
EDITORIAL COMMENTARY

Corporate Governance: Incentive, Conflict of Interest and Bias

The last decade has been marked by steadily increasing interest in the topic of corporate governance, which is followed by heightened public scrutiny after the corporate scandals of the early 2000s. Conventional wisdom now states that stock- and option-based incentive compensation should constitute a significant part of executive pay to align the interest of the executives with that of the shareholders, and corporate boards should be dominated by independent directors to promote more effective monitoring. These measures are assumed to mitigate the agency problems. With all the theoretical arguments favoring such measures, empirical evidence to date includes contradictory results signaling for the counter measures that may have evolved over time. In this paper, we discuss the issues revolving around board structure, executive compensation, the role of external markets and public policy from the perspective of shareholders.

There is a marked focus on the structure of board of directors, since the board is considered to be the most important monitor of management. The two dimensions of boards that have received most attention from policy makers and academics alike are board size and independence. Board size is believed to be negatively associated with firm performance,¹ though recent literature argues that board size is determined endogenously depending on the tradeoff between the costs and benefits of adding additional directors.² The premise of the board independence argument is that outsiders do not have the conflict of interest that insider directors have and therefore provide better monitoring of the management for the shareholders. Firms seem to have adopted this recommendation, as observed in Table 2, where median percentage of outsiders on corporate boards is 69.2 among the extended list of Dow Jones companies listed in Table 1.³ However, a recent survey by Hermalin and Weisbach (2003) concludes that the proportion of board outsiders (the independents) is not related to superior firm performance.⁴ Also, in some of the recent cases that are exemplified as failure of corporate governance, e.g. the Enron case, majority of the directors were outsiders. What seems to be missing from the equation? One potential explanation lies in the agency problem between the directors and the shareholders. As observed from Table 2, outside directors hold less than 0.03 percent (median value) of company shares. It is difficult to believe that directors, independent or not, will spend sufficient time and effort

for their duties unless they have the incentives to do so. After all, management and directors share the same problem of incentives at a fundamental level.

Agency theory suggests alignment of the incentives of the management with those of the shareholders as a solution to the problem faced by firms with dispersed ownership. The alignment of incentives is realized by a combination of stock and stock-options in compensation packages. Conformably, the sensitivity of executive pay to firm performance in the US has vastly increased since the 1990s.⁵ The issue of whether the incentives are at an optimal level is less settled, though. The traditional view has been that the compensation contracts are optimal given the constraints on contracting with the incentives levels determined by firm characteristics.⁶ However, Morck, Schliefer and Vishny (1988) and Jensen (1993) argue that contracting arrangements are largely inefficient and do not minimize agency costs.⁷

We do not know how exactly stock and option based compensation contracts alter or bias managerial behavior. For example, managers that are compensated with stock options, have high exposure to firm-specific risk. This condition has the potential to change managerial behavior so that the firm eventually invests in safer projects. On the other hand if compensation contracts are designed such that managers are protected from firm specific risk, will their incentives work? Incentives should ideally reward managers for firm specific and not market/ industry performance. This is also the basic idea behind RPE or relative performance evaluation, where managerial pay is benchmarked to the performance of peer firms.

On a related note, a practice that has been controversial is the resetting of stock option contract features, e.g. strike price, to the benefit of the management, when firms perform poorly. This may be due to either poor governance or a rational need to retain the incentives of managers and protect them from industry- or market-wide shocks. Chance, Kumar, and Todd (2000) argue that firms with more severe agency problems are more likely to reset option features. Alternatively, Acharya, John, and Sundaram (2000) argue that resetting might be optimal when costs of replacing incumbents and the impact of external factors on firm performance are high. Designing option contracts based on the RPE principle may help resolve these problems without a need to change contract features ex-post.

Recent evidence suggests that the practice of granting stock and options to executives leaves much to be desired. Yermack (1995) finds that stock option granting practices are not explained by several efficient contracting hypotheses. Ofek and Yermack (2000) find that high ownership managers reduce the effect of stock based compensation on their ownership by selling already owned shares. There is also evidence to suggest that managers can time their option grants (Yermack (1997) and Aboody and Kasznik (2000)) to maximize their benefit. In a recent survey, Bebchuk et al. (2002) argue that many features of executive compensation contracts can be explained better by limits on 'outrage costs' or costs of alarming regulators and investors than by optimal contracting, i.e. executives get paid to the extent that their compensation does not attract attention from investors and regulators. Furthermore, recent accounting scandals have highlighted the effect of stock based compensation on executives' incentives to misreport financial information. For example, Burns and Kedia (2003) report that option based and not stock based compensation is related to propensity to misreport earnings. Managers simply let prices inflate based on erroneous earnings information and do not correct them until after they cash out their stock-option grants. Compensation contracts certainly do not have the intended effects if performance measures, in this case stock price, can be manipulated.

