Topic 7
Monitoring the Corporation: Corporate Governance

(Policing the Behaviour of Management)

1) **External Monitors**
   - -P_______ Markets
   - -C_______ Markets

2) **The Free ______ Problem and the Tender Offer**
   -Why bad management remains

3) **I________ Monitors of management**
   - -Expense Preference (utility theory)
   - -Ex-post Settling Up

4) **The Principle Agent Relationship and Ownership Structure**

5) **Expense Preference Under a Profit Constraint**

6) **The Unregulated Firm and Expense Preference**

<u>Introduction:</u> We have assumed that the firm pursues the primary goal of ______ maximization. The firm's managers look after shareholder interests by maximizing firm profits.

But is this a realistic assumption?

Since it is very common for managers to be acting separately from shareholders in large firms, why should a manager look after the interests of shareholders ***<u>and</u>*** <u>not the manager's interests</u>**?**

The m______ may be more interested in building an <u>empire</u>, devising massive <u>compensation</u> packages, having a large support <u>staff</u>, taking trips on company <u>jet</u>, etc...

- The interests of shareholders can ***c______t*** with those of managers.

Who then m______ the manager, such that the interests of the shareholders is of primary concern?

☺ There are economic forces that constrain the behaviour of managers.

External and Internal Monitors:

The **product** and **capital** markets are **external** monitors that limit the opportunistic actions of managers. C_____ markets operate in such a way that they create the proper **incentives** for managers to maximize _______, regardless of the market structure.

Plus, there are **internal** monitors of managerial performance. The board of directors can ______ good performance or eliminate managers who do not maximize profits

External Monitors: Product and Capital Markets

In **competitive markets**, managers maximize profits by minimizing cost and by producing the profit-maximizing quantity. Any firm that does not cost minimize will **not s______** because _____ will be less than long-run average cost. Hence, competition in the **product market** motivates managers to pursue the goal of profit maximization.

Product market competition is an important external monitor in competitive industries.

The **capital market** also monitors management performance.

When a firm is offered to the public, it offers ownership shares called common _____. Owners of these stock shares become owners of the company. When the firm's profits increase, the value of the _____ also increases. Shareholders expect the management to maximize profits so that the _____ prices reach a maximum.

If management is ***not*** maximizing the profit of the firm, outsiders and/or current shareholders may begin to buy up shares in order to **c______** the company and replace management with new managers who will pursue profit-maximizing strategies.

Hence, the capital market punishes bad management by replacing them.

Studies have shown that:

1) A management ______ leads to an improvement in the operating performance of a firm.

2) The capital market tends to _______ managements that do not improve the operating performance of firms.

The Free Rider Problem and The Tender Offer

This section describes why each shareholder has little incentive to _______ a management team that is not maximizing profits:

Commonly, an individual shareholder has limited power over the management team of a firm, since no one shareholder owns a large interest in a firm.

For firms with many small shareholders, a **free-rider** problem arises when the _______ market attempts to replace a management team that performs badly.

<u>Situation:</u> We will assume that an individual concludes that the current management is not maximizing _______. She believes that new management would raise the profits of the firm. The individual decides to replace management by ______ shares to gain a majority of shares through a ***tender offer***. With a majority of shares, she can vote to eliminate the current management.

In a **<u>tender offer</u>**, an individual offers to pay a price ______ than market price for each ______, <u>provided</u> shareholders ______ a ***specified*** number of shares.

<u>Dilemma:</u> ***Does an individual stockholder sell his shares or ____ to see if the bidder can replace the current management with new management that will maximize profits?***

<u>Compare:</u> Suppose profit is currently Π_0 and the stock price is P_0 with the existing management team.
With a new management team, the bidder expects profits will increase to Π_1 and the stock price will rise from P_0 to P_2.

The bidder offers a price of P_1, which is less than P_2, but greater than the current price P_0, to existing shareholders if 50% of the firm's shares are tendered.

If the majority does not tender, the takeover fails and no shares change hands.

Do you sell your shares to the bidder?

Probably ___!

