

# Corporate Governance: An Academic's Thoughts

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# Lots of complaints about governance

- But complaints aren't new:
  - Adam Smith (1776): “The directors of [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance [as the owners]. ... Negligence and profusion, therefore must always prevail.”

# Corporate governance reform is the rage

- In US:
  - Sarbanes-Oxley (SOx)
- In UK:
  - Cadbury Report
- In Japan:
  - Major reform to adopt “American-style” committee structure

# Many questions

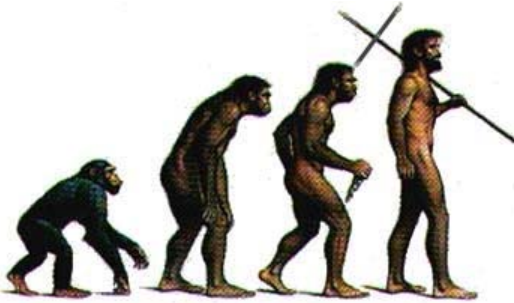
- Are complaints about governance justified? Sensible?
- What do we make of trends in governance?
- Are proposed reforms good? How do we tell? Can they have unintended consequences?

# Outline of talk

- Introduction
- Some general observations
- Some specific observations

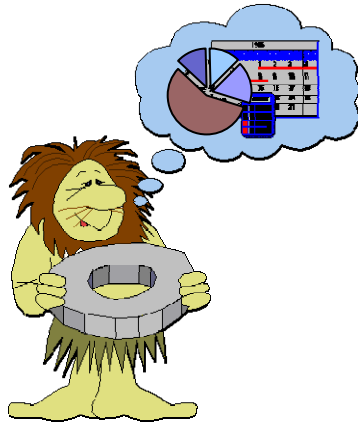
# General observations

- The corporate form is a survivor
- It's a second-best world
- Scope for reform is limited



# Darwin was right

- The fittest survive



- ◆ Not the best
- ◆ Just better than the rest

# Survival of the Fittest

- Despite all complaints about governance, corporate form exists
- Has existed for over 400 years
- Is, in terms of wealth, the dominant form
- Remember, it's survival of the fittest, not the perfect

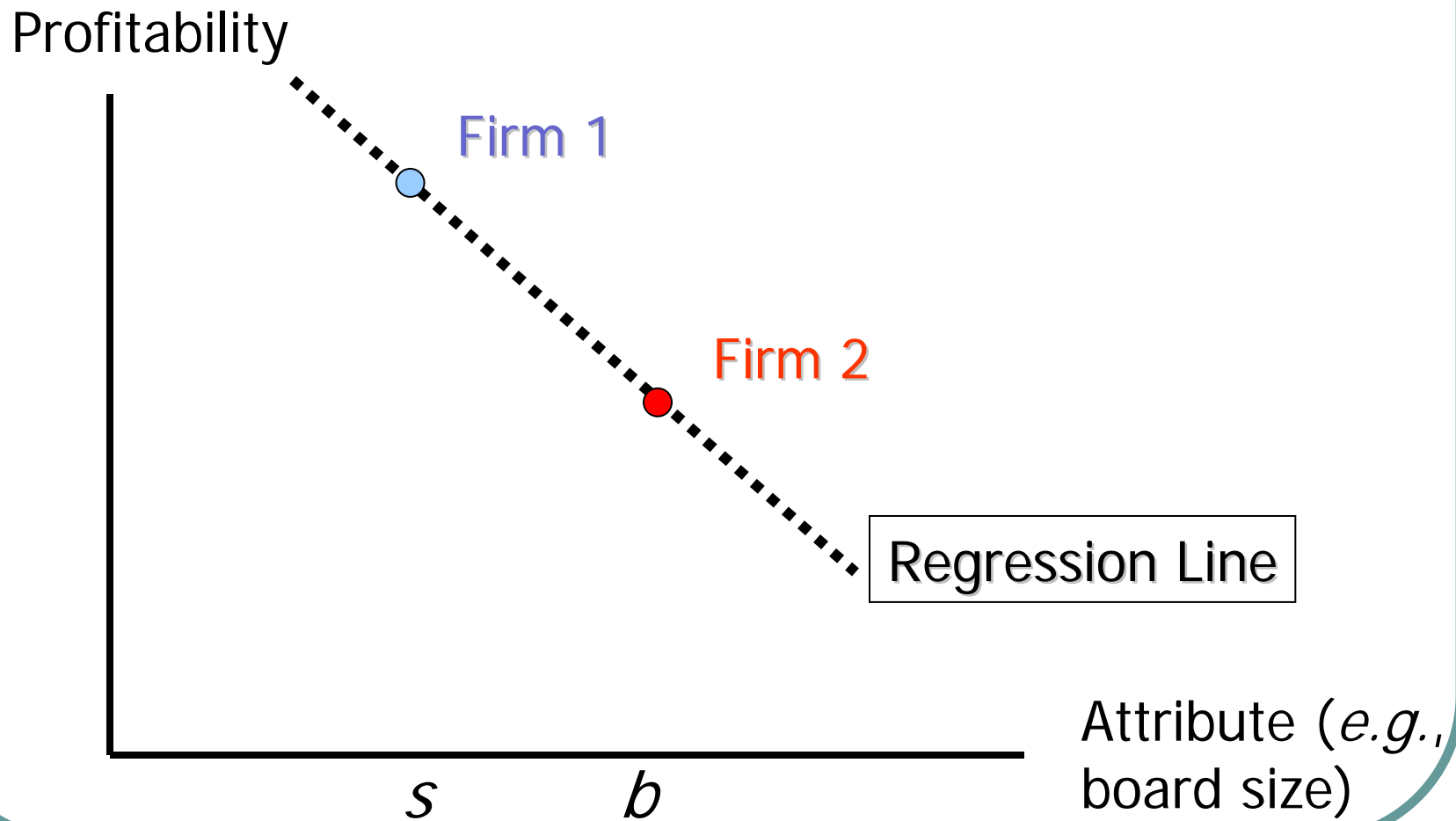
# No low-hanging fruit

- After all this time, it is unlikely that quick and cheap fixes exist.
- Be particularly wary of reforms that each individual firm could have imposed itself.