If and when internal governance fails, there are external market forces to fill the void. But when do the external market forces fail? One potential problem arises due to overvaluation. Related to the problem of misreporting of financial information, Jensen (2004) argues that overvaluation will create perverse incentives to executives to mislead the markets to sustain the overvaluation. This problem is further exacerbated by equity-based compensation because managers fear loss of value of their equity if the overvaluation is corrected. Further, the overvaluation prevents any external corrective mechanisms like takeovers, which are more likely to take place when targets are severely undervalued. Consistent with this notion, hostile takeovers have been very scarce since the 1990s.

The next line of defense for shareholders is public policy. The most topical policy debates are with respect to the effects of the recently enacted Sarbanes Oxley (SOX) Act and the issue regarding expensing of option based compensation and its effect on firm valuation. Academic debate on the effectiveness and desirability of the various provisions of the SOX act is ongoing and inconclusive so far. The general agreement seems to be that for smaller firms, the costs of compliance seem too high compared to the potential benefits. Romano (2004) surveys the literature related to the following provisions of SOX act; (i) requirement of hundred percent independent Audit Committees, (ii) restriction on provision of non-audit services by auditors, (iii) banning of loans

to executives and, (iv) certification of financial statements by the CEO and the CFO. He concludes that most provisions of SOX are ill-conceived and should be made optional at best instead of mandatory.

Another important debate is on whether or not stock options should be expensed. Theoretically this issue should not concern the impact on value—assuming that the markets are unbiased in pricing the impact of stock option grants on share prices—but it is certainly an issue in terms of the impact of expensing on firms' reported earnings. Most academic literature has argued that stock options are an expense and should be treated as such. Most opponents of expensing argue about the difficulty of expensing stock options and resulting valuation errors. Bodie, Kaplan and Merton (2003) make a very strong argument that stock options should be expensed. The authors state that to argue that expensing of stock options would be harmful to firm value, is to admit that the economics of current option grants as disclosed are not fully reflected in stock prices. Ferri, Markarian and Sandino (2004) provide an interesting piece of evidence on shareholder voting on expensing treatment of options. They find that insider ownership is positively associated with votes against expensing, consistent with the concern that expensing will lessen the ability of insiders to extract rents. Seethanraju and Zach (2004) argue that it is not stronger governance but higher publicity that drives most firms that chose voluntarily to expense stock options in the recent past.

Where Do We Stand?

Effective corporate governance can be thought to be based on two pillars. The first is the alignment of agent managers' incentives to those of the shareholders and the second is the improvement of internal and external monitoring of those agents so that their ability to deviate from their duties is minimized. The tools that were most stressed upon to achieve these two objectives were stock based compensation of executives and move towards independent boards. However, as recent literature and anecdotal evidence suggests, these tools are not without their problems. As incentive compensation helps align the interests of management and shareholders, it brings its own set of problems in the form of propensity of managers to mislead the markets and incentive to invest firm assets sub-optimally. The monitoring of executives by so-called independent boards leaves much to be desired unless the directors have incentives to carry out their tasks properly.

Directors are more likely to be plagued by cognitive errors, when there is less incentive to devote the resources required to monitor the management. Absent incentives, the instinct to herd and participate in group-think may be stronger. A very positive image presented by management (e.g. Enron's seemingly

huge profits in a new era of high-technology information based trading) has a strong affect component that would be difficult to counteract in the absence of a determined effort to sort out the facts. Directors and investors may not rely on seemingly independent financial analysts to sort out the facts either, since analysts share their own version of incentive problems. As the incentives grow, there is a stronger motive to utilize, perhaps unwittingly in some cases, methods that bias shareholders in terms of both cognitive and behavioral issues. Accounting facts that portend problems can be glossed over with a very positive image of the future of a new technology, for example. Hence, the concept of affect whether it is used intentionally or not can be instrumental when one group of decision makers and information providers has so much to gain.