To illustrate why, examine the payoff matrix:

		Tender offer	
		Successful	Unsuccessful
Shareholder	Do Not Enter		
Decisions	Tender		

The shareholder may tender or not and the takeover is either successful or not.

If the bidder is unable to get a majority and the takeover is unsuccessful, the firm's _______ do not change, no shares change hands, and the price of the shares remains the same at P_0, whether the shareholder tenders or not.

➢ Hence, the shareholder is in__________.

❖ If the takeover is **successful** and the new management increases profits, such that the stock price increases, the shareholder's capital gain is (P_1-P_0), if the stock is tendered, and (P_2-P_0), if the stock is not tendered.

- Since the **bidder** will never offer a tender price as ____ as P_2 for the shares, because the bidder will not gain anything if the tender offer succeeds, the shareholder surmises that the tender price must be less than the _____ the bidder expects the stock price to reach.

- The bidder hopes to buy the shares at the tender price of P_1 and sell or retain them when the price reaches P_2.

- Hence, a shareholder will not tender the shares, but will **wait** until the price increases to P_2 before selling them.

The shareholder hopes that other shareholders ______ their shares, the tender offer succeeds and a new management increases profits. That way, the shareholder will gain from increased stock price by ***not*** tendering.

Shareholders get a **f___ ride** because of the tender offer. The bidder most likely has done her research and formed a new management strategy at her personal cost. She cannot charge other shareholders for this research or effort. Hence, shareholders benefit from the takeover without incurring the ____ of effort or initiating the tender offer.

If one shareholder devotes resources to improving management, then all shareholders benefit. Other shareholders ***free-ride*** on the efforts of the bidder/shareholder.

<u>If most shareholders behave this way, a takeover will fail and the non-profit maximizing management team remain in their jobs.</u>

☹ The ____-_____ problem reduces the effectiveness of the capital market as a **<u>m______</u>** of managerial performance.

The capital market is an ________ and complicated means of disciplining management.

When the capital market acts, it signals that the internal monitors are ineffective.

In the next section we will examine how an internal monitor can affect management.

Internal Monitors of Management

There are **two** internal monitors:

1) **concentrated _____ ownership**
- a few shareholders own 20-30% of the company
- incentive to collect data and monitor management decisions

2) **the board of _________**
- monitor, evaluate and reward/punish management
- can attenuate the consequences of the free rider problem

How does the board serve the shareholders?

Expense Preference

- The board of directors is an internal institution that monitors managerial performance and offers advice to the management.
- However, the board does not have the information or time to monitor management on a day to day basis.
- It assesses management, and either rewards or punishes the manager or CEO (Chief executive officer).

In large corporations, the CEO may have a great deal of power, such that she or he decides what projects the firm will undertake.

- She or he may also indulge her/his own preferences for some kinds of expenses that increase her/his **u______** and raise the firm's _____.

Example: Private planes, support staff, fancy furniture

- Or the manager may decide to err on the side of caution and not undertake projects that are potentially profitable, lowering the potential profits of the firm, but raising the manager's _______.

- Or the manager may decide to hire the wrong staff.

<u>Example</u>: hire a friend, when there is a more qualified worker available and willing to take the same salary.

A CEO can raise expenses above the cost-__________ amount for a given quantity produced. The excess of expenses above this amount is referred to as **expense ___________.**

Expense preference is the ______ of expenses over the level that maximizes the firm’s profits.

Ex Post Settling Up

Although the board of directors cannot prevent expense preference of the ________, it can make the manager pay for the expense preference.

The board can link the manager's ______________ to expense preference.