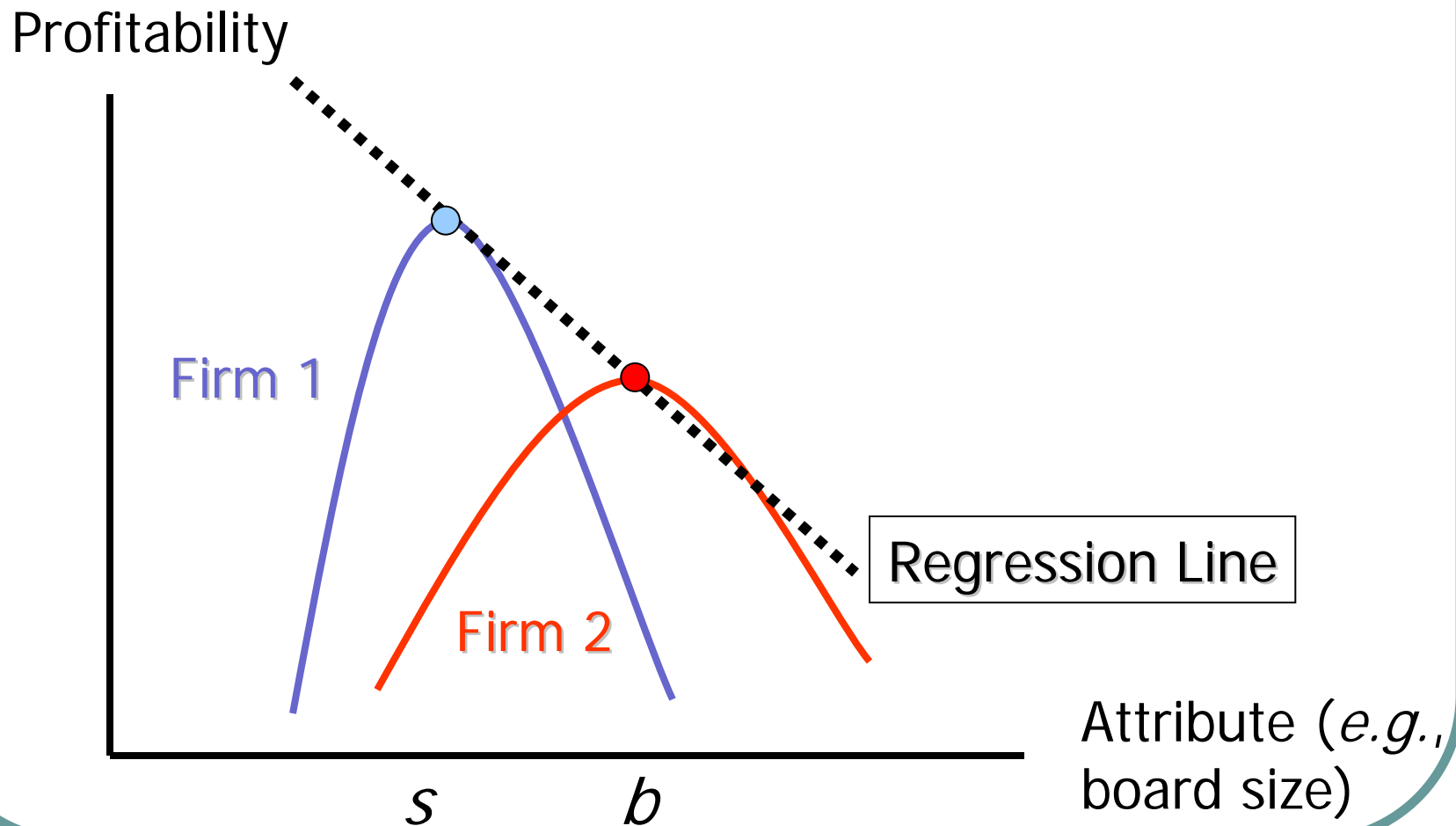
# Firms too face Darwinian forces

- A firm is a survivor against other competitors
- It must be relatively fit
- Beware of claims that a firm is clearly behaving less than optimally

