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CONTENTS

EVIDENCE ON THE RELATION BETWEEN INVENTORY CHANGES, EARNINGS AND FIRM VALUE

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ABSTRACT

Prior studies contend that an unexpected increase in inventory reflects a firm's difficulty in generating sales and results in negative earnings growth and stock returns. Using a sample with over 85,000 observations for the period of 1950-2005, we confirm the negative relation between inventory changes and firm performance but find that the relation is sensitive to the choice of sample period. Moreover, this relation is somewhat attenuated for firms in the wholesale and retail industry as well as for firms that normally carry low levels of inventory. Our findings suggest that the macroeconomic and industry-specific environments are important moderators of the relation between inventory changes and firm performance.

JEL: G34

KEYWORDS: Inventory; Working capital management

INTRODUCTION

In their survey of research on inventories, Blinder and Maccini (1991) point out that the drop in inventory accounts for 87% of the drop in Gross National Product (GNP) during an average recession in the US. Ramey and West (1997) point out a similar link between inventories and GDP for five of the G7 countries. At the firm level, Thomas and Zhang (2002) find that changes in inventory are the primary driver for the relation between accruals and future abnormal returns. Taken together, they suggest that inventories are important determinants of firm performance and value. Yet, there is very little research that has examined this issue and our understanding of the influence of inventory on firm value remains incomplete. Notable exceptions are the work of Abarbanell and Bushee (1997) and Lev and Thiagarajan (1993). Abarbanell and Bushee (1997) examine the relation between EPS changes and several firm characteristics (including the change in inventories) from 1983 to 1990 and find that an unexpected increase in inventory (to sales) is negatively related to short-term earnings growth measured by one-year-ahead EPS change. Lev and Thiagarajan (1993) examine the relation between inventory changes and stock price returns by examining a large cross-section of firms from 1974 to 1988 and find that unexpected increases in inventory result in lower stock price returns. However, even this evidence is not complete. First, our present understanding of the role of inventory relies disproportionately on a relatively small number of studies that analyze a narrow set of metrics over a small number of years. As a result, it is not clear if the conclusions will hold out of sample. Second, prior research has not delved into potential differences between industries. In particular, inventory management is at the heart of the operations of retailers and wholesalers (in this paper we collectively refer to them as distributors). Therefore, increases or decreases in inventory levels for retailers and wholesalers may be driven by very different considerations than similar changes for firms in any other industries.

In this paper we address these two issues. First, by employing a relatively long 56-year sample period, we examine if the negative correlation between the unexpected changes in inventory and earnings growth holds for all time periods. We also test for the robustness of our conclusions using a number of alternate metrics of firm performance. Second, by further classifying firms by industry, we examine if the negative

EXAMINING BOARD COMPOSITION AND FIRM PERFORMANCE

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ABSTRACT

This paper investigates the relationship between key factors of board composition and firm performance. We find that listed companies in Taiwan are suffered from the divergence between stock-control rights and earnings-distribution rights, and the divergence of rights is negatively associated with firm performance, as predicted. Besides, consistent with the viewpoint of Agency Theory that the controlling interests of CEO may induce them to enhance company performance, we find that, CEO internalization is significantly positively associated with firm performance. In addition, the results of the influence of board structure document that, the more outside independent directors of a company, the better performance the company has. Our findings provide strong support for the notion that corporate ownership structure and board compositions are key factors in determining the corporate governance efficiency and play important roles in enhancing firm performance.

JEL: G34, L25

KEYWORDS: Board leadership structure, CEO duality, Independent directors, firm performance

INTRODUCTION

The management level of a company plays a determining role in how well a company performs, but the structure of a firm's leadership and various supervising mechanisms play an even more crucial role. The leadership structure of the board of directors and performance evaluation are among the most important topics in the literature of corporate governance. Although companies around the world have different cultural and legal backgrounds, making it inappropriate for localized studies to be applied to other regions, Taiwan adopted the U.S. regulations regarding external directors such that listed firms in Taiwan must have independent directors in order to facilitate the operation of the board of directors and achieve optimal corporate governance. Therefore, it is therefore safe to say that, with suitable cultural and legal adjustments, well-designed foreign managing structures and models can be adapted by other nations to achieve desirable results.

