

2 Theoretical Foundation and Previous Research Approaches

2.1 Theoretical Foundations of Corporate Disclosures

2.1.1 Asymmetric Information and Agency Cost Theory

Akerlof's description of „Lemon Markets“ (Akerlof, 1970) is not only the basis for a critical reflection of the working mechanisms of markets and their efficiency. His theory also sets the fundamental theoretical basis of corporate reporting.

Akerlof takes the used car market into consideration to explain the problem of quality uncertainty. Here, the person who intends to sell a car has extensive knowledge about the specific conditions of the car. The quality of a car varies for instance by the frequency of maintenance, the accident history and the owner's driving style. The potential buyer of a car cannot verify those features because many mechanical parts are hidden from view or in general not provable under normal circumstances.

This concept of asymmetric information can surely not only be observed at the used car market. However, the conclusion can be drawn that sellers with above-average-quality goods will tend to leave such a market. The reason is that buyers' best guesses for a given product under asymmetric information is that it is of average quality and accordingly they are only willing to pay the price of a product of known average quality.

This means from a theoretical point of view that in the worst case the interaction between quality heterogeneity and asymmetric information can lead to the disappearance of a market. Comparable market characteristics are also described by Gresham's Law which is one of the most traditional economic principles. (Giffen, 1891)

As there exist many markets with the (initial) tendency of asymmetric information and the selling side is surly not willing to accept prices that fall below the quality of the product in the long run, approaches were developed to reduce information asymmetry and its negative impact on markets.

This objective can be achieved by establishing rules that force market participants to exchange information or through voluntary information exchange. In both cases the verification of the given information are a critical success factor.

The transfer of the concept of asymmetric information to the field of corporate report-

ing can be described as followed. In many cases, companies are owned and managed by different (groups of) persons. While the managers are responsible for the business activities, the owners (or investors) finance the company's operations. Thanks to their activities and position, managers have a deeper knowledge about the situation of the company at the market, their own managing skills and potential operating or even financial problems of the company.

At the same time, the owners have a lower level of information about these issues. By analogy with Akerlof, information asymmetries can be observed. Within this context, the described problem is named Principle-Agent dilemma under the condition that both parties are maximizing their own benefits (Jensen and Meckling, 1976). This theorem is based on Akerlof's description of "lemon markets".

The existence of asymmetric information in the context of companies and investors causes several problems. The uncertainty of the investors about the situation of the company could lead to adverse selection which depends on the level of information asymmetries and the investors' attitudes towards uncertainty.

This ex ante problem of information asymmetry reduces the financing activities or could in the worst case lead to a breakdown of the financial supply. Irrespective of the exact result, the financial supply would deviate from Pareto efficiency as long as the investors are not affine to uncertainty. This is the first part of the so called agency costs (Jensen and Meckling, 1976). Generally spoken, for the case, that actions, which are useful for the principal yet costly for the agent, occur, these deviations from the principal's interests are called agency costs.

In addition to adverse selection, the second group of problems that arise by the principal-agent dilemma can be summarized by the term moral hazard. These problems occur when the management is already established. In general, moral hazard arises when a party is willing to take risks or to conduct activities that would not be accepted without knowing that the potential costs or burdens are taken in whole or in part by others. While the acting party has the chance to receive (partly) the positive consequences of these activities, the responsibility for a negative outcome is mainly taken by the other party.

In economic theory, moral hazard is regarded as a special case of information asymmetry because it can only occur if one party is isolated from risks and has more infor-

mation about the potential consequences of the activities than the other. A further precondition is that a complete monitoring is impossible.

Applied to the situation of managers and agents on a corporate level, agents may have an incentive to decide for activities that are inappropriate from the viewpoint of the principal because their risks are limited to losing their jobs, they have a deeper knowledge about potential consequences of their acting and usually they cannot be completely monitored.

There exist several specifications of these ex post conflicts and approaches to reduce their negative impacts for instance by implementing contracts that aim to align the interests of the principal and the agent (Grenadier and Wang, 2005). These approaches propose methods like profit sharing to reduce the divergence of interests.

Apart from setting incentives to align the different interests, the reduction of information asymmetries between the involved parties leads closer to a perfect market and its benefits. Corporate disclosures offer an opportunity to reduce this asymmetry by improving the knowledge of the principals.

In order to reach this goal, the agents have to publish reliable information about the situation of the company and their activities. These disclosures can be either published on a voluntary basis or the agents are obliged to report on a regular basis. As long as the agents are interested in improving the market situation into the direction of a perfect market, disclosure obligations are not necessary.