# Interpreting empirical findings: Remember Darwin

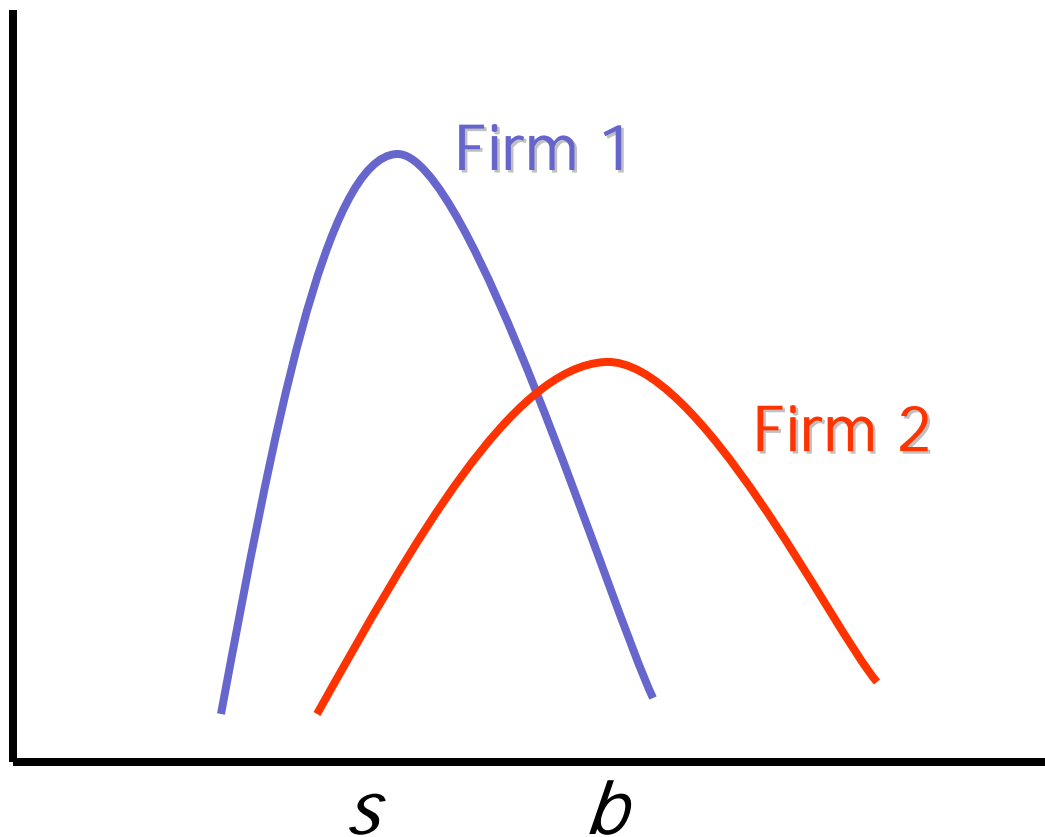


# A false inference



# Empirical work comparing characteristics does not yield normative conclusions

Profitability



Attribute (*e.g.*,  
board size)

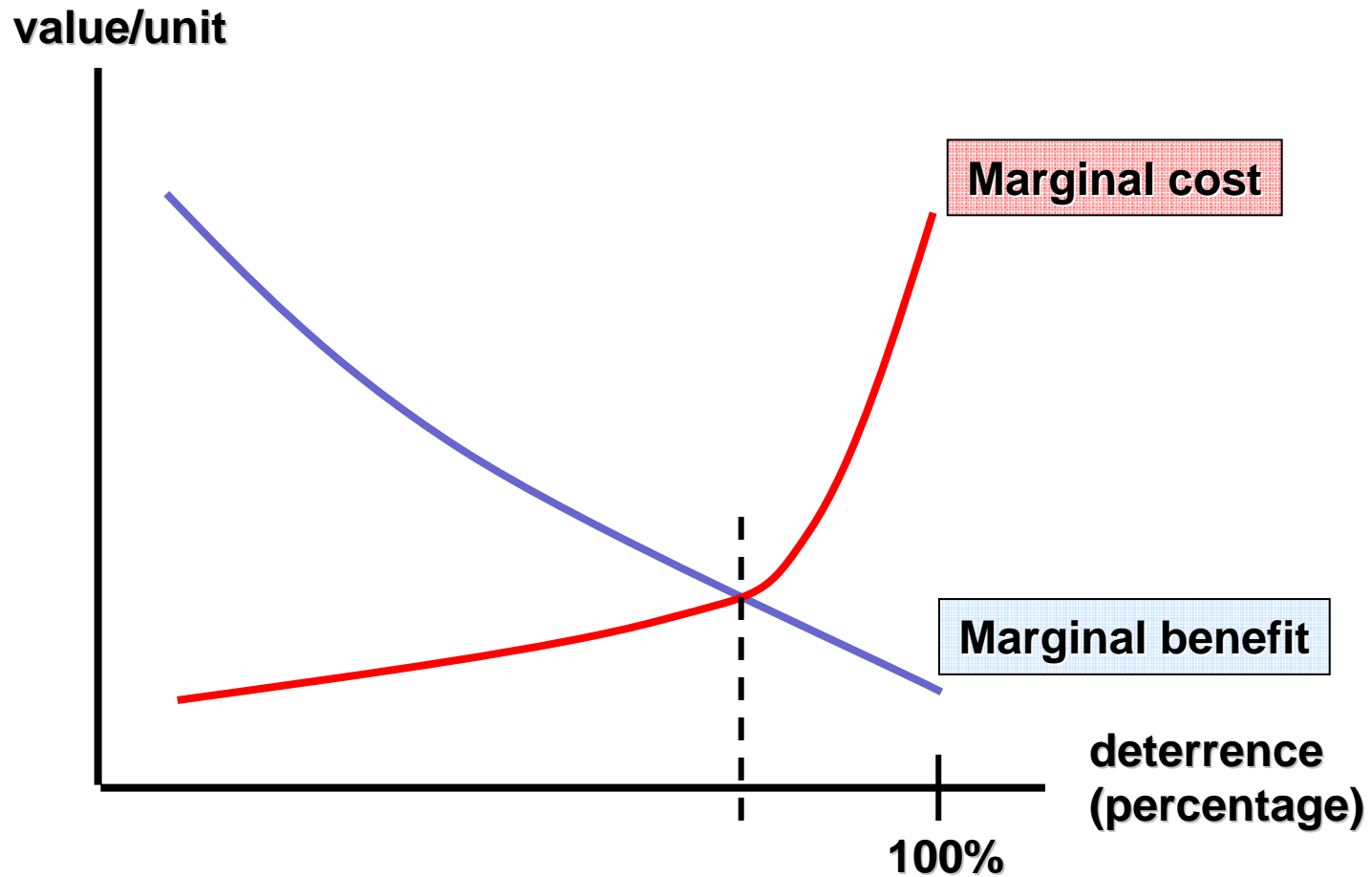
# Implication

- If all firms are optimizing against their constraints, then a regression of endogenous variables on each other doesn't provide normative conclusions.
- Cross-firm comparisons are probably not telling us what we would like them to tell us.

## It's a second-best world

- ... or Mae West was wrong, too much of a good thing is excessive.
- The benefits of deterring bad behavior have to be weighed against the costs of deterrence.

