PRICE Business Research

Spring, 2011

Does Government Ownership Affect the Cost of Debt? Evidence from Privatization

Ginka Borisova, former doctoral student, and William Megginson

The recent financial crisis has brought government ownership of companies into the spotlight once again. Whether through interventions and bailouts or the divesting of government assets via privatization, transfers of control between public and private sectors continue to raise questions about the impact these changes have on corporate finance. We investigate how government ownership affects the cost of debt financing by looking at corporate bond spreads of privatized firms over the last decade. These former state-owned enterprises have been either fully or partially sold to private investors, and in the latter case, governments often still retain significant holdings in the firm. From one perspective, this state presence could provide an implicit guarantee

William Megginson

Rainbolt Chair in Finance and Professor of Finance

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From the Dean

Welcome to our recent edition of Price Business Research. Our lead feature is an article from Borisova and Megginson. In this study the authors find that the extreme conditions of either government ownership or those completely divested by the state have lower bond spreads.

Nan investigates organizational information technology use outcomes and discovers that in spite of our desires to control outcomes that more successful systems evidence reciprocal adjustments between IT users and IT system designers.

Mitchell, Shepherd and Sharfman found contrary to their expectations that the more dynamic the CEO's primary industry the more stable were their decisions. The authors explore additional insights from their data and offer a number of managerial implications.

Fan, Barua, Cready and Thomas' work seeks to sort out the effects of classification shifting in firm valuation. In a separate study, Song, Thomas and Yi found evidence that pricing of fair values is greater for firms with strong corporate governance. Both studies offer valuable implications for our understanding of firm valuation.

Samaha, Palmatier and Dant's article highlighted in this issue focuses on factors that contribute to poisoning channel relationships. Their findings were that above all else, the presence of unfairness seems to have the most devastating consequence on channel member cooperation and flexibility.

Emery and Marques' work on explaining inventory levels of firms sheds light on why, in spite of the wide-spread use of just-in-time inventory systems firms tend to retain abnormally high inventory investments.

Uysal, in his study on capital structure, demonstrates the interdependency of capital structure and investment decisions in the presence of financial frictions.

Finally, Lipe and Koonce look at the combined effects of earnings per share relative to benchmarks and EPS trends and how they are used by investors. Findings suggest the interaction to be extremely influential in determining the firm's prospects.

Our faculty continue to play a valuable role in advancing our understanding of business practice. Their work as evidence by those highlighted in this issue of Price Business Research appears in the top journals. It is a distinct pleasure and honor to work with such a highly talented group of scholars.

Kenneth R. Evans, Dean and Fred E. Brown Chair

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Capturing Bottom-Up IT Use Processes: A Complex Adaptive Systems Model

Ning Nan

Organizational IT use outcomes often emerge unpredictably from individual user behaviors over time. In order to understand this so-called "bottom-up" IT use process, I present a complex adaptive systems (CAS) model of IT use that encodes a bottom-up IT use process into three interrelated elements: agents that consist of the basic entities of actions in an IT use process; interactions that refer to the mutually adaptive behaviors of agents; and an environment that represents the social organizational contexts of IT use. Agent-based modeling is introduced as the analytical tool for computationally representing and examining the CAS model of IT use. This CAS model of IT use and agent-based modeling tool are applied to an examination of the impacts of employee learning, IT flexibility and workplace rigidity on organization transformation following IT implementation. Results from this examination have two implications for managers responsible for the success of a newly-installed IT system. First, user perceptions and IT characteristics may not be effective predictors of the long-term IT use outcomes as their impacts can be offset by the unanticipated effects stemming from the interactions among users and between users and the IT system. Second, IT managers should seek to evolve rather than control the IT use process and outcomes. They are encouraged to provide a legitimating context for the reciprocal adjustments of IT users and IT system since these adjustments are the critical means for the IT-enabled performance improvements to occur.