Yet the agents may also benefit from information asymmetries and their interests to publish information are limited to that degree which makes the investors willing to finance their activities while the future risks are hidden. Consequently, compulsive reporting standards that set a minimum quality level regarding corporate disclosures have to be established.

In practice, nothing else is done by regulatory authorities. Nevertheless, voluntary reporting does not vanish. There is a large scope of activities that make voluntary reporting still relevant due to branch specific features that cannot be respected by regulatory authorities or it can be seen even used as an advantage regarding the competition for financial supply. These issues will be discussed thoroughly in a further chapter.

Disclosures provide the opportunity for corporate entities to signal superior quality and attractiveness compared to competitors at the market. This aspect may vary on the na-

ture of reporting (voluntary or obligatory), benchmarking aspects and other factors. Analogously, the agency costs are supposed to vary on the legislative system (statutory vs. common law) or contractual issues (Jensen and Meckling, 1976).

This consideration shows that already the simple relationship between two actors in the light of asymmetric information causes demanding challenges and environmental issues increase this complexity extraordinary.

The original corporate governance model is just based on the dilemma between principal and agent as well as the control over the agency costs (Jensen and Meckling, 1976). Nevertheless, agency costs do also play a role in more situations, companies are confronted with. A vast literature on agency-theoretical explanations has been published over the last decades.

The financial leverage of a company was identified to reduce agency costs through the threat of liquidation that is connected to personal losses to managers like reputation or salaries (Williams, 1987). Moreover, the pressure to generate cash flows to make interest payments also enhances this effect (Jensen, 1986). But as already described by Jensen and Meckling (1976), the effect of leverage on the agency costs is expected to be non-monotonic.

This means that at low levels of leverage, the described positive incentives for managers reduce the agency costs yet this effect is reduced at high levels of leverage where bankruptcy become more likely. This theorem is based on a separate consideration of the agency costs that are connected to the debt and the equity. In the last case, the agency costs of debt overwhelm the agency costs of equity. Consequently, the total agency costs increase.

In addition to effects that arise from the capital structure, even more aspects that have an impact on agency costs are known in the area of corporate finance. It is discussed and empirically tested that a high dividend yield compared to corporate earnings lower agency costs (Rozeff, 1982). This effect is comparable to the effect of interest rate payments as described above. However, the raise of transaction costs of external financing reduces this positive impact and leads again to the question of the perfect capital structure of a company.

Agency cost theory has been used in many different areas like economics, accounting, organizational behavior and many more. Of course, this theory is also surrounded by

controversy. Critics complain that the agency cost theory does not address clear problems (Perrow, 1986).

Its proponents argue that the agency cost theory is a revolutionary foundation for research affecting different types of organizations (Jensen, 1983). According to Eisenhardt (1989, p. 72), the valid perspective lies in the middle and agency cost theory “provides a unique, realistic, and empirically testable perspective on problems of cooperative effort.”

For the purpose of this study, the presented approaches of information asymmetry and agency costs are respected in the context of corporate disclosures like the majority of research papers linked to this area also do. Nevertheless, the theoretical framework of corporate disclosures is much more complex. The analysis is not limited on the relation between corporate entities and their shareholders.

2.1.2 Stakeholder Theory

While the original corporate governance model is limited to principals and agents as well as the control over agency costs (Jensen and Meckling, 1976), there are actually much more parties involved in the scope of corporate activities. The concentration on the owners of a company and the maximization of shareholders’ benefits do not respect the influence, participation and the legitimate interest of these parties. Freeman and Reed (1983) and Freeman (1984) create the first stakeholder model that broadens the limited shareholder approaches.

This theory of organizational management and business ethics addresses not merely morals and values, but rather identifies and models the stakeholder groups of corporate entities (Kochan and Rubinstein, 2000). Moreover, managerial methods are provided that support the management to recognize and integrate the interests of the different groups.

There are several definitions and differentiations of stakeholders in the academic literature. “Common to nearly all stakeholder definitions is the notion that a stakeholder is any individual or group of individuals that is the legitimate object of managerial or organizational attention.” (Phillips, 2003, p. 25)

Concerning the field of corporate reporting, the various stakeholder groups are rele-

vant from two different perspectives. On the one hand, they can be regarded as potential addressees of corporate disclosures as they are interested in the development of the company with a certain thematic priority. Secondly, they can be object of the corporate reporting.

By focusing on the stakeholder differentiation of Freeman (1984), stakeholders can be divided in internal and external ones. Based on the involvement in the company's nexus of contracts, the internal or direct stakeholders are for instance investors, employees, customers and suppliers (Baret, 2006).