This paper is a discussion of the relationship between, on one hand, board composition and leadership structures in listed companies in Taiwan and, on the other, company performance. One related issue is whether independent directors and institutional directors can oversee companies properly and create a positive effect on company performance. Another task is to examine the unique characteristics demonstrated by the boards of directors in listed Taiwanese companies and how they are different from their counterparts in other regions. For example, how is a company's performance influenced when it is family-owned or when the shareholders through manipulation, a process also known as the "internalization" of the CEO, elect its chief executive officer (CEO)? How is a company's performance affected when power of attorney is bought as a means of gaining a seat in the board in order to gain control of the company? What separations are created between the stock-control or seat-control rights and cash-flow rights? Can the effects of this action on the company's decision-making process also affect the company's performance?

The findings of this paper serve as a reference for both the Taiwanese authority in its formulation of legal regulations regarding listed companies and the public investors and stakeholders in their decision-making. They also demonstrate how the mechanism of corporate governance in Taiwan's listed companies is different from those in other countries.

DEPOSITOR SENSITIVITY TO RISK OF ISLAMIC AND CONVENTIONAL BANKS: EVIDENCE FROM INDONESIA

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ABSTRACT

Islamic banks operate without involving interest, and therefore are believed to be less risky during financial crises than conventional banks. This advantage may not be significant if the government either partially or fully guarantees bank deposits. In the presence of deposit insurance the public can be indifferent to risk of both Islamic and conventional banks. However, insufficient studies have examined the issue of deposit insurance impact on depositor behavior and market discipline. This research conducts empirical tests on whether the risk of Islamic and conventional banks influence depositors in Indonesia, during two periods using cross-sectional analysis. This research also investigates the behavior of Indonesian depositors towards risk of both bank types during the US crisis through panel data analysis. Data from all insured domestic banks in Indonesia, from January 2002 to December 2009 are examined.

JEL: G 21

KEYWORDS: Bank Risk, Deposit Insurance, Market Discipline, Islamic Bank

INTRODUCTION

Deposit insurance may be useful in preventing bank runs (Diamond & Dybvig, 1983) and improving risk sharing (Niinimaki, 2004). However, Merton (1977) argues that deposit insurance may also encourage banks to be more risk takers. Some scholars like England (1991) further explain that the presence of high deposit insurance ceilings have made depositors almost insensitive to bank risk. Depositors are argued to be indifferent to bank's fundamentals and the associated potential risk to their deposits. They trust their government to ensure the safety of their deposits (Demirguc-Kunt, 1998a, 1998b, and 2000a). This depositors' insensitivity worsened the moral hazard consequences of deposit insurance, inducing banks to engage in high-risk activities, which in turn boosted their default rate (Grossman, 1992, Wheelok, 1992, Thies & Gerlowski, 1989, and Demirguc-Kunt & Detragiache, 2002).

Studies on banking crises have proposed solutions that might be effective in preventing reoccurrence. The capability of non government agents to control bank risk-taking, i.e. market discipline, has increasingly attracted both policy-makers and economists. Market discipline works through a mechanism, in which depositors, bond-holders, and shareholders punish risky banks by using their market power. Depositors withdraw their deposits from, or require high deposit interest from risky banks (Hosono, 2005). In some market economies, traditional government regulation and supervision have not functioned as effectively as expected. Banking activities have become increasingly complex as a result of tougher competition and advanced customer preferences. At the same time, the market's role in stimulating appropriate banks' risk taking behavior becomes more and more significant. This fact has partly accounted for the growing policy-makers emphasis on market discipline (See, e.g., Calomiris, 1999).

Nevertheless, it is unclear if such market discipline works well in emerging economies. Will depositors be sensitive to bank risk in developing countries deposits are insured by the government or a government-related institution? Another important question is whether depositors are sensitive to the risk of Islamic

USING DEPOSIT INTEREST RATES IN SETTING LOAN INTEREST RATES: EVIDENCE FROM TURKEY

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ABSTRACT

Bank credit margins are set by two dynamics: loan interest rates and deposit interest rates. The latter is the leading funding cost for the commercial banks. Sampling the period running from the last financial quarter of 2002 to the last financial quarter of 2009, we consider all the listed commercial banks operating in Turkey. We obtain strong evidence of one-way causality between loan interest rates and deposit interest rates. In setting their loan interest rates, banks use deposit interest rates of the preceding period. The reverse is not true. Concurring with the literature, this causation implies that deposit interest rates explain the changes in the margin.

