Equity-Based Compensation to Outside Directors and Management Earnings Forecasts

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Abstract: We examine the relationship between equity-based compensation to outside directors and management earnings forecasts. Since equity-based compensation facilitates the alignment of interests between outside directors and shareholders, we predict that it also provides enhanced corporate governance to oversee management earnings forecast (MF) disclosures and reduces information asymmetry. We find that both the proportion and the amount of equity-based compensation to outside directors increase the quality of MFs. In addition, market reactions to MF disclosure are stronger when outside directors are awarded with more equity-based compensation. The results seem to indicate that an increase in equity-based compensation improves the monitoring function of outside directors and mitigates information asymmetry.

Key Words  Equity-based compensation  ·  Management earnings forecast  ·  Information asymmetry  ·  Corporate governance

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1. Introduction

Separation of management and ownership creates agency problems. To mitigate these problems, investors delegate their decision rights to a board of directors as well as to top management. Fama and Jensen (1983) argue that a firm’s decision process is separated into four steps: (1) initiation of proposals, (2) ratification of the proposals, (3) implementation of the ratified decisions and, (4) monitoring of agents’ execution. The board of directors is usually in charge of processes (2) and (4), which is referred to as ‘decision control’. The top managers are generally involved in (1) and (3), referred to as ‘decision management’. Transparent financial disclosure fills the information asymmetry gap between investors and managers, helping investors make sound decisions. The presence of independent outside directors on the board assists the firm in improving its quality of financial information disclosure. However, the independent outside directors also serve as agents to investors. Certain natural questions arise from this situation: what makes the independent outside directors effectively exercise their decision control rights? Do more incentivized outside directors better monitor managers when managers disclose financial information? Do two boards that have the same director characteristics but different compensation schemes monitor equally effectively? In this paper, we examine whether equity-based compensation to outside directors is related to managers’ decisions on voluntary information disclosure, namely, management earnings forecasts (MFs). We also investigate whether the market responds differently to MF disclosures made by firms with different outside director compensation schemes.