Forthcoming in *MIS Quarterly*, June 2011

More than $1.3 million in competitive external grants for research has been awarded to the Division of Management Information Systems faculty in the past three years.

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to bondholders that the company will service its debt and is unlikely to go bankrupt due to the government's interests. Conversely, previous research has shown that privatized firms are more profitable and efficient once they are free from government control, and these improvements should translate into lower costs associated with borrowing funds via bond issuance.

After controlling for various firm and yearly factors, we find that companies with significant government ownership and those completely divested by the state have lower bond spreads than companies with mid-range levels of government ownership, in-between these two ends of the spectrum. This suggests that bondholders prefer firms to either have a strong, clearly-defined state presence or to be completely free from the influence of government owners. Similarly, we also show firms that are fully divested by the government in a shorter period of time have lower bond spreads than those involved in a longer privatization process. These findings link higher debt pricing to the uncertainty associated with ownership transfer and to the concessions that governments often make to potential shareholders at the expense of bondholders.

Forthcoming in *The Review of Financial Studies*, 2011

Erratic Strategic Decisions: When and Why Managers are Inconsistent in Strategic Decision Making

John R. Mitchell, Dean A. Shepherd and Mark P. Sharfman

As the business environment becomes increasingly fast-paced and competitive, managers' decision making seems to become more erratic and as a result, less effective. However, in such challenging environments, there is less room for error and a greater need for the consistency with which effective strategic choices are made. In a field experiment where we examined 2,048 decisions made by 64 chief executive officers of technology companies, we directly focused on whether working in such complicated environments would decrease the stability with which mangers made choices. Prior research has shown erratic choices lead to sometimes devastating outcomes for companies. We wanted to see if we could determine what leads to such inconsistency. However, the results were not exactly what we expected. We examined the extent to which two elements of the CEO's actual business context (dynamism and hostility) affected how they made decisions during the experiment. We did find as we predicted that the more hostile the context (e.g., higher levels of competitive rivalry, great threat of failure and more pressures on margins) the more likely these CEO's were to make decisions erratically. However, the more dynamic (e.g., high levels of strategic change, less predictability in demand and high rates of product obsolescence) the CEO's primary industry was, the more stable their decisions were. It is possible that managers in dynamic environments develop the ability to tune out distractions and thus reduce the extent to which they make erratic strategic decisions. We also looked at the interplay of these two dimensions and found that even when managers faced hostile contexts, if their environment also was dynamic, they still made less erratic decisions.

Mark Sharfman

Director of the Division of Management and Entrepreneurship and Professor of Strategic Management

In addition to the effects of business context on decision stability, we also wondered if managers who understood their own decision process might be able to withstand the effects of a challenging business context. We found that the more thoughtful managers were about the choices they were making (i.e. the more they thought about their own thinking) the less likely they were to be erratic in their decision patterns. Combined, these results help us understand why managers might be more (or less) susceptible to making erratic strategic decisions and when. As we gain a better handle on the conditions under which the order that underlies successful strategic decision making is diminished, we can do a more effective job of training managers to both recognize these threats and react more effectively. Note that the results of this study were discussed recently in the "Business Education: Focus on Research" column of the *Financial Times* website at ft.com/cms/s/2/987bf670-fc79-11df-a9c5-00144feab49a.html#axzz16n4PVoFq).

Forthcoming in the *Strategic Management Journal*, 2011

Craig Russell, Professor of Management, had his chapter, "Establishing the Usefulness of Strategic Management Research: On Inverted Lewinians and Naked Strategy Scholars" published in *Research Methodology in Strategy and Management,* chosen as an Outstanding Author Contribution Award Winner at the Literati Network Awards for Excellence 2010.