JEL: G21, M41.

KEYWORDS: Causality; Bank; Funding cost; Deposit interest rate; Loan interest rate; Size; Margin; Istanbul Stock Exchange.

INTRODUCTION

Kaymaz *et al.* (2010) shows that the larger the bank, the greater the bank credit margin (henceforth, referred to as margin). The reason for this was that the funding costs of the larger commercial banks (henceforth, referred to as banks) were significantly lower than those of the smaller banks. These funding costs are deposit interest rates. The authors make a further investigation to understand whether loan interest rates as the source for revenue streams also affect the degree of margin. They find that loan interest rates do not explain the changes in the margin.

Kaymaz *et al.* (ibid.) also finds that smaller banks have higher loan rates than larger banks. This linkage relies on the scholars' main implication once again, deposit interest rates. They explain this linkage saying that, as smaller banks have higher funding costs than those of their larger counterparts, they also have to set their loan prices higher. Otherwise, smaller banks will face losses in their financial statements. Therefore, Kaymaz *et al.* (ibid.) overall imply that the higher (smaller) the bank size, the lower (higher) the deposit interest rates will be.

The above-mentioned results that derive from factual information are both interesting and intuitive. As agents with major stakes in the economies, banks could be reasonably expected to set their loan prices as high as possible so as to maximize their interest revenues. The findings of Kaymaz *et al.* (ibid.), however, report that this may not always be the case.

This should not be surprising though. Indeed, we see that, in practice, after a certain point, banks cannot further rise their loan rates, due to the fear of losing (a) some of their clients, particularly the good ones with ability-to-pay and willingness-to-pay *and* to (b) the competition power in the market. This is particularly true for the larger banks. On the other hand, smaller banks do necessarily have to keep their loan prices high, and if they do not, their long-term survival will be literally at stake (Kaymaz *et al.*, unpublished a).

The above discussions indicate that banks consider their deposit interest rates in setting their loan prices. We aim to specifically document the predicted causality between bank deposit interest rates and loan

THE IMPACT OF IAS AND BASEL II REGULATIONS ON NET INTEREST MARGIN: EVIDENCE FROM ITALY

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ABSTRACT

The paper examines the impact of the costs of complying with IAS and Basel II regulations on the net interest margin and operating costs of Italian banks using bank level data for the period 2001-2007. More specifically, the paper intends to ascertain whether: a) IAS and Basel II compliance costs have increased operating costs and have been incorporated in a larger spread; b) there is the presence of scale diseconomies related to compliance costs for Italian mutual banks. An empirical analysis demonstrates that compliance costs have indeed affected operating costs and net interest margin although mutual banks do not face a higher average cost of complying with IAS and Basel II regulation, thanks to the presence of the mutual bank network which enables them to exploit economies of scale. Moreover, empirical findings show that mergers among banks can increase the impact of regulatory costs on net interest margin. These findings remain unchanged even if they are checked for individual bank characteristics represented by labor productivity, size, credit quality, loans, net fee income margin and equity. High net interest margin and operating costs tend to be associated with banks with low productivity that concentrate on traditional lending business, with high credit risk and relatively high equity.

JEL: D18; G21; G28; G33; G38

KEYWORDS: Net interest margin; compliance costs, Italian mutual banks, business processes

INTRODUCTION

There are a relatively large number of studies on the rationale behind financial regulation (Bhattacharya et al., 1998; Llewellyn, 1999). Such regulation can generate both benefits and compliance costs (Goodhart et al., 1998; Elliehausen, 1998). Beyond a certain threshold, financial regulation may introduce a perverse effect on market structure and behavior, such as lower levels of competition, greater entry barriers and increased moral hazard (Briault, 2002; Alfon and Andrews, 1999). Studies on the cost of regulation demonstrate that regulation increases operating costs, but the impact of these costs is not always constant for all firms (Hail and Leuz, 2006). Lastly, compliance costs can significantly affect the prices of financial products and services.