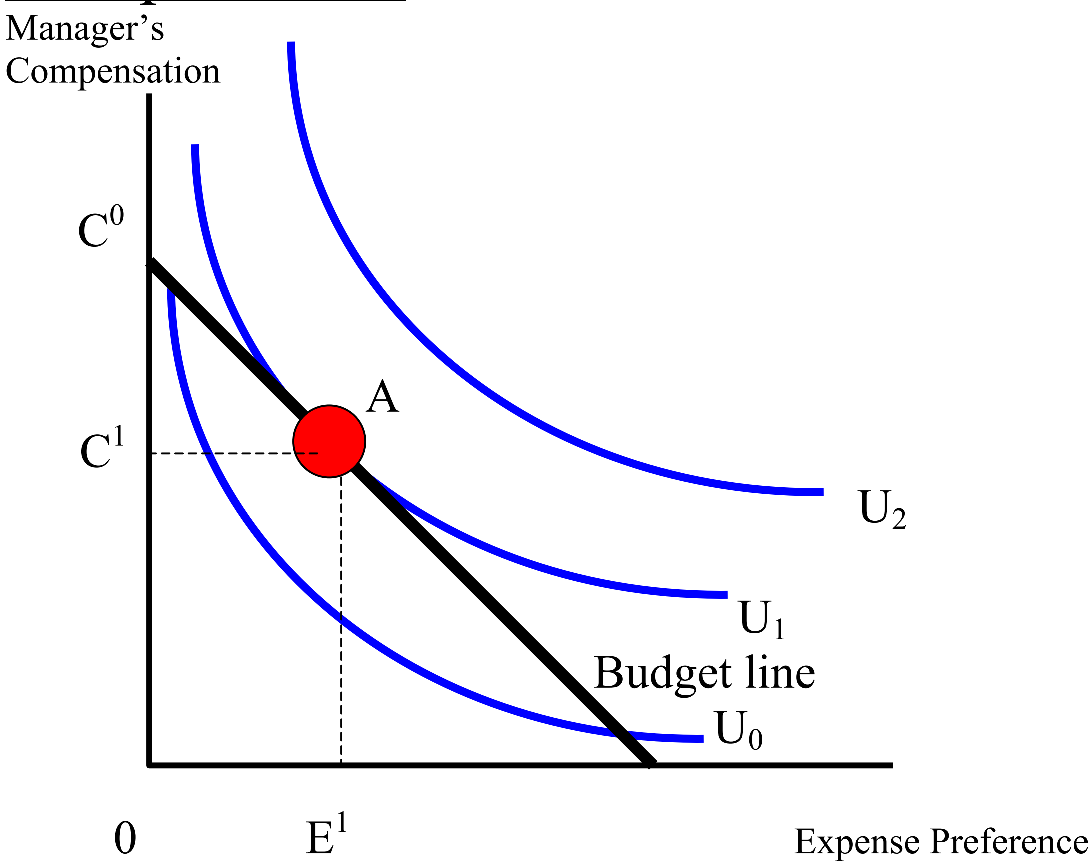
- The board would evaluate and settle up with the manager at specified times.

The board of directors could pay the manager a base salary and at the end of the year determine a ______, based on the results for the year.

If the manager incurred costs by indulging in his own agenda, the board reduces total ____________ by reducing the bonus.

Ex post settling up means the board reduces compensation dollar for ______ for the increase in cost. This way the board of directors can adopt a policy that makes the manager pay for any increase in expense preference.

Example: The Trade-Off Between Preference and Compensation



In this model, the manager maximizes **u_______** by selecting a market basket of expense preference and compensation.

The board sets the **manager's compensation** at a level C^0, with the understanding that the manager will maximize _______.

If the board finds that the manager indulged in his expense preference and did not maximize _______, it will reduce the manager's compensation, dollar for dollar, with the increase in expense preference.

The straight line represents the manager's budget constraint between compensation and expense preference. The _____ is -1 (compensation decreases by $1 for every $1 increase in expense preference.)

To determine the point where the manager maximizes his utility, examine the manager's ________function.

In this diagram there are several indifference curves for the manager.

- The manager maximizes utility at point A where indifference curve U_1 is tangent to the budget line.

The manager prefers combination of $C^1$and E^1, to C^0 and no expense preference because his utility is only U_0.

The manager pays for the expense preference, not the shareholders.

- The example assumes that the board of directors is an independent body, and has enough information to evaluate the manager's performance.

- Often, though, managers are members of the board and have a great deal of influence on the evaluation.

Note: Often the board of directors has _____________ information in order to make the necessary adjustments to the manager's compensation to offset increases in expense preference. It is more likely to react once there are obvious differences in expected output and costs to the firm.