Managing Earnings Using Classification Shifting: Evidence from Quarterly Special Items

Yun Fan, current doctoral student; Abhijit Barua; William M. Cready and Wayne B. Thomas

An important aspect of assessing firm valuation and managerial ability is understanding the firm's core performance. To do this, investors and financial analysts typically focus on the firm's reported core profitability, defined as revenues less expenses from core activities. Some hypothesize that managers intentionally reclassify (or shift) certain core expenses to a separate classification of expenses known as special items. Special items are intended to signify expenses that are typically not expected to recur in the following year, thereby reducing their relevance in assessing firm valuation and managerial ability. By engaging in this type of manipulative reporting behavior, managers can inflate core performance and potentially fool investors and financial analysts. We present empirical evidence that managers shift core expenses to special items. Furthermore, we identify conditions under which this type of manipulative reporting behavior is more like to occur. Classification shifting is more likely to occur (1) in the fourth quarter (2) when the ability of managers to manipulate accruals appears to be constrained (3) and in meeting a range of earnings benchmarks (including the analysts' earnings forecast). These results should be of interest to investors and other financial statement users attempting to assess the firm's core performance.
The Accounting Review, July 2010

Value Relevance of FAS No. 157 Fair Value Hierarchy Information and the Impact of Corporate Governance Mechanisms

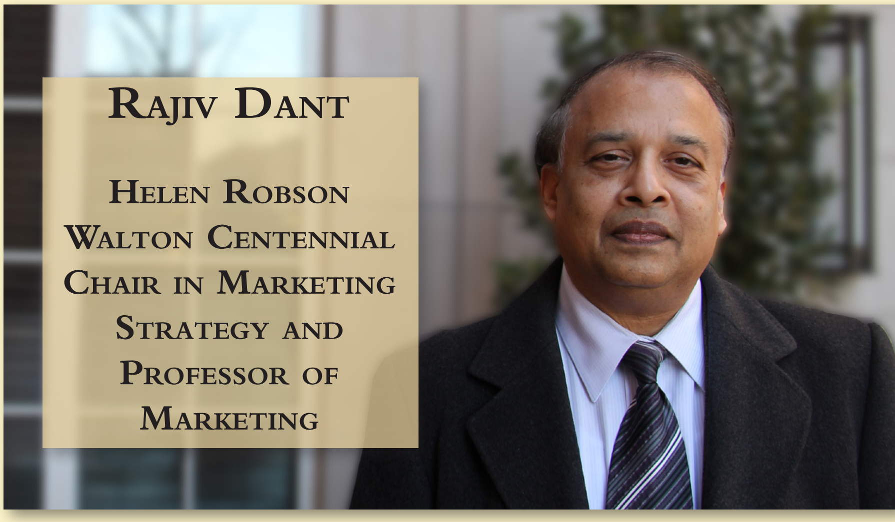
Chang Joon Song, Wayne B. Thomas and Han Yi

Statement of Financial Accounting Standards No. 157 (FAS 157), Fair Value Measurements, requires companies to report the fair value of their assets and liabilities by levels, where levels are based on reliability of inputs used to measure fair values: (1) Level 1 (observable inputs from quoted prices in active markets) (2) Level 2 (indirectly observable inputs from quoted prices of comparable items in active markets, identical items in inactive markets or other market-related information) and (3) Level 3 (unobservable, firm-generated inputs). Using quarterly reports of banking firms in 2008 (i.e., during the financial crisis), we find that Level 1 and Level 2 fair values are more highly priced by investors than are Level 3 fair values. In other words, investors place greater weight on fair values that are more reliable (Level 1 and Level 2). Importantly, we find evidence that the pricing of fair values (especially Level 3 fair values) is greater for firms with strong corporate governance. Strong corporate governance has the effect of eliminating uncertainty surrounding less reliable Level 3 fair values. Our findings should be important to U.S. and international standard setters for understanding not only the effects of FAS 157 disclosures, but also how future standards (e.g., the joint IASB/FASB project on financial statement presentation) can enhance existing fair value disclosures.
The Accounting Review, July 2010