# It's a second-best world



## It's a second-best world

- Usually doesn't pay or is impossible to eliminate bad behavior completely
- A firm that tried would be wasting resources

# It's a second-best world

- Models of governance indicate that first best is *impossible* due to
  - Asymmetries of information
  - Tradeoffs between incentives and insurance
  - Career concerns distortions
  - Costs of monitoring

# We should expect failure

- In very few circumstances is zero tolerance optimal
- We should expect to see “governance” failures
- If we didn't, then we should conclude that too many resources are being spent on governance

# Economics of regulation

- To understand what happens when the state constrains a firm, one should start from a model in which we understand how the firm behaves when unconstrained.

## Limits on what externally imposed reform can accomplish

- Contract theory tells us that there are four scenarios in which outside interference in private contracting can be beneficial:
  - State more efficient at writing contracts than private parties
  - Asymmetric information at the time of contracting.
  - Externalities on a third party
  - State has access to remedies/punishments unavailable to private parties (e.g., incarceration)
- Under reasonable assumptions about bargaining, can be shown these are only four scenarios

# How does governance fit?

- Hard to see how state is more efficient at writing contracts than private parties
  - Perhaps some savings by having state design *default* contracts
  - But big difference between *default* and *mandatory*
- Some have argued many shareholders face transactions costs bargaining with firm, so have state do it
  - But can see shareholders as one of many suppliers to firm
  - Don't think state should write contracts for suppliers generally
  - Moreover, multitude of shareholders matters for distribution not efficiency

# How does governance fit?

- Asymmetries *at time of contracting* are a possibility, but not clear proposed reforms address these.
- Externalities could exist ...
  - ... but hard to see that most reforms address these.
  - Perhaps if crisis in one firm (Enron) causes investors not to trust other firms.
- Does, however, seem role possibly for government to strengthen penalties.

# Summary of general observations

- Criticism of Governance must accept
  - Corporate form is a hardy survivor
  - It's a second-best world, so it's wrong to expect and misguided to seek perfection
- What we see is the second-best outcome of a struggle among optimizing actors
  - Hence, policy prescriptions formed from regressions of endogenous variables on each other are likely misguided
- Contract theory tells us the scope for efficiency-enhancing regulation is limited

# Some Specific Observations

New work with Michael S. Weisbach:  
“A Framework for Assessing Corporate  
Governance Reform”

# Outline

- Consider two types of reform:
  1. Reforms that improve the quality of information transmitted to the board.
  2. Reforms that increase the penalties for concealing information.

# Model: Timing

Board hires  
new CEO.



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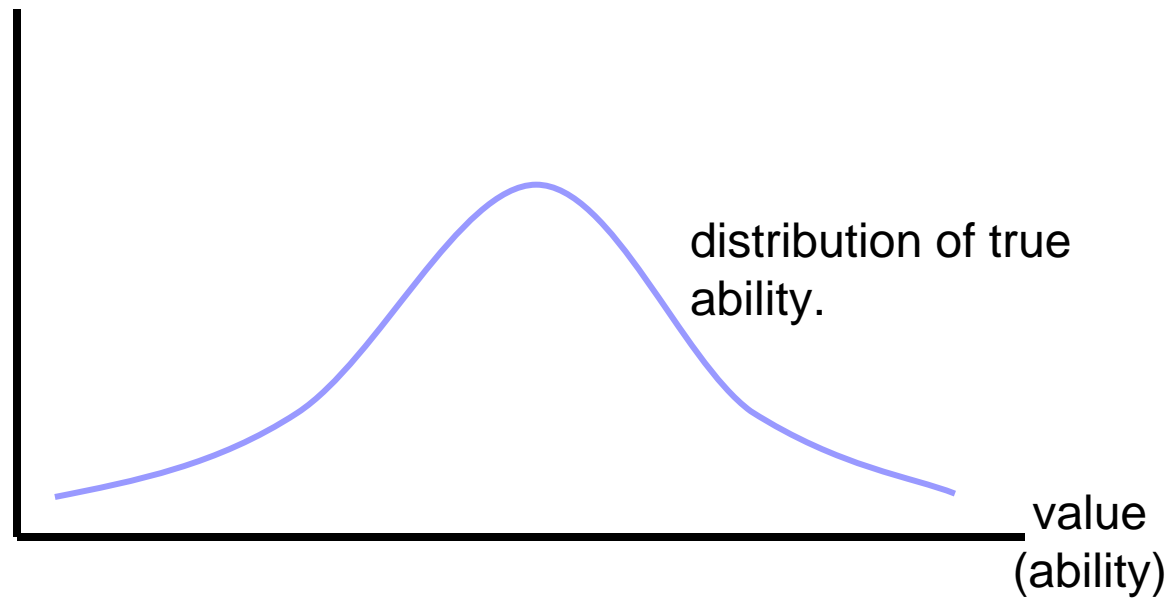
# Preferences and Ability

- Earnings are distributed normally with a mean equal to the ability,  $\alpha$ , of the CEO hired at stage 1 if the board makes *no* change.
- Otherwise earnings have a mean of zero less a disruption cost  $\delta \geq 0$  if board makes a change.
- Assume preferences of board can be aggregated so that it acts as a profit maximizer; that is, the board is a perfect agent for shareholders.