This paper contributes to this discussion on regulation costs by focusing on the International Accounting Standards, hereinafter IAS and the new Capital Accord, hereinafter Basel II. In fact, IAS and Basel II (Basel Committee on Banking Supervision, 2006) have been the most important innovations in financial regulation of the last decade. IAS has caused a dramatic change in bank balance sheets, and Basel II has introduced new ways to measure overall bank risk and capital absorption. Banks have been required to invest heavily in both human resources and technology systems to comply with IAS and Basel II regulations, but there are no studies, available to the public, on the impact of these regulations on bank operating costs and profitability.

This paper tackles two sets of questions: 1) Have IAS and Basel II compliance costs increased operating expenses, and have these compliance costs been translated into larger spreads? 2) Has this impact been different for banks of different size and, in particular, for mutual banks? To address these questions,

THE IMPACT OF DOLLAR-RAND VOLATILITY ON U.S. EXPORTS TO SOUTH AFRICA

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ABSTRACT

This study investigates the effects of exchange rate volatility on the top ten categories of exports by the United States to South Africa over a 20-year period from January 1990 to December 2009. The paper uses several measures of volatility to generate a measure of exchange rate volatility, which is then tested in a model of U.S. exports to South Africa. We employ sectoral trade data at the 2-digit HS level to evaluate these effects on the top ten individual commodities traded. Utilizing bounds testing cointegration, we estimate the short- and long-run impact of exchange-rate volatility on the US exports to South Africa. Our results suggest that while the effects of exchange rate volatility on exports is mixed in the short-run, in the long-run, exchange rate volatility exerts a negative effect on the U.S. exports to South Africa.

JEL : F14, F31

KEYWORDS: exchange rates, volatility, exports, ARDL bounds testing, South Africa.

INTRODUCTION

The breakdown of the Bretton Woods system and the adoption of the flexible exchange rate regime in 1973 has led to a proliferation of research on the impact of exchange rate volatility (ERV) on real exports. The interest in this research was prompted by three main developments: (a) both the real and nominal exchange rates have undergone periods of substantial volatility since 1973; (b) during the same period, international trade declined significantly among industrialized countries; and (c) macroeconomic instability in terms of output, inflation, interest rates, and employment began to surface.

Despite the sizeable number of studies conducted, no real consensus about the impact of exchange rate volatility on exports has emerged. While a large number of studies find that ERV tends to reduce the level of trade, others find either weak or insignificant or positive relationships. For example, Onafowara and Owoye (2008), Byrne, Darby, and MacDonald (2008), Choudhry (2005), Bahmanee-Oskooee (2002), Arize, *et al.* (2000), Arize (1995), Chowdhury (1993), Pozo (1992), and Bahmani-Oskooee and Ltaifa (1992), find evidence for negative effects. According to these scholars, ERV may affect exports directly through uncertainty and adjustment costs for risk-averse exporting investors. Further, it may have an indirect effect through its impact on the structure of output, investment and government policy. On the other hand, Doyle (2001), Chou (2000), McKenzie and Brooks (1997), Qian and Varangis (1994), Kroner and Lastrapes (1993), and Asseery and Peel (1991) find evidence for a positive effect for volatility on export volumes of some developed countries because exchange rate volatility makes exporting more attractive to risk-tolerant exporting firms. However, other scholars such as Aristotelous (2001), Bahmani-Oskooee and Payestch (1993), Bahmani-Oskooee (1991), and Hooper and Kohlhagen (1978) have reported no significant relationship between ERV and exports.

Reasons for contradictory results by different studies may be due to a variety of factors, among them: different methods used to measure ERV; the use of different price deflators; the differential use of sample data, for example, the use of aggregate export data versus sectoral export data; different time-frame periods; ignoring import dependency on intermediate and capital goods of the receiving country, as is the

APPLICATION OF A HIGH-ORDER ASYMPTOTIC EXPANSION SCHEME TO LONG-TERM CURRENCY OPTIONS

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ABSTRACT

Recently academic researchers and practitioners have use the asymptotic expansion method to examine a variety of financial issues under high-dimensional stochastic environments. This methodology is mathematically justified by Watanabe theory (Watanabe, 1987), and Malliavin calculus (Yoshida, 1992a,b) and essentially based on the framework initiated by Kunitomo and Takahashi (2003) and Takahashi (1995, 1999) in a financial context. In practical applications, it is desirable to investigate the accuracy and stability of the method especially with expansion to higher orders in situations where the underlying processes are highly volatile. After Takahashi (1995,1999) and Takahashi and Takehara (2007) provided explicit formulas for the expansion to the third order, Takahashi, Takehara and Toda (2009) develop general computation schemes and formulas for an arbitrary-order expansion under general diffusion-type stochastic environments. In this paper, we describe these techniques in a simple setting to illustrate thier key ideas. To demonstrate their effectiveness the techniques are applied to pricing long-term currency options.