External or indirect stakeholders are state authorities, local residents, competitors, media and NGOs (Baret, 2006). The existence and influence of these different stakeholder groups varies with the sphere of activity of corporations.

On the one hand, Freeman's theory receives increasing attention over the years and his approach is integrated in several research papers across different disciplines and educational books. Moreover, it is used as the leading framework in the majority of corporate social responsibility methods.

On the other hand, critics complain that the interests of the various stakeholders can hardly be balanced against each other and even a stakeholder paradox is identified (Goodpaster, 1991).

According to the argumentation of Goodpaster (1991), it seems to be illegitimate to orient corporate decisions by ethical values that go beyond strategic stakeholder considerations because the obligations of agents to principals are stronger than those of agents to third parties.

Freeman (1994) replies that the stakeholder paradox is built on wrong theses that imply separation within corporate entities and society instead of regarding business activities on a common base and in the light of ethical standards. While this disputation appears philosophically in some parts, it also shows that different interests drive the behavior and actions of the participants and conflicts can arise. With regard to the variable compensation components for managers in practice and their orientation based on financial figures in most cases, this debate is still actual.

However, this characteristic does not reduce the importance of the stakeholder theory but makes a differentiated view necessary. The evaluation of the influence of each stakeholder and its implication on the corporate attention differs on the activity field of

the company and situational factors. The relevance of the various stakeholder groups with respect to the field of corporate reporting has to be ordered in order to achieve a solid theoretical basis for empirical tests of hypotheses.

As already described before, Freeman (1984) and Baret (1986) group the different stakeholders. The examination of the legitimacy of these groups within companies was subject to several studies. Phillips (2003) as well as Andriof and Waddock (2002) work primarily with the following two approaches. On the one hand, the strategic approach focuses on stakeholders' analytical aims.

On the other hand, the normative approach concentrates on the moral perspective and postulates as well as ethical orientation for the appraisal of the legitimacy of stakeholders. For the purpose of this study, the focus is on those stakeholders that are close to the corporate business activities and most responsible for the generation of economic performance as described by Hillman and Keim (2001). This restriction has to be made to enable the analysis of a sufficient large number of companies for empirical tests. Moreover, the aim of this study is to work with corporate financial figures that are essential to evaluate the risk assessment of investors.

As stakeholder theory developed to a broad field and the different stakeholder groups, their roles and influence as well as their relevance for business activities are debated, a limited stakeholder model is necessary for research purposes. Wolfe and Putler (2002) examine the stakeholder categories and propose to pay special attention to stakeholders that are involved in the company's operating cycle.

By arguing that companies are adding value through their purchasing, manufacturing and sales activities, the identification of the responsible parties in these fields can be regarded as a first approach. Husser et al. (2012) use a similar approach and argue that the regularly equated first-order stakeholder groups are consisting of suppliers, employees and customers because these stakeholders represent the economic and investment cycle of corporations. These stakeholders are also part of the list of direct stakeholders published by Baret (2006).

The usage of a limited shareholder model reduces the number of stakeholders significantly. Nevertheless, the remaining stakeholders are in the most cases not homogenous groups with a full alignment of interests. Employees and executive employees can be named as an example of persons from the same stakeholder group with partly differing

interests because the executive employees fulfill to a certain degree the job of employers.

Secondly, there are only a few obligatory regulations regarding corporate disclosures with respect to suppliers, employees and customers and most information are published on a voluntary basis (Clarkson, 1995). The regulatory minimum requirements differ significantly from country to country.

Thirdly, the way to communicate with stakeholders can differ. While employees can be addressed internally and externally, the possibility to communicate with (potential) customers is more limited. All these features play an important role for the transfer of stakeholder theory to the field of corporate reporting and have to be integrated to the evaluation of the research results.

Ullmann (1985) develops a conceptual framework to explain the relationships among social disclosure and corporate economic performance. His framework is an advancement of the strategic management approach by Freeman (1984). The first dimension of his approach is “stakeholder power”. It is regarded as the power of a stakeholder to influence the management and is viewed as a function of the stakeholder’s degree of control over resources that are required by the corporation.

The second dimension is the corporate strategic posture towards corporate social responsibility activities. Ullmann (1985) outline two different strategic posture of the companies’ key decision makers which can be named as active and passive and describe their response to social demands.

The third dimension concerns the economic situation of the company and its financial capability to social investment and its credible reporting. This approach combines the ideas of the stakeholder theory with the field of corporate reporting for the first time. However, this conceptual framework is limited to social issues.

