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Corporate governance, firm value and risk: Past, present, and future

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ABSTRACT

This paper, which serves as the lead article for this special issue of the Pacific-Basin Finance Journal published in conjunction with the 5th FMCG Conference 2014, reviews and comments on the current state of and potential for future research on the linkage between corporate governance and risk. The corporate governance–risk nexus is founded on the fundamental premise that corporate governance regulation primarily aims at curbing opportunistic managerial behavior and excessive risk taking. Accordingly, we discuss the key work on managerial risk taking, idiosyncratic risk, information risk, accounting opacity, executive compensation, directors and shareholder activism and finally governance, risk and value creation in a way that gives strong hints on possible future research directions across this broad academic landscape. Such coverage dovetails nicely with the special issue content featuring twenty one papers on the theme "Governance and Risk". As such, our paper naturally concludes with a brief roadmap of the papers published within.

1. Introduction

The impact of corporate governance is diverse and resounding. Corporate governance improves the timeliness of financial information, helps combat accounting fraud, enhances transparency in reporting, and entrusts responsibility to the top corporate officials in the case of non-compliance. There are various first order relationship networks connecting corporate governance and firm value creation. Arguably, the nexus between corporate governance and risk is one of the most important first order linkages which explains the ultimate link between corporate governance and the maximization of firm value. The nexus between corporate governance and risk stems from the fundamental proposition that corporate governance can deter managerial opportunistic behavior and excessive risk taking.

However, such a relationship can also take place via a number of channels including managerial ownership (Holderness and Sheehan, 1988; Mehran, 1995), compensation structure and entrenchment behavior (Eisenmann, 2002; Kim and Lu, 2011); accounting opacity and restoring trust building (Baber et al., 2012; Chakravarthy et al., 2014; Dechow et al., 1996; Farber, 2005; Klein, 2002; Krishnan, 2005); managerial risk taking (Bargeron et al., 2010; Chen and Ma, 2011; Coles et al., 2006; Garvey and Mawani, 2005; John et al., 2008; Laeven and Levine, 2009; Nguyen, 2011; Pathan, 2009; Wright et al., 2007); and shareholder activism (Admati and Pfleiderer, 2009; Ertimur et al., 2011; Karpoff et al., 1996; Smith, 1996). Our review and discussion on the key work on executive compensation, directors and shareholder activism, managerial risk taking, idiosyncratic risk, information risk, and accounting capacity, provide strong signposts on possible research directions across these broad academic landscapes.

We also discuss in turn twenty-one papers published in this special issue of *Pacific-Basin Finance Journal*, sourced from the Financial Markets and Corporate Governance Conference in 2014. Each of these papers along with our review and discussion, advances our

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understanding on the important research question of how governance mechanisms affect the firm's risk level vis-à-vis the value of the firm. Throughout the paper we keep the focus on linking a wide spectrum of issues relating to the broader corporate governance framework in pursuit of augmenting new research dimensions such as the proposition of a value maximizing disclosure equilibrium.

Our paper proceeds as follows. We begin in Section 2 by examining the impact of corporate governance and managerial risk taking. Section 3 presents the link between corporate governance, information risk, and liquidity. Section 4 discusses the role of corporate governance in reducing accounting scandals. Section 5 discusses the role of managerial ownership, compensation structure and entrenchment behavior in risk-taking by firms. We present the role of corporate governance in the context of risk-taking by financial firms in Section 6. Section 7 presents the link between corporate governance and firm value. Section 8 outlines suggestions of a future research agenda. Section 9 concludes the paper by briefly outlining the contribution of the papers published in this special issue.

