



Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

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

Top managerial power and stock price efficiency: Evidence from China[☆]

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ARTICLE INFO

JEL classification:

G12
G14
G34

Keywords:

Managerial power
Stock price delay
Accounting quality
A-shares
China

ABSTRACT

Using higher top managerial ownership, occurrence of CEO duality, and lower ownership of the controlling shareholder to proxy for higher top managerial power in China's A-shares, we find firms with higher top managerial power have higher stock price delay after controlling for liquidity and investor attention variables. Moreover, top managerial ownership of SOE firms exhibits a lower influence on stock price delay than top managerial ownership of non-SOE firms, suggesting top managers' promotion incentive in SOE firms has the opposite effect to their equity incentive on stock price efficiency. Furthermore, our findings show that firms with higher top managerial power component of stock price delay exhibit lower quality of accruals, spend more time to release financial reports, and have higher chances of financial misconduct and that accounting quality measures associated with top managerial power significantly explain stock price delay, indicating top managerial power influences stock price efficiency through the accounting quality channel. Finally, our evidence shows that the Split-Share Structure Reform initiated in 2005 increases the influences of both top managerial ownership and ownership of the controlling shareholder on stock price delay and suggests that the anti-corruption campaign launched in 2012 restricts financial manipulations from top managers whereas decreases the incentives of the controlling shareholder to monitor top managers.

1. Introduction

Top managers are the major agents for maximizing value for their principal shareholders. However, when making crucial decisions for the company, those managers are often faced with the dilemma of whether to maximize shareholders' value or to appropriate shareholders for their own personal benefits. A key factor in these decisions is how much power those managers have. If top managers of a firm have equity positions and are faced with less monitoring from shareholders, they may have stronger equity incentives to manipulate earnings to maximize their own benefits, as shown by Cheng and Warfield (2005)¹. Moreover, if the CEO of a top management team is also the chairman of the board of directors, the CEO and his/her management team will have more decision power at their discretion. Therefore, for a firm with higher top managerial ownership, occurrence of CEO duality, and lower

[☆] All errors are ours. We thank participants at the 2015 conference on cross-strait banking and finance. Ping-Wen Sun gratefully acknowledges the financial support from the National Natural Science Foundation of China (No. 71463018).

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¹ Cheng and Warfield (2005) hypothesize that managers with high equity incentives are more likely to sell shares in the future and this motivates these managers to engage in earnings management to increase the value of the shares to be sold.

ownership of the controlling shareholder, it is easier for its top managers to manipulate the firm's accounting numbers to maximize their own benefits. Likewise, since the accounting quality of a firm with higher top managerial power may be worse than other firms, the firm's stock price efficiency will also be worse according to Callen et al. (2013). In this study, we empirically examine the potential link between top managerial power and a firm's stock price efficiency and explore whether accounting quality provides a channel through which top managerial power may influence stock price efficiency. If there is a significant relationship between top managerial power and stock price efficiency, regulatory institutions or board of directors can identify ways to adjust top managerial power to improve a firm's stock price efficiency. By examining China's A-shares, we show that there is a significant and negative relationship between top managerial power and stock price efficiency, suggesting that restricting top managerial power can improve a firm's stock price efficiency and further lower its cost of equity capital.

China's A-share market fits well for our study due to the following features. First, firms listed on China's A-shares market can be separated into state-owned enterprise (SOE) firms and private firms. In addition to the common equity incentive to maximize personal benefits of top managers in a private firm, top managers of an SOE firm also have the promotion incentive to perform well to maximize shareholders' wealth. Therefore, the two different controlling types of China's A-shares help to characterize the relationship between top managers' differing incentives and stock price efficiency from the top managerial ownership perspective. Second, China's A-share market experienced two major regulation changes during our sample period from 2004 to 2015. The two major regulation changes (the 2005 Split-Share Structure Reform and the 2012 anti-corruption campaign) can serve as exogenous shocks to China's A-shares for us to more clearly explore how the regime change may influence the relationship between top managerial power variables and stock price efficiency. These changes can also suggest how to design a better top managerial power structure to improve a firm's stock price efficiency.

