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Managerial Manipulation, Corporate Governance, and Limited Market Participation

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Abstract

The low fraction of U.S. households participating in equity markets, despite the sizable equity premium, has been referred to as the stock market participation puzzle. We explore a part of this puzzle by examining the role of managerial manipulation in accounting for the properties of stock market participation. We show that when investors have heterogeneous beliefs about managerial manipulation, investors who are relatively pessimistic about reporting quality consider stock prices unjustified by the underlying firm value and rationally withdraw from the stock market, giving rise to limited market participation in equilibrium. Our model also suggests that tightened accounting standards have the effect of reducing the dispersion of investor beliefs regarding financial reporting and thus help encourage stock market participation. Consistent with this idea, we find that stronger accounting and governance policies are associated with higher market participation across countries.

Keywords: Managerial manipulation, Corporate Governance, Accounting standards, Limited stock market participation

JEL Classifications: D82, D83, G12, G14

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