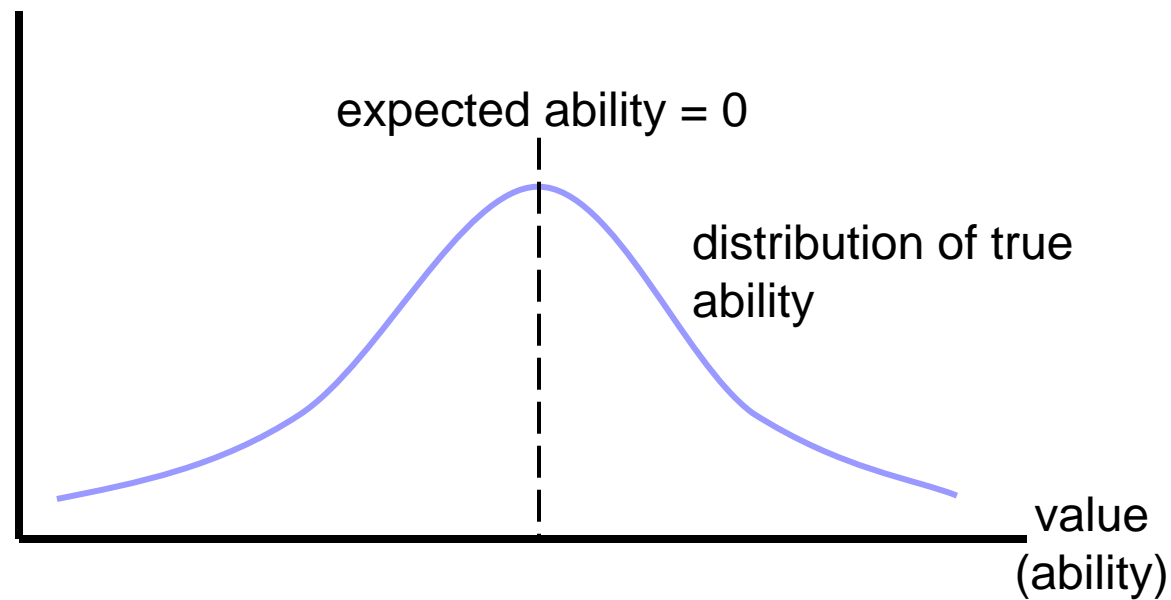
# Informational Assumptions

- CEO's ability,  $\alpha$ , is fixed throughout his career. It is unknown, *ex ante*, by anyone, but it is common knowledge that  $\alpha$  is the draw from a normal distribution with mean 0 and precision  $\tau$ . [Recall precision = 1/variance]
- The signal,  $y$ , is distributed normally with mean  $\alpha + e$  and precision  $q$ .
- The parameter  $q$  is measure of reporting quality.
- The signal is public.