Finkelstein (1992) describes top managers' power from four dimensions: structural power, ownership power, expert power, and prestige power. Our study focuses on top managers' structural and ownership power. According to Finkelstein (1992), structural power is based on formal organizational structure and hierarchical authority, and the strength of a manager's position in the agent-principal relationship determines ownership power. Considering the current governance structure of China's A-shares, we identify three important factors which determine top managerial power: top managerial ownership, CEO duality, and ownership of the controlling shareholder. Top managers in our study include the CEO, CFO, secretary of the board, and deputy general managers, and higher top managerial ownership means higher ownership power. In addition, when the CEO and chairman of the board is the same person, the CEO and his/her management team can make more decisions at their discretion and therefore have more structural power. Finally, higher ownership of the controlling shareholder means more monitoring from the controlling shareholder to restrict top managers' ownership power.²

To measure stock price efficiency, we use the market-wide news portfolio stock price delay proposed by Hou and Moskowitz (2005) as our major proxy. In addition, we also follow Callen et al. (2013) to calculate the firm-specific news individual stock price delay as another proxy for price efficiency. After controlling for liquidity variables (such as the percentage of non-tradable shares, dollar trading volume, and number of trading days) and investor attention variables (such as institutional ownership, analyst coverage, number of employees, and number of shareholders), we find that top managerial ownership and the occurrence of CEO duality significantly and positively correlate with stock price delay, while ownership of the controlling shareholder significantly and negatively explains stock price delay. Collectively, our findings suggest that higher top managerial power proxied by higher top managerial ownership, occurrence of CEO duality, and lower ownership of the controlling shareholder will lead to lower stock price efficiency. Moreover, we also observe that the positive relationship between top managerial ownership and stock price delay weakens for SOE firms, suggesting the promotion incentives of top managers in SOE firms have the opposite effect as equity incentives on stock price efficiency.

We next explore what could be the channel through which top managerial power influences stock price delay. Cheng and Warfield (2005) find a positive link between managers' equity incentives (arising from stock-based compensation and stock ownership) and earnings management. Callen et al. (2013) document accounting quality variables, such as accrual quality, special items, earnings surprise, and annual reports' lexical properties, such as Li (2008)'s FOG score and the length of annual report. These researchers observe that these variables significantly explain stock price delay, showing that accounting quality strongly correlates with stock price efficiency. Hence, we conjecture top managers with higher power will have more equity incentives to manipulate earnings and decrease their company's accounting quality accordingly. Consistent with our hypothesis, we observe that accounting quality variables, such as accrual quality, total number of days needed to release quarterly and annual reports, and occurrence of financial misconduct, all significantly explain the top managerial power component of stock price delay and that the accounting quality measures associated with top managerial power significantly explain stock price delay (after controlling liquidity and investor attention variables). This finding suggests top managerial power influences stock price efficiency through accounting quality.

Finally, we investigate whether the 2005 Split-Share Structure Reform and the eight rules promulgated by the Political Bureau of the Central Committee to get rid of corruptions in December 2012 had any impact on how top managerial power influenced stock price efficiency. For the 2005 Split-Share Structure Reform, our results show that once a firm has completed the Reform, top managerial ownership has greater positive explanatory power on stock price delay. This finding suggests that once the firm has more outstanding tradable shares, top managers will have more equity incentives to manipulate earnings, which will cause lower stock price efficiency. Similarly, ownership of the controlling shareholder also has more positive explanatory power on stock price delay

² Bhagat and Bolton (2008) contend that higher stock ownership of board members and CEO-Chair separation are associated with better corporate governance and find those proxies are significantly positively correlated with better contemporaneous and subsequent operating performance.

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