JEL: C63, G13

KEYWORDS: Asymptotic Expansion, Malliavin Calculus, Stochastic Volatility, Libor Market Model, Currency Options

INTRODUCTION

This paper explains two alternative computation schemes proposed by Takahashi, Takehara and Toda (2009). The work is based on the asymptotic expansion approach based on Watanabe theory (Watanabe, 1987) in Malliavin calculus. The explanation is provided in a simple setting and applied to pricing long-term currency options under a cross-currency Libor market model and general stochastic volatility of spot exchange rates.

Recently, academic researchers and practitioners have used the asymptotic expansion method for a variety of financial issues. e.g. pricing or hedging complex derivatives under high-dimensional underlying stochastic environments. These methods are fully or partially based on the framework developed by Kunitomo and Takahashi (1992), Takahashi (1995,1999) in a financial literature. In theory, this method provides the expansion of underlying stochastic processes. This has a proper meaning in the limit of some ideal situations including deterministic cases (for details see Watanabe, 1987; Yoshida, 1992a; or Kunitomo and Takahashi, 2003).

In practice, however, researchers are often interested in cases far from the ideal, where the underlying processes are highly volatile as seen in recent financial markets. From the view point of accuracy and stability in practical uses, it is desirable to investigate behaviors of estimators with expansion to high orders.

THE ROLE OF LONG RETURNS IN SECURITY VALUATION: INTERNATIONAL EMPIRICAL EVIDENCE

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ABSTRACT

This study examines empirically the role of financial information in explaining long return windows in three major capital markets, UK, USA and France. We hypothesize that the relationship between financial information and security returns improves the longer the return window, and that this robustness depends on the country under investigation. The dataset consists of more than 40,000 USA, UK and French firm-year observations over a nine year period. Multivariate statistical regression analysis is undertaken to test the major research hypotheses. Results indicate that the importance of earnings and cash flows in all three countries over a longer period of time (more than a year and up to five years) is more robust, and that investors perceive earnings and cash flows differently. Interestingly, the importance of earnings and cash flows from one to five years , as measured by the R^2, increases the highest in the USA (almost quadruples), whereas increases the least in France. These results are not that surprising in that in Anglo-Saxon countries such as the USA and the UK the increase is greater than in a code law country such as France. This is due to the fact that in the shorter run there is a greater manipulation of financial information in Anglo-Saxon countries than in more conservative countries such as France.

JEL: G14, G15, G30

KEYWORDS: Capital markets, earnings, international, empirical.

INTRODUCTION

The value relevance of earnings in the capital markets has been among the primary empirical questions raised in several studies in the past few decades. The usefulness of earnings has also been examined recently in conjunction with cash flows (Bali et al (2009), Banker et al (2009), Bartov et al., 2001; Charitou and Clubb, 1999, Ball et al., 2000, among others). Empirical research provided evidence to support that earnings are more useful than cash flows in the capital markets. Existing evidence on the association of cash flows beyond earnings in explaining security returns in international capital markets has been inconclusive. The present study hypothesizes the value relevance of earnings and cash flows are country specific and it is affected by the security return measurement interval.

Regression analysis was undertaken to test the major hypotheses. A sample of more than 40,000 USA, UK and French firm year observations was used to test the research hypotheses. The major conclusions of the empirical results are summarized as follows. First, regarding our basic proposition which stated that earnings and cash flows are associated with stock prices in USA, UK and France, results indicate that indeed both earnings and cash flows are taken into consideration by investors in their investment decisions. Second, regarding our major hypothesis which stated that the value relevance of earnings and cash flows depends on the measurement interval and on the country under investigation, our results again support the hypothesis that investors in USA, UK and France perceive earnings and cash flows differently. Interestingly, the importance of earnings and cash flows from one to five years , as measured by the R^2, increases the highest in the USA (almost quadruples, 7% to 27.8%), whereas increases the least in France (almost triples, 11.4% for the annual and 32% for the five year interval). These results are not

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