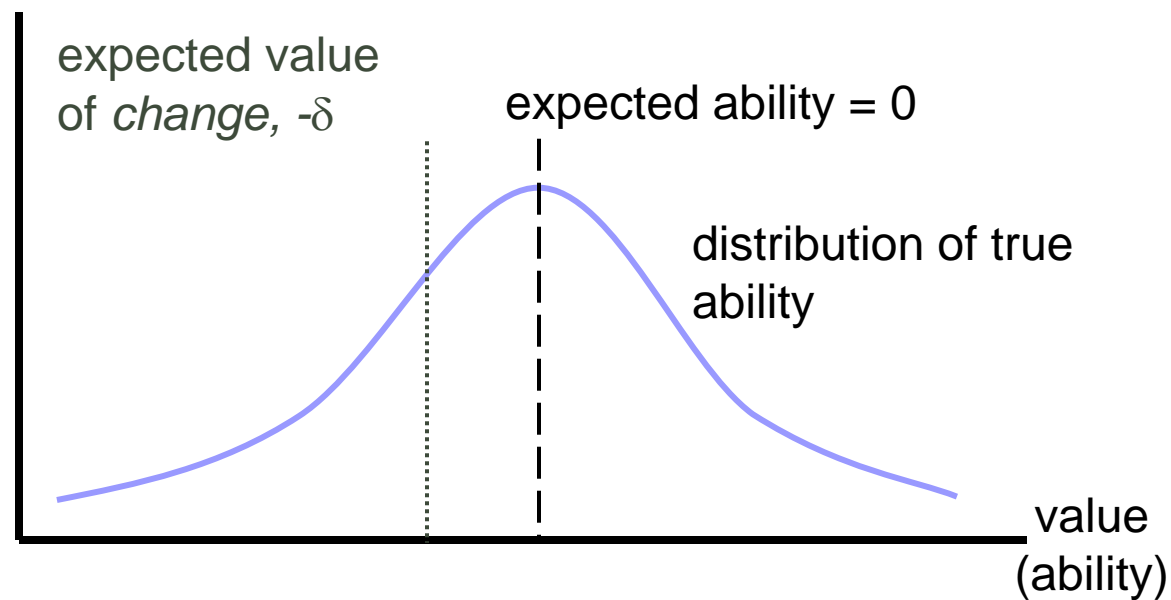
# Thinking about incumbent ability



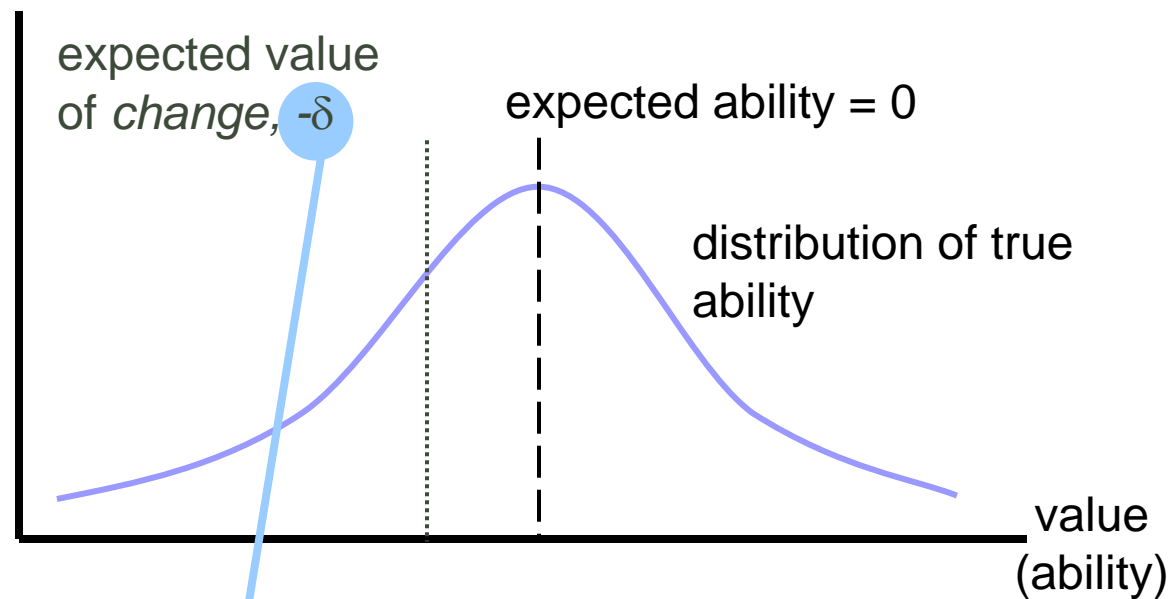
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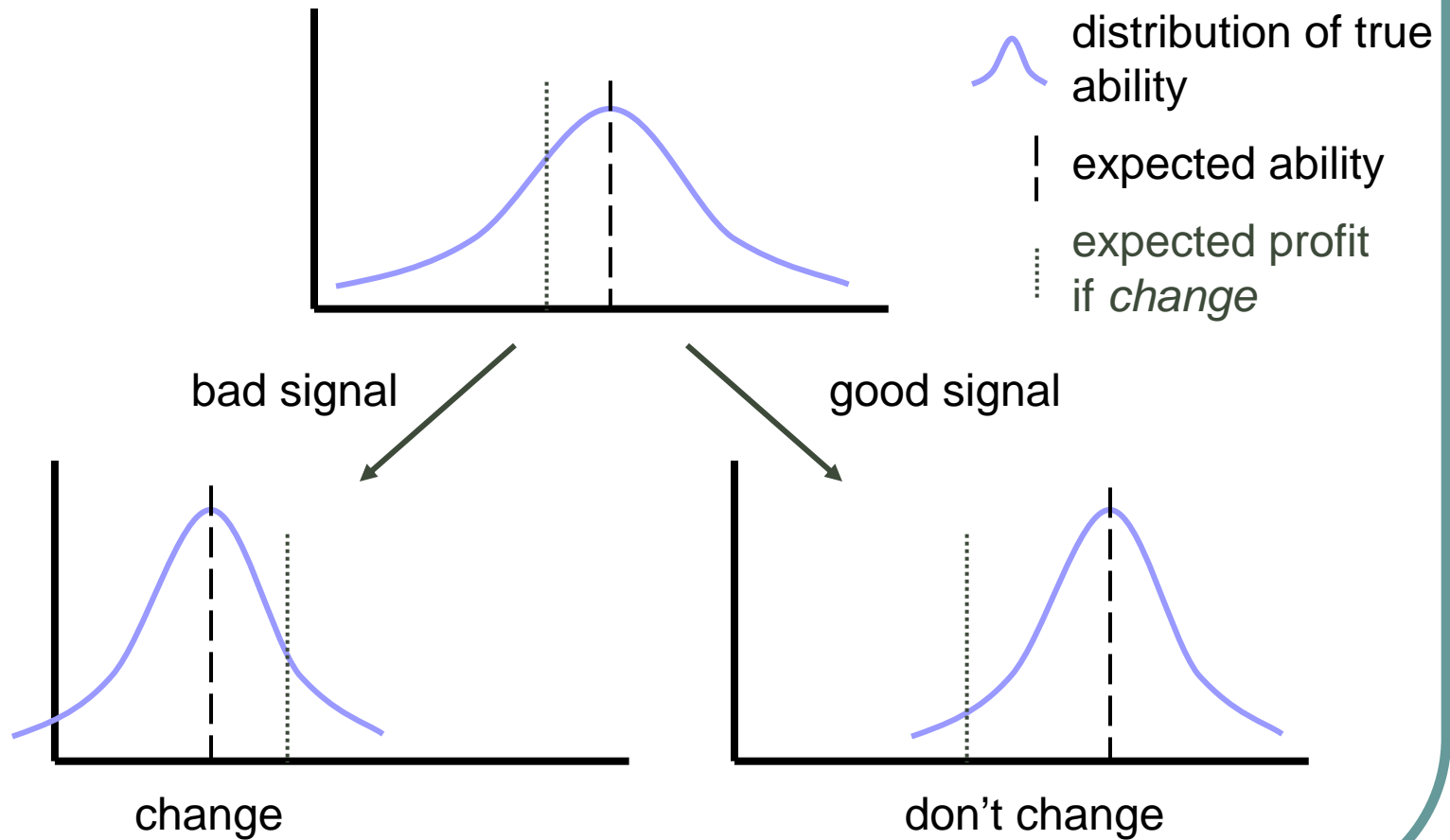


