Efficient resource allocation depends on the flow of information from a firm’s divisions to corporate headquarters. But what if managers are incentivized to distort that information to increase the capital allocated to their division?

This research gauges the internal information disparity between divisions and corporate headquarters and explores the economic consequences on the efficiency of capital allocation and firm value.

Corporate headquarters must rely on several sources of information as part of the capital budgeting process, including information provided by division managers. Yet managers may have incentives to distort that information to increase the capital allocated to their divisions. The resulting information disparity between division managers and corporate headquarters may reduce the efficiency of the internal capital market and firm value.

Professor Martin’s research employs a novel measure to gauge the difference between the internal-trading profits of division managers and top executives to measure information asymmetry within conglomerate firms.

“Differential trading profit between division managers and top executives serves as the empirical measure, where trading profit is computed as buy-and-hold market-adjusted return over the six month period after internal trade,” explains Martin. “The higher the differential trading profit, the greater the information advantage division managers likely have over top executives, the higher internal information asymmetry. On average, division managers trade less profitably than top executives by 2.5 percent, which makes sense because top executives have information about the overall company. However, for about a quarter of conglomerates in our sample, division managers trade more profitably than top executives by 8.5 percent.”

The results show a negative relationship between internal information asymmetry and both internal capital market efficiency and firm value. These results are more pronounced for more diversified and weakly governed conglomerates and for divisions that are geographically farther from corporate headquarters.

The research also found that divisions with greater information asymmetry are more likely to be divested, implying that internal information asymmetry is one of the reasons that drive firms to take restructuring actions.

KEY TAKEAWAYS for Managers

• Internal information asymmetry has a measurable economic effect on firm value and the efficiency of internal capital allocation.
• Organizations need to take action to enhance the effectiveness of communication between divisions and corporate headquarters to increase firm value and internal capital market efficiency.
• Stronger corporate governance mitigates the adverse effect of internal information asymmetry by reducing agency conflicts between division managers and top executives.
• If high information asymmetry persists, organizations are more likely to refocus through either divestiture or reorganization in the future.

“If Internal Information Asymmetry, Internal Capital Markets, and Firm Value”

Xiumin Martin, Associate Professor of Accounting, Olin Business School, Washington University in St. Louis

Coauthors: Matthew T. Billett, Indiana University; Chen Chen, University of Auckland; Xin Wang, University of Hong Kong

Publication: Working paper
True Numbers

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