The Principal Agent Relationship and Ownership Structure

- The **manager** is the **a____** in a corporation.
- The **shareholders** are the **p__________** in a corporation.

Often the principal cannot monitor the management decisions of the agent ***perfectly***.

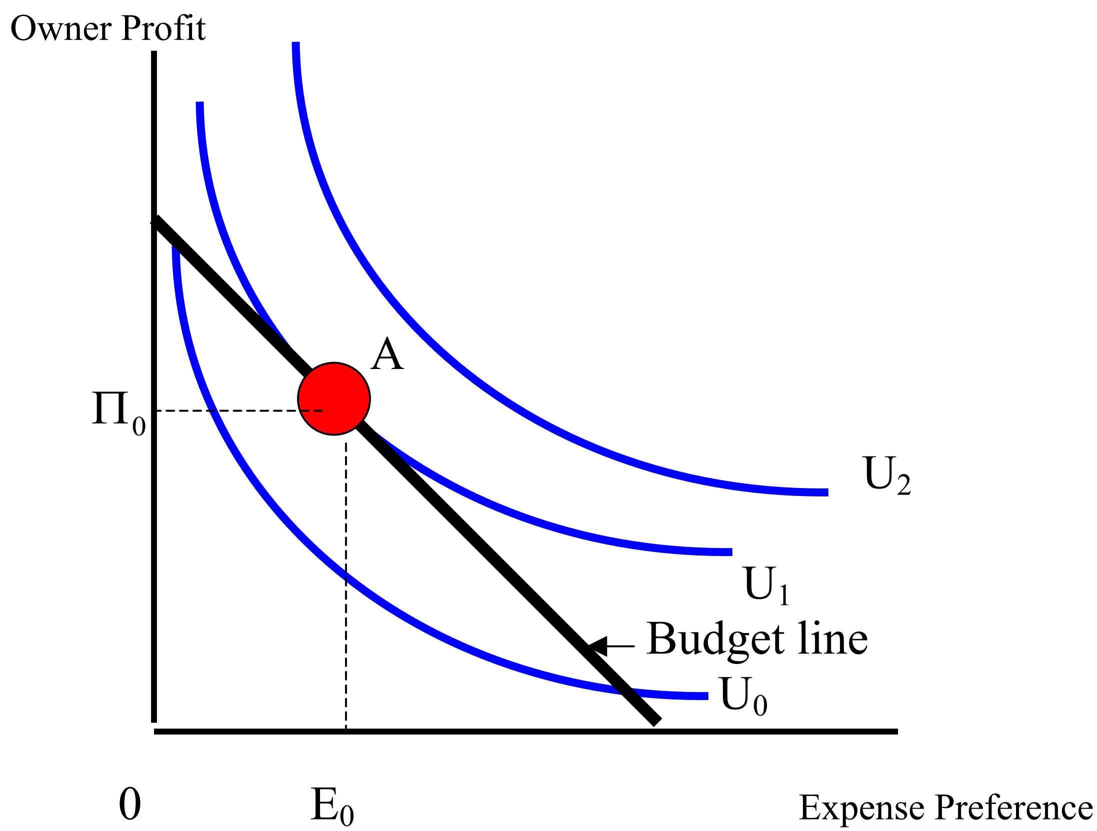
A principle-agent relationship exists whenever an agent makes decisions that affect the well-being of the principal.

Previously, we assumed that the manager did not ___ any part of the firm.

How does the managerial behaviour change when the manager is also an _____ of the firm?

When there is a single owner of the firm, he or she receives any profit or incurs any loss of the firm.

If the manager is the sole _____, he makes a trade-off between the <u>profits of the firm</u> and <u>expense preference</u> instead of a trade-off between compensation and expense preference.



In the graph above, total profits are on the vertical axis and expense preference is on the horizontal axis.

Any expense preference reduces the profits of the manager-owner dollar for dollar, since the manager is the owner.

The budget line illustrates the trade-off between profits and expense preference.

The owner's indifference curve U_1 is <u>tangent</u> to the budget line at point A.