# Thinking about incumbent ability



$\delta$  is the cost, in terms of disruption, etc., of implementing a change

# Thinking about Consequence of Signal



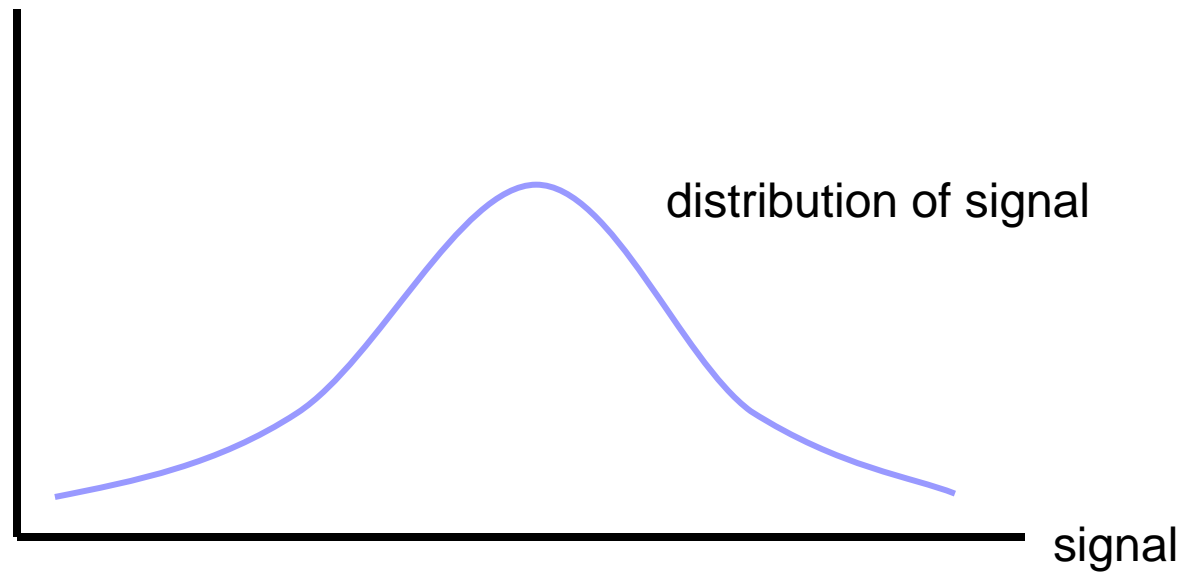
# Value of Signal

- Ability to change creates valuable option
- This option exists precisely because can respond to a bad signal by changing
- As previous illustrations suggest, ***ceteris paribus*** the more precise the signal, the greater is firm value
- Interpreting signal precision as a statement about reporting quality, then *ceteris paribus* want as high as possible reporting quality.

## Problem – Situation is not *Ceteris Paribus*

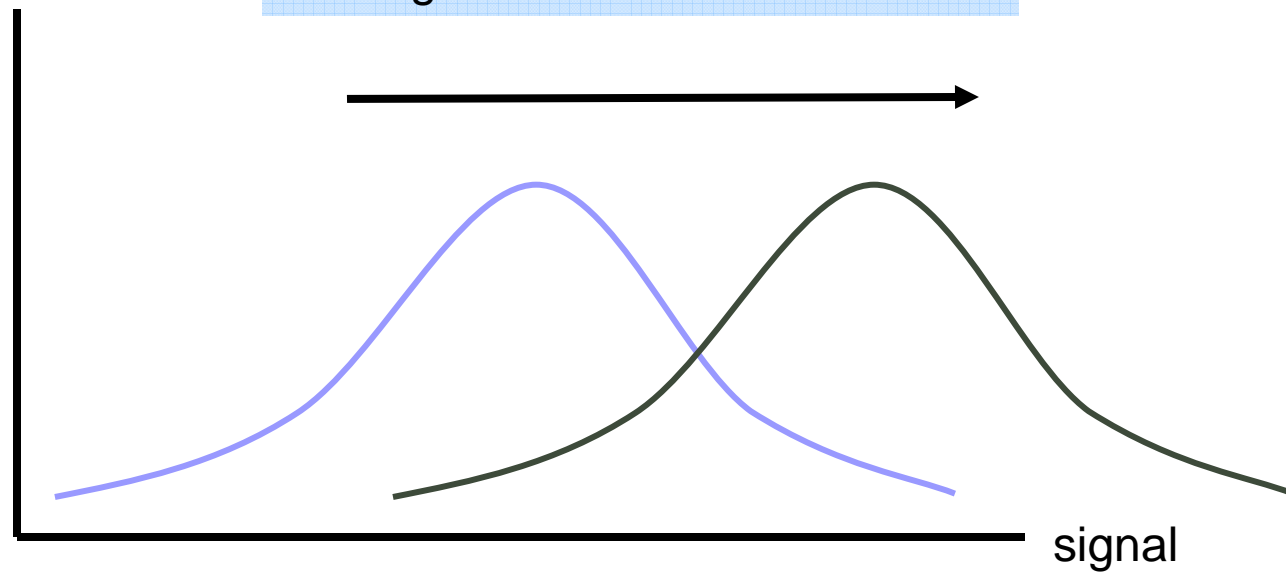
- CEO can adjust his effort to try to jam the signal.
- How much effort he expends is a function of how responsive potential future employers are to the signal
- This, in turn, is a function of the precision of the signal (quality of reporting).