It can be summarized that the neo-classical perspective, arguing that expenditures on social causes are reducing the shareholder’s wealth and are a violation of the management’s responsibility, is obsolete (Friedman, 1962). Apart from moral issues, respecting the different demands of stakeholder groups are relevant even in order to avoid diminished shareholder value through labor strikes, boycotts or lawsuits. This is the core message that can be derived from the modern stakeholder theory.

From a stakeholder theoretical perspective, the corporate performance is assessed in

terms of the degree a company meets the demands of multiple stakeholders. Basically, there exist two different approaches combining the field of stakeholder theory and corporate reporting.

From the perspective of Transaction Cost Economics, companies that try to satisfy the demands of their (most important) stakeholders and signal their quality can avoid higher costs that arise from more formalized contractual compliance mechanisms (Williamson, 1985). From the resource-based perspective, companies regard the meeting of stakeholders' demands as a strategic investment. The fulfillment of these expectations can be seen as a competitive advantage that can hardly be imitated (Russo and Fouts, 1997).

Both strategic approaches are in fact a consideration of the advantages and disadvantages that arise for the company due to its activities and reporting behavior. This view is captured comprehensively and in more detail by the information cost theory that is presented in the next chapter.

2.1.3 Information Cost Theory

Information costs can be regarded in two slightly different contexts. As part of the transaction costs which arise from economic exchanges, the search and information costs are (in most cases) seen as costs that are caused by the buying party to determine the availability and the price of a product (Dahlman, 1979).

In the context of corporate reporting and for the application in this study, information costs are costs that publishing companies are confronted with. These companies have to estimate the costs that are connected to generating and publishing information (Verrechia, 2001). In both cases, asymmetric information can be identified as the basic precondition for the existence of information costs.

For the purpose of this study, the information cost theory is used as an approach that describes the corporate consideration of the costs and benefits that are connected to publishing disclosures. Cormier and Magnan (2003) examine this cost-benefit analysis and call it briefly the "communication strategy of a company". It is characterized by the balance between the benefits of publishing disclosures, the risks that could rise from stakeholder pressure and regulatory constraints.

The following two graphics provide an overview about the cost-benefit consideration and the type of different costs companies are confronted with. These underlying characteristics of the information costs theory and the influence of stakeholders as well as the impact of regulatory specifics are described below.

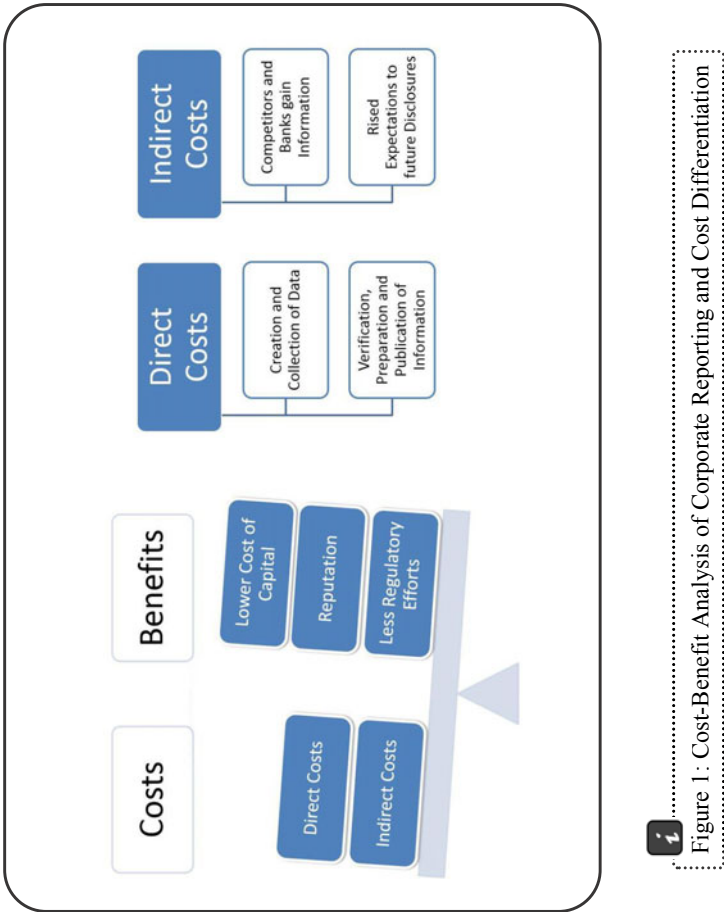


Figure 1: Cost-Benefit Analysis of Corporate Reporting and Cost Differentiation

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