The **<u>manager's _______</u>** is maximized when profits are Π_0 and expense preference is E_0.

The owner who indulges pays for the indulgence through **<u>lower</u>** ________.

The last two examples represent two **extremes**.

- manager has no ownership
- manager has total ownership

✿ In both cases it is the **m_______** who pays for the expense preference.

In reality, the manager usually owns a certain percentage of the total shares and the board uses ex post settling up to monitor management.

It has been seen that as the share of ownership of the firm falls, the behaviour of the manager changes.

◆ Suppose the owner sells 25% of the ownership claims on profits and retains a 75% share of any profits. If outsiders purchase 25% of the rights to profits, ***how much will they be willing to pay***?

When the manager is the sole _____ of the firm, the profits of the firm are Π_0. Hence, outsiders might be willing to pay 25% of Π_0.

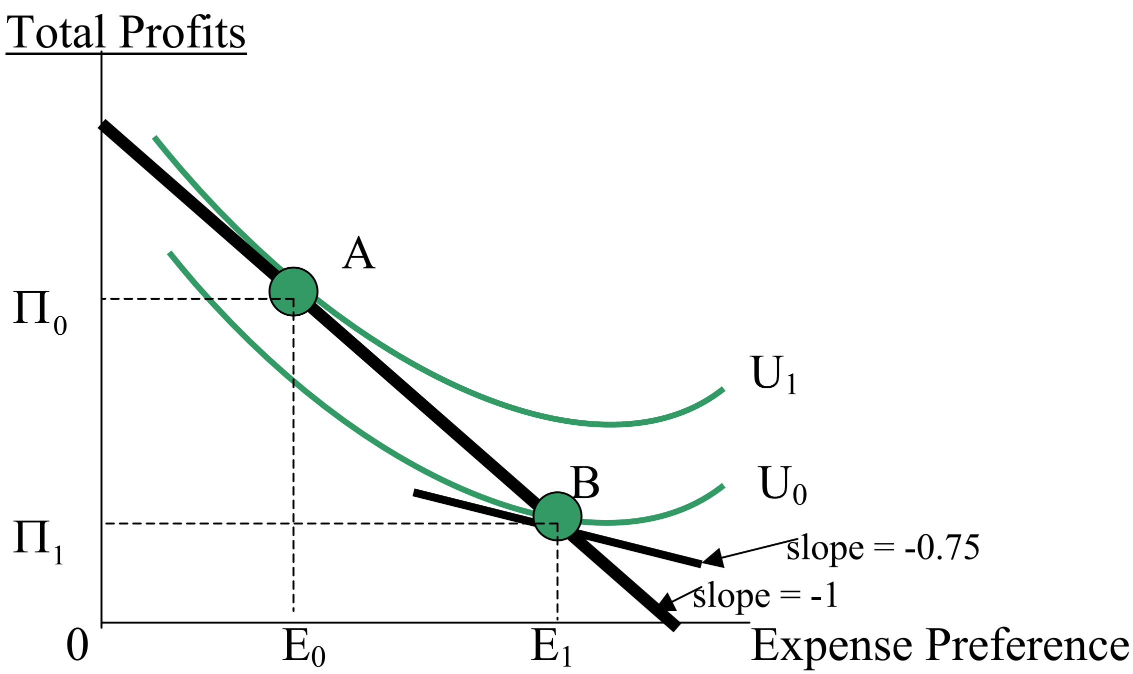
☹ But, we have not considered how a change from full to partial ownership affects the **b________** of the manager.

After selling off 25% of the ownership rights, the manager faces a different trade-off between profits and expense preference.

➔Before, a $1 increase in expense preference costs the owner-manager $1 in profits.

➔Now, the manager can indulge in expense preference of $1 and lose only __¢ in profits, since the new owners collectively suffer a loss of the other 25¢. The partial owner no longer faces a dollar for ____ trade-off between expense preference and profits.

Because the relative ____ of increasing expense preference declines for a partial owner, the manager-owner behaves differently from a full owner by increasing expense preference and decreasing ______ of the firm by more than a sole owner would.