Poisoning Relationships: Perceived Unfairness in Channels of Distribution

Stephen A. Samaha, Robert W. Palmatier and Rajiv P. Dant

Understanding how relationships are damaged is a critical component in building and preserving strong distribution channels. Using longitudinal data from a Fortune 500 firm and its channel members, we develop and empirically test a conceptual model of the simultaneous effects of three relationship-destroying factors (conflict, opportunism and unfairness) on channel member cooperation, flexibility and, ultimately, performance. Results show that perceived



unfairness truly acts as the critical relationship poison: It directly damages channel relationships, aggravates the negative effects of both conflict and opportunism, and undermines the benefits of using contracts to manage the distribution channel.

Of all the relationship-destroying factors studied, perceived unfairness had the greatest impact on channel member cooperation and flexibility. Surprisingly, at low levels of perceived unfairness, conflict and opportunism have small or even insignificant effects on outcomes like cooperation and performance, which implies that research investigating the negative impact of conflict and opportunism on exchange outcomes may need reevaluation because these effects are contingent in nature and may vary depending on the levels of perceived unfairness.

Certainly managing channel member conflict and seller opportunism are important, but reducing perceived unfairness appears even more critical because it has large direct and indirect effects on channel relationship success. Finally, we demonstrate that using contracts to manage channel relationships represents a double-edged sword that suppresses the negative effects of conflict and opportunism while aggravating the negative effect of unfairness. With regard to this double-edged-sword phenomenon, contract utilization can have a net positive or net negative effect, depending on the amount of unfairness present, relative to the levels of conflict and opportunism. Thus, the toxic effects of unfairness are not limited to direct effects or the aggravation of other negative behaviors; unfairness can also cause contract utilization to harm, rather than help, channel relationships.

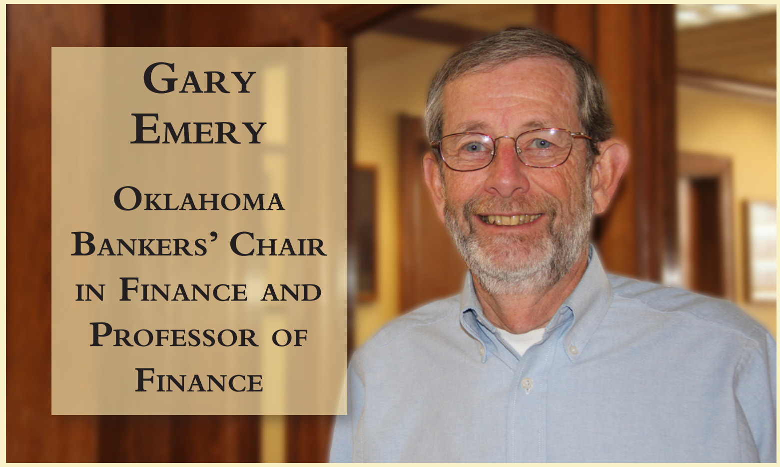
In general, then, managers should increase contract utilization when conflict and opportunism are high because then the suppressive effects of contract utilization increase and make the strategy more desirable. From a managerial perspective, firms should not use a contract to manage a single negative behavior at a time but rather should consider the joint implications of contract utilization on many negative behaviors.

Forthcoming in the *Journal of Marketing*, May 2011

Dean Kenneth Evans and Walton Chair Rajiv Dant received the 2011 Louis W. Stern Award for their article "Factors Influencing the Effectiveness of Relationship Marketing: A Meta-Analysis" from the American Marketing Association, which recognizes the article published between 2003 – 2008 that made the most significant contribution to the literature on marketing and distribution channels.