# Effort



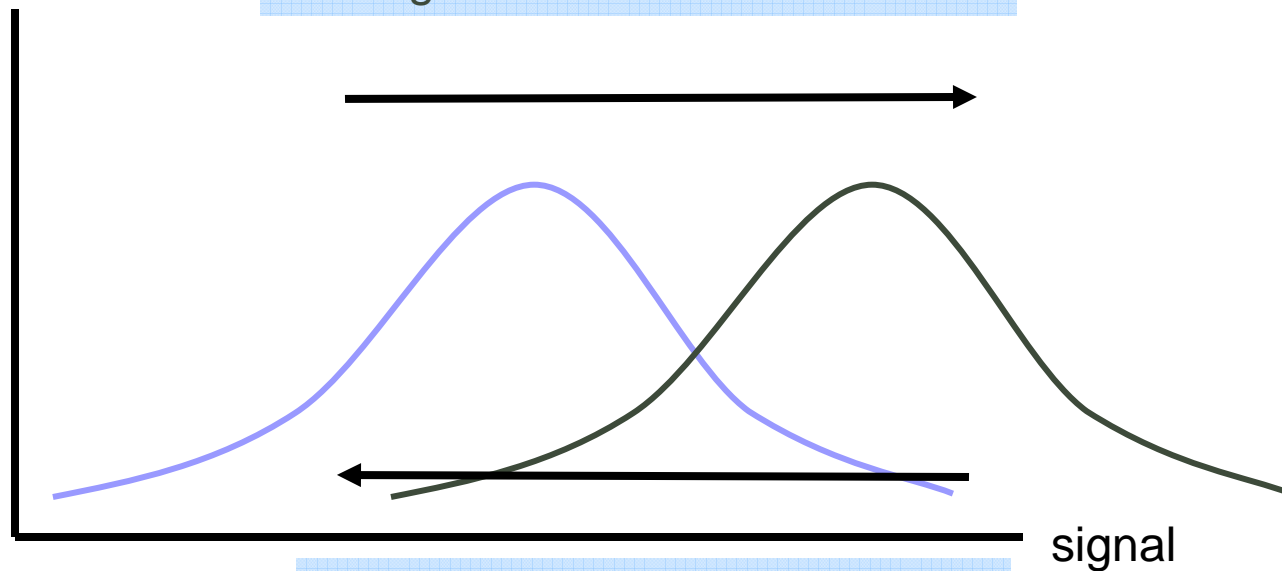
# Effort

effort shifts the signal to the right,  
making CEO seem better



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But in equilibrium nobody is  
fooled — *expected* effort is  
subtracted when inferring ability

# Consequences of Reporting Quality on CEO Wellbeing

- **Proposition 1:** The CEO's equilibrium effort at distortion increases with the quality of reporting (*i.e.*,  $de^*/dq > 0$ ).
- Intuition: As seen, more responsive is board to signal, the greater the motive the CEO has to distort.
- **Proposition 2:** The *equilibrium* probability of change increases with the quality of reporting.

## Plus: CEO faces job-market risk

- CEO is risk averse in future salary
- If signal were total noise, then posterior would be prior and no risk.
- If signal is perfectly predictive, then he faces maximum risk (no weight on known prior).
- So improved quality of reporting; that is, improved predictive power of signal reduces the CEO's *expected* future utility.

# Pros and Cons to Improved Reporting

- Pro: Holding CEO compensation fixed, an increase in reporting quality raises firm value
- Con: Makes CEO's job worse
  - Has to work harder
  - Exposed to more job-market risk
  - *Therefore*, his compensation must rise.
- Hence, consequences for firm profits are ambiguous.
- As a consequence, the *optimal* level of reporting quality could be finite.

# Note

- Proposition: The CEO's equilibrium compensation is increasing in the level of reporting quality.

# Other formulations (work in progress)

- Let CEO not distort mean of signal, but make it noisier
  - Next model could be considered opportunity of CEO to make signal infinitely noisy.
- Embed problem in a real agency problem
  - To an extent this was done in Hermalin & Katz (2001)
    - “Corporate Diversification and Agency” in *Incentives, Organization, and Public Economics: Papers in Honour of Sir James Mirrlees*, edited by P. Hammond and G. Myles, Oxford: Oxford University Press, 2001.
  - But work remains.

# A Second Model: SOx as Raising Cost of Concealment

- Imagine now that reporting quality is fixed.
- Now, CEO can also expend effort on concealing signal.
- Reform seeks to increase the cost to the CEO of doing so (e.g., increase the penalty if caught distorting the signal).
  - Let  $c(p,r)$  denote (expected) cost to CEO who selects probability of signal concealment,  $p$ , under reporting standard,  $r$ .

# Interpreting $c(p,r)$ : Three Possibilities

- The parameter  $r$  is probability CEO's efforts to hide the signal,  $p$ , are detected and his penalty is an increasing function of those efforts (*i.e.*, of  $p$ ).
- The parameter  $r$  is the penalty the CEO receives if caught and the penalty of being caught is the greater his efforts to conceal.
- The parameter  $r$  captures nuisances, obstacles, or other costs (*e.g.*, signing certificates) associated with hiding the signal and these costs are increasing in efforts to conceal.

# Equilibrium

- Distortion (*i.e.*,  $e$ ) and concealment (*i.e.*,  $p$ ) are substitute activities for the CEO.
- Lemma 3: An increase in  $r$  results in the CEO's expending less effort on concealment and more effort on distortion.
- No strong prediction between  $r$  and firm's expected profits.
  - Under some conditions (*e.g.*, CEO cares a lot about future risk), optimal  $r$  small; but
  - Under others (*e.g.*, CEO cares little about future), optimal  $r$  large.

# Consequences of Reform

- The consequences of reform depend on the model parameters.
- Under certain parameter values, the optimal penalty for concealment is 0
  - Lowers CEO compensation by reducing future risk *and* effort expended on distorting signal
  - This benefit not offset by reduced option value of being able to make changes.
- Under certain parameter values, the optimal penalty is infinite.
  - The lost option value dominates the lower compensation
  - Now reform potentially valuable insofar as firms could be up against a binding boundary, so relaxing the boundary (e.g., putting in tougher penalties) is welfare improving.

# Summary of results

- Improvements in reporting quality have ambiguous effects on firm profitability
  - But observe firm is achieving second best solution setting reporting quality.
  - Hence, scope for reform is limited.

## Summary of results (continued)

- Optimal level of deterrence against concealment is also ambiguous
  - If firm limited with respect to punishments, then scope for welfare-improving reforms in the shape of greater criminal punishment for concealment
  - But, not clear that level of deterrence is optimal—less could be more—so caution is dictated.

# Conclusions

- What we see has survived Darwinian forces
- Governance is a second-best phenomenon
- No governance failures  $\Rightarrow$  too much being spent on governance
- Scope for external reforms to be efficiency enhancing is limited

# Conclusions (II)

- Governance is a system
- Taking monitoring seriously illustrates that
  - Even “free” monitoring has costs in terms of impact on CEO compensation and behavior
  - Pure reporting reforms are unlikely to improve matters
  - Enhanced punishments could be—but are not guaranteed to be—beneficial.