2. Corporate governance and managerial risk taking

What are the economic implications of stronger governance achieved through higher investor protection, especially with regard to the potential impact of risk taking by firm managers? The literature in this area is divided. The argument for a positive investor protection-risk taking linkage is built on the fact that, other things being equal, managers always try to pursue their self-interest. John et al. (2008) argue that the risk choices are affected not just by the insiders' or the managers' explicit ownership and compensation structures, but also by the private benefits that they can capture, including the corporate cash flows that they plan to divert to themselves. They suggest that investor protection dampens the magnitude and the importance of private benefits to insiders, resulting in less forgoing of positive net present value risky projects. Shleifer and Wolfenzon (2002) develop a model and demonstrate that firms are larger, more valuable, and more plentiful, dividends are higher (and diversion of profits lower), ownership concentration is lower, and stock markets are more developed in countries with better protection of shareholders. John et al. (2008) suggest that arguments can also be made for a negative relationship between investor protection and risk taking. For example, the reduction in dominant shareholders' presence may result in greater managerial discretion to implement conservative investment policies, and this can give rise to a negative relation between investor protection and risk-taking. However, using both a cross-country panel and a US-only sample, John et al. (2008) examine the relationship between investor protection and the risk choices in corporate investment and show that corporate risk-taking and firm growth rates are positively related to the quality of investor protection.

Bargeron et al. (2010) examine whether risk-taking by publicly traded US companies declined significantly after adoption of the Sarbanes–Oxley Act in 2002 (SOX). The study finds that after SOX there is a significant reduction in investment, as measured by capital expenditure, by US firms as opposed to their non-US counterparts. Moreover, US firms have increased their cash holdings, representing a non-operating and low risk investment. Furthermore, US firms equity risk has also declined compared to non-US firms. Bargeron et al. (2010) suggest that the magnitude of the risk decline is related to several firm characteristics, including pre-SOX board structure, firm size, and R&D expenditure. They further document a decline in investment which is greater for larger firms, firms with more R&D expenditures, and firms with less independent boards in the pre-SOX period. They argue that the key driver is the costs of complying with SOX. Their evidence is consistent with the proposition that SOX discourages risk-taking by US public companies.

Dey (2010) in a commentary on the work of Bargeron et al. (2010) argues, however, that the effect of SOX in reducing risk taking by managers might not hold if one considers that having independent directors does not necessarily increase the cost of acquiring information on risky projects. This is because the primary goal of SOX is to improve corporate transparency by providing more timely and reliable information. Therefore, it can reduce the cost of information acquisition by independent directors. Moreover, research suggests that the effectiveness of outside directors depends on the information environment, and when outside directors can acquire information at relatively low cost, they can be effective (Adams and Ferreira, 2007; Raheja, 2005). Moreover, Dey (2010) argues that one of the implications of better policing by independent directors is taking on fewer negative NPV projects. This does not necessarily equate to less risk-taking. Furthermore, one of the primary goals of SOX is to prevent fraud by executives undertaking a host of mechanisms. Post SOX with greater accountability in place, independent directors are less likely to scuttle risky projects.

Cohen and Dey (2013) extend the work of Bargeron et al. (2010) to examine the mechanism(s) through which SOX affects corporate investment strategies, CEO incentives, and risk-taking behavior. In general, Section 302 of SOX requiring CEOs and CFOs to certify financial statement information coupled with other provisions increase the legal and political exposure for directors. Therefore, the obvious manifestation of such regulation is an overall decline in corporate risk-taking behavior (Bargeron et al., 2010). Further, increased litigation risk could also encourage boards to reduce the level of risk taken by their corporations and change the reward structure accordingly. Cohen and Dey (2013) document that the passage of SOX was followed by a significant decline in performance- and incentive-based compensation awarded to CEOs, which were in turn associated with a decline in risky investments by corporations. They also find evidence that the changes in investments are related to lower operating performances of firms, suggesting that these changes were costly to investors. Their findings demonstrates how corporate governance regulation interacts with firms' and managers' incentives, and ultimately affects corporate operating and investment strategies.

King and Wen (2011) examine the relation between the CEO ownership, overall corporate governance structure and managerial risk-taking behavior. Using a simultaneous equations framework, they show that strong (weak) bondholder governance is often combined with weak (strong) shareholder governance. Additionally, strong bondholder governance leads to more low-risk investments; while, weak shareholder governance encourages high R&D expenditures. They also show that risky (conservative) investment policy results from a weak (strong) overall corporate governance structure. However, a governance structure either with strong (weak) bondholder but weak (strong) shareholder governance suggests mixed implications for risk-taking behavior. Kim and Lu (2011) study the relation between specific governance mechanisms such as CEO ownership in affecting firm value and risk taking. Generally,