The Effects of Transaction Costs, Payment Terms and Power on the Level of Raw Materials Inventories

Gary W. Emery and Manuela A. Marques



U.S. companies held $1.4 trillion of inventories at the end of June 2010. This very large investment persists even though we have more than 25 years of experience with just-in-time and other innovations in supply chain management. Our research explains where these necessary inventories are held. Consider this: except for location and ownership, a supplier's finished goods inventory is identical to its customer's raw materials inventory. Our theory, based on the work of Oliver Williamson (who won the Nobel prize in economics), predicts that those who hold these parts depend on the customer's ability to replace a supplier for poor performance or dishonesty, the supplier's payment terms and the customer's power.

Our empirical tests confirm these predictions. We found that customers hold larger raw materials inventories when (1) replacement parts are hard to find because the parts are unique or there are few suppliers (2) the supplier bears the financial opportunity cost of storage and (3) the customer is not important to the supplier. These results shed light on why and where inventories build up at certain points in a supply chain when just-in-time is not an option.

Forthcoming in the *Journal of Operations Management,* 2011

Deviation From the Target Capital Structure and Acquisition Choices

Vahap Uysal

Traditional theories of capital structure suggest that firms have target capital structures that are determined by balancing the costs and benefits of debt financing. However, firms often deviate from their target capital structures, and these deviations may limit the ability of overleveraged firms to raise capital on short notice, in general, and constrain them from issuing further debt, in particular. While the inability to raise capital on short notice may impede a firm from bidding aggressively for acquisition targets, the constraints on issuing further debt may reduce the cash component of acquisition offers. In this study, I find evidence supporting this view: managers take deviations from their target capital structures into account when planning and structuring acquisitions. Specifically, firms that are overleveraged relative to their target debt ratios are less likely to make acquisitions and are less likely to use cash in their offers. Furthermore, they acquire smaller targets and pay lower premiums. Managers of overleveraged firms also actively rebalance their capital structures when they anticipate a high likelihood of making an acquisition. Finally, they pursue the most value-enhancing acquisitions. Collectively, these findings improve our understanding on how firms choose their capital structures and shed light on the interdependence of capital structure and investment decisions in the presence of financial frictions.

Forthcoming in the *Journal of Financial Economics*, 2011

Earnings Trend and Performance Relative to Benchmarks: How Consistency Influences Their Joint Use

Lisa Koonce and Marlys Gascho Lipe

Marlys Gascho Lipe

Rath Chair in Accounting and Professor of Accounting

Each quarter, companies report earnings per share (EPS) information for use by investors and potential investors. Prior research indicates that investors respond to various aspects of these numbers. Specifically, investors place higher values on firms that have positive trends in EPS than firms without this pattern. In addition, investors value the ability of firms to meet or beat analysts' forecasts of EPS in the current period. While prior research investigated reactions to these two aspects of EPS, their effects were studied in isolation even though both aspects are evident each time EPS is reported. In contrast, our study investigates the concurrent effects of the trend in earnings and the performance of earnings relative to the forecast benchmark for current and prior periods.

We use experimental methods to investigate how and why investors react to these two aspects of EPS. Based on decision-making research, we predict that reaction to each aspect of EPS will be dependent on its consistency over time. We find this to be true – investors react to consistent trends (for example, positive or flat trends) in EPS and consistent performance relative to analyst forecasts (for example, consistently beating or missing the forecast). If either aspect of EPS is inconsistent over time, investors instead focus on the other aspect. When trend and performance relative to the forecast are both consistent through time, investors value both aspects of EPS and do so in an additive fashion, suggesting that investors view these as providing different types of information about the firm.

Delving further to find out why investors react to EPS trend and performance relative to forecasts, we find that investors interpret each of these as providing information about a firm's future prospects and firm management's credibility. Further, judged future prospects fully explains the effect of earnings trend on investor judgments – that is, investors' reaction to EPS trend is really a reaction to what the trend relays to investors about the firm's future prospects. In contrast, while investors interpret consistent performance in meeting or missing analysts' forecasts as providing information about the credibility of firm's management and the favorability of the firm's future prospects, investors extract additional information from this performance that, currently, remains unidentified.

Journal of Accounting Research, September 2010

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