Market efficiency does not rule out idiosyncrasies in individual behavior. Directors and managers can both suffer from hubris which can lead them to believe in their decisions irrespective of the feedback that they get from the markets. Misreporting of earnings by executives and their auditors can be at least partly attributed to these agents believing in the potential of their business, which was not justified by later realizations. Less settled is the issue of whether markets can be systematically erroneous in providing feedback to the managers regarding the value of their stock and the impact of their actions. Because, like all corporate decisions, governance decisions and behavior of managers and directors is likely to be highly influenced by market feedback. Underlying the notion of efficient capital markets is an understanding that individual limitations are made irrelevant by market forces like arbitrage and learning. However, recent literature on behavioral finance point out to the limits of arbitrage and market constraints (for example those on short selling) that can lead to misvaluations that persist over significant periods.⁸ For corporate governance and decision making, the issue is whether or not the actions of a few investors can mislead the markets for long enough time to misguide managers in their decision making. Unlike long term investors who can ride out noisy fluctuations, managers involved in daily decision making cannot afford to reasonably ignore stock price variations. Allen (2001) points out that agency problems at financial institutions might account for asset pricing bubbles as these agents of people's money have an asymmetric payoff in the performance of the funds they manage. Since most trading activity is accounted for by financial institutions' agents with imperfect incentives rather than investors trading on their own account, it is not implausible that the actions of few individuals might bias market prices.

Finally, strong-handed regulation is unlikely to prove to be a solution for shareholders as it comes with its associated compliance costs and even bigger costs in the form of firms choosing not to access the equity capital markets. One is tempted to see the recent losses

in the corporate scandals in perspective of the gains in value made in the 1990s. However, given the severe implications of these scandals for shareholders, employees, etc., ex-post settling of agency problems—or the problems that evolve as a result of measures to counter them—does not seem to be bullet-proof, at least over the short run. Over time and with more analyses, there is much more insight to be gained.

Notes

1. See Yermack (1996) and Eisenberg et al. (1998).
2. See Boone et al. (2004) and Lehn et al. (2003).
3. The extended list includes the firms in the Dow Jones Industrial Average and Dow Utilities and Transportation indices.
4. The authors find that board structure is associated with decisions regarding acquisitions, CEO turnover and compensation
5. See surveys by Murphy (1999) and Core et. al (2003).
6. See Demsetz and Lehn (1985), Smith and Watts (1992) and Core et al (1999)
7. Schliefer and Vishny (1997) and Zingales (1998) suggest that contracts may be optimal, but transactions costs prevent adjustment over time so that the contracts deviate from the optimum eventually.
8. See Barberis and Thaler (2002) for a survey on literature on behavioral finance

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Appendix 1. Sample

No	Firm Name	SIC	No	Firm Name	SIC
1	Amr Corp/De	4512	22	Intel Corp	3674
2	Honeywell International Inc	3728	23	Intl Business Machines Corp	7370
3	Alcoa Inc	3350	24	Intl Paper Co	2600
4	American Express	6199	25	Johnson & Johnson	2834
5	AT&T Corp	4813	26	Mcdonalds Corp	5812
6	Boeing Co	3721	27	Merck & Co	2834
7	Caterpillar Inc	3531	28	3M Co	2670
8	J P Morgan Chase & Co	6020	29	Northwest Airlines Corp	4512
9	Coca-Cola Co	2080	30	Procter & Gamble Co	2840
10	Citigroup Inc	6199	31	Southern Co	4911
11	Delta Air Lines Inc	4512	32	Southwest Airlines	4512
12	Disney (Walt) Co	4833	33	SBC Communications Inc	4813
13	Dominion Resources Inc	4911	34	TXU Corp	4931
14	Du Pont (E I) De Nemours	2820	35	UAL Corp	4512
15	Duke Energy Corp	4911	36	Union Pacific Corp	4011
16	Eastman Kodak Co	3861	37	US Airways Group Inc	4512
17	Fedex Corp	4513	38	United Technologies Corp	3724
18	General Electric Co	9997	39	Wal-Mart Stores	5331
19	General Motors Corp	3711	40	Williams Cos Inc	4922
20	Hewlett-Packard Co	3570	41	Microsoft Corp	7372
21	Home Depot Inc	5211	42	Philip Morris (Altria)	2111

Note: The sample is derived from the set of firms in the Dow Jones Industrial Average and Dow Jones Utilities and Transportation indices.

Appendix 2. Board Characteristics

	Average	Median	SD	5th Percentile	95th Percentile	MIN	MAX
Board Size	12.90	13.00	2.50	9.00	16.70	6.00	21.00
Percent Outsider directors	66.90	69.20	15.10	41.70	91.70	30.80	93.03
Percent Insider directors	17.90	16.70	8.80	7.10	35.30	4.80	50.00
Percent Outside Director Ownership	0.99	0.03	3.93	0.00	5.24	0.00	28.06
Percent Board plus Executive Ownership	4.72	1.18	9.33	0.08	30.34	0.05	43.63

Note: All data are for sample of 168 firm years from 1998 to 2001.

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