If the new owners can anticipate the increase in expense preference, they will pay only __% of Π_1, where Π_1 is the _____ of the firm after expense preference increases to E_1.

As a result of this change in ownership, total ______ will decrease.

Two conditions must be satisfied if the manager is to maximize utility:

1) The manager must be ***on*** the ______ line that describes the firm's trade-off between profit and expense preference

2) The manager must maximize utility, such that the slope of manager's budget constraint equals the slope of the manager's _______ function.

On the diagram, the manager’s budget line has a slope of -0.75.

At point B, the slope of the manager’s indifference curve is -0.75, and the budget constraint is ______ to this indifference curve.

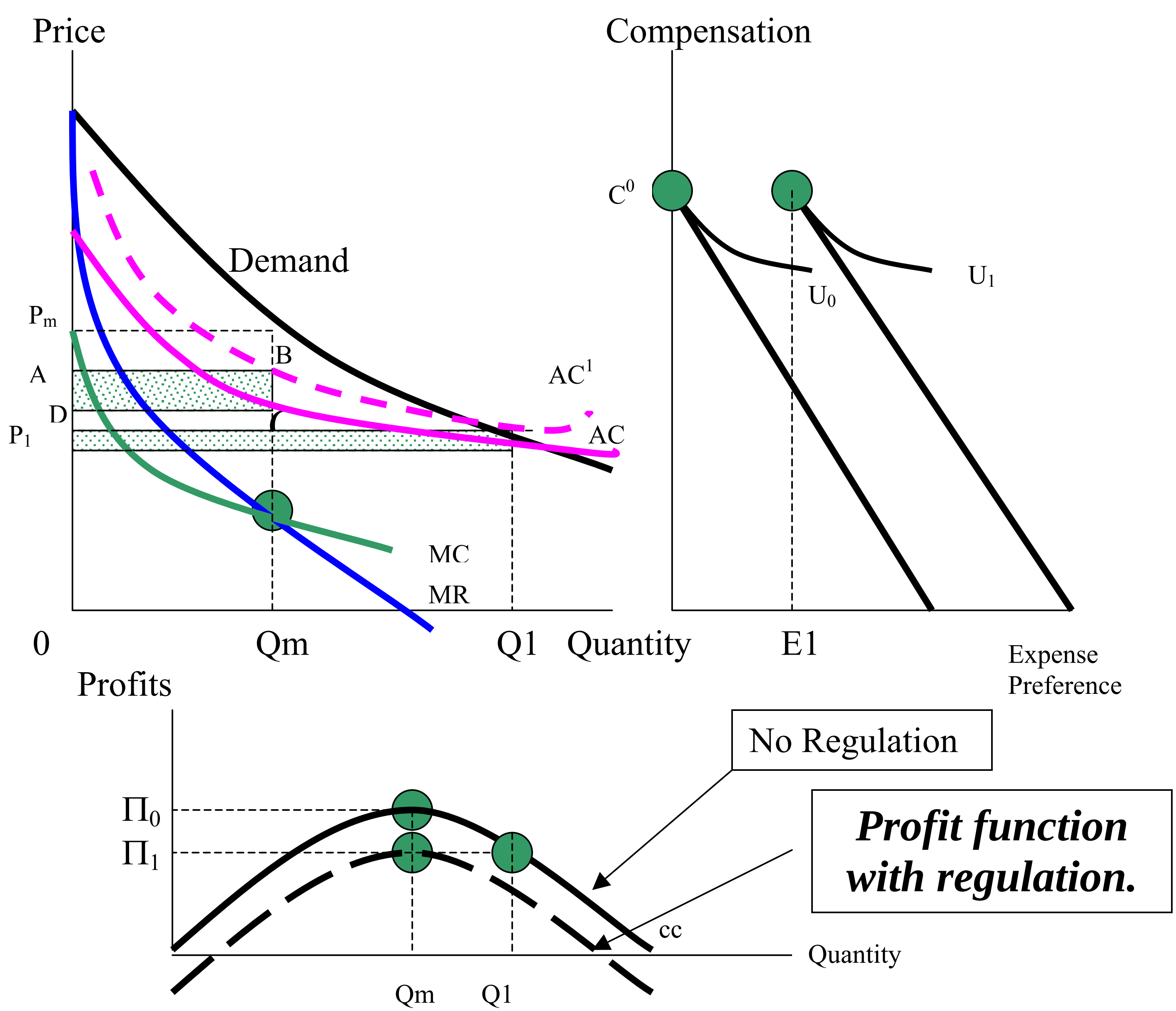
Conclusion: The **more** that management is separated from ownership, the higher the _______ preference and the lower the ______. The **smaller** the fraction of profits owned by the manager, the greater the incentive for the manager to indulge in expense preference.

