Corporate Governance and Skewness in Stock Returns*

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Abstract

This paper analyzes the relationship between corporate governance and idiosyncratic skewness of stock returns. We test this hypothesis by analyzing the impact of external as well as internal governance provisions, and are thus able to provide an overall understanding of the relationship between governance and firm-specific return asymmetries. Our results show that better governance leads to a reduction in idiosyncratic skewness in relatively non-competitive industries. In relatively competitive industries, governance has less to no impact on firm-specific return skewness. Furthermore, an overall increase in transparency, quality and disclosure of information, proxied through the Sarbanes Oxley Act, reduces relative idiosyncratic skewness. Our findings can be regarded as detrimental for shareholders, who have a preference for positive idiosyncratic skewness. The evidence contributes to a debate, which suggests that – at the end of the day – an act like Sarbanes-Oxley, which was intended to protect shareholders from accounting errors and frauds and to improve the accuracy of corporate disclosures, comes at the expenses of shareholders. The reduction of idiosyncratic skewness through better governance collides with shareholder's preference for idiosyncratic and positively skewed stock returns, which present a lottery like upside option of monetary gains and value creation through the right tail. This side effect of governance is also in line with the literature that highlights potential costs of corporate governance.

Keywords Idiosyncratic Skewness, External and Internal Provisions, Corporate Governance, Sarbanes Oxley Act
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