. Therefore, capital concentration does not outweigh the role of independent directors, whose presence enhances transparency and accountability through reporting information beyond that required by accounting regulations. The results not only contribute to the literature and debate on the complementarities between information and governance mechanisms in the agency relationship, but also suggest the need to develop strong legal and enforcement safeguards that guarantee the appointment of genuinely independent directors. In fact, results suggest that even in a strong regulatory environment, the effectiveness of governance mechanisms should be periodically tested to assess potential improvements. The empirical analysis reveals that, in spite of the effect that independent directors have on disclosure, the duality of executive and Chair responsibilities negatively affects transparency, creating potential conflicts with independent directors.

We contribute the existing literature on this topic by looking at the complementary role of independent and voluntary corporate disclosure in a context where agency problems are severe. In particular, we focus on a setting typified by high ownership concentration, where the conflict of interests between minority and majority shareholders may limit the monitoring role of independent directors and therefore, the beneficial complementarities between governance mechanisms and financial information.

The remainder of this paper is organized as follows. Section 2 reviews the prior literature on corporate governance and voluntary disclosure and formulates the research hypotheses. Section 3 describes the data collection, sample selection procedure and introduces the information requirements for corporate boards. Finally, Sections 4 and 5 describe the research method and results. Section 6 concludes.

2. Corporate governance and voluntary disclosure: developing the hypotheses

2.1. Independent directors and disclosure

A good corporate governance system is a key element in optimising the performance of a business in the best interests of shareholders, limiting agency costs and favoring the survival of corporations (Fama & Jensen, 1983). The board of directors is one of the most important internal controls where external independent directors play a key role in shareholders' interests, "*carrying out tasks that involve serious agency problems*" between managers and shareholders (Fama, 1980; Fama & Jensen, 1983).

From this premise, since the beginning of the 90s,[4] an increasing number of countries have started to work on the development of CGCs to promote confidence in financial reporting and governance mechanisms in a context of increasing globalization of capital markets, where small investors have been gaining importance. Following academic and professional recommendations, CGCs refer to two main categories of directors: executive and independent non-executive directors. While the former have the knowledge and expertise on how the firm is run, the latter play an advising and monitoring role. Non-executive directors are determinant in reducing the costs of the agency relationship. However, due to the relevance of ownership participation on corporate

[1] The enactment of the Transparency Act in 2003 (26/2003) reinforced transparency and information requirements on corporate boards. Since its enactment, firms are required to file a corporate governance report, giving detailed information on their boards' structure. Boards must comply with the recommendations of the CGC.

[2] Rosenstein and Wyatt (1990, p. 235) define gray as outside directors "*family members of insiders, attorneys whose firms represent the firm, investment or commercial bankers whose firms have relationships with the firm, consultants to the firm and directors who personally or through their employers have substantial business dealings with the firm*". Gray directors are the non-executive directors representing majority shareholders while independent directors represent small investors' interests.

[3] As Luo, Courtneay, and Hossain (2006) explain, Verrecchia (2001) suggests that due to the rich US disclosure environment, empirical studies on disclosure based on US firms are unlikely to discover substantial first order effects of voluntary disclosure on information asymmetry.

[4] Following the publication of the UK Cadbury Report in 1992, the majority of the developed countries published similar Codes of Conduct dealing with the structure of the boards of directors. 1994: Canada; 1995: Australia, France and the European Union; 1996: The Netherlands; 1997: Japan and EE.UU.; 1998: Spain, Belgium Germany and Italy; 1999: Greece, Ireland and Portugal. 2000: Denmark. 2001: Sweden; 2002: Austria; 2003: Finland and New Zealand; 2004: Norway. The European Corporate Governance Institute offers an overview and free access to all the Corporate Governance Codes around the world. http://www.ecgi.org/codes/all_codes.php.

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