Expense Preference Under A Profit Constraint

Assumption: **firms are scrutinized by regulators if they become too __________**.

We will see how a profit constraint changes the behaviour of managers, such that profit regulation can allow a manager to ______ paying for an increase in expense preference.

Assume: manager of a regulated ________ is not an owner. He will receive a compensation package equal to C_0.


Price
Compensation
Demand
Pm
A
B
D
P1
AC1
AC
C0
U0
U1
MC
MR
0
Qm
Q1
Quantity
E1
Expense
Preference
Profits
No Regulation
Π0
Π1
Profit function with regulation.
cc
Quantity
Qm
Q1

Assume for an unregulated monopolist manager, that the manager's ________ is maximized when he receives compensation of C_0 and zero expense preference.

Profit maximizing price is Pm and the profit maximizing quantity is Qm.

- The profits are Π_0. (diagram 3)

The budget constraint illustrates the manager's trade-off between compensation and expense preference. The manager is on indifference curve U_0.

The **profit function** of the unregulated monopolist is **cc**.

The Profit Constraint

Next, assume the firm faces a profit ________ that is less than Π_0:

$$\Pi_0 > \Pi_1.$$

That is, the monopolist becomes __________ and the regulator places a profit constraint of Π_1.

What happens?

The regulator does not have enough ____________ to know whether the firm is producing any quantity at ________ total cost. If profits are higher than the profit constraint, the regulator imposes a limit and enforces it by reducing price until profits equal Π_1.

The manager can comply with the profit constraint in two ways:

1) The manager can lower the _____ from Pm to P_1 and sell more units, Q_1. This way profits fall to the regulated maximum, Π_1. The firm is still a cost-efficient producer since it is producing Q_1 units at the lowest total cost, so that it remains on cc. The manager receives C^0 in compensation before and after the firm operates under a profit constraint.

2) The manager can _______ his tastes and allow _____ to increase until profits fall to Π_1 while still producing the profit maximizing quantity Qm. This is shown as a shift in the average cost function upward (AC_1). The rectangular area measures the increase in expense preference. The trade-off between profits and expense preference is illustrated by the budget line BL_1.

When a firm is forced to comply to a profit constraint, the manager can increase expense preference without a decrease in compensation. The manager's _______ increases and the expense preference increases to E_1, the manager's budget constraint becomes BL_1, and his compensation is still C^0. The manager moves to a higher indifference curve U_1.

The manager would most likely choose option __.

With a profit constraint, the cost of being an inefficient manager and indulging in expense preference decreases.

A common criticism of regulated firms is that they are run in____________, have inflated _____, and are less demanding to work for.

With a profit constraint, the manager receives C^0 in compensation and increased utility because expense preference increases from zero to E_1.

The Unregulated Firm and Expense Preference

When an unregulated firm does not minimize cost, it indicates that:

1) the internal monitor is ineffective or
2) product competition is weak

A takeover attempt signals that internal monitors are not working to force a firm to operate at minimum ____.

Outsiders believe they can introduce new management in order to increase profit and lower costs.

It is not unusual for a firm's management to receive less ________ when the firm produces results that are similar to other firms in the industry, even it is not maximizing profits.

Managers will most likely be left to operate independently until something within the industry forces the shareholders to take note, such as a sudden change in ______ or increased competition from new firms.

It is only then do shareholders take a closer look at the firm's research and development capabilities, compensation packages, community service activities, asset allocation, etc..