Management Turnover

Factors associated with turnover

\[ \text{Pr (CEO turnover)} = f (\text{Firm Performance, CEO age} \ldots) + u \]

Adverse share-price and earnings performance followed by CEO turnover


Fraud scandals can create incentives to change managers in an attempt to improve the firm’s performance, recover lost reputational capital, or limit the firm’s exposure to liabilities that arise from the fraud. It also is possible that the revelation of fraud creates incentives to change the composition of the firm’s board, to improve the external monitoring of managers, or to rent new directors’ valuable reputational or political capital. Despite such claims, we find little systematic evidence that firms suspected or charged with fraud have unusually high turnover among senior managers or directors. In univariate comparisons, there is some evidence that firms committing fraud have higher managerial and director turnover. But in multivariate tests that control for other firm attributes, such evidence disappears. These findings indicate that the revelation of fraud does not, in general, increase the net benefits to changing managers or the firm’s leadership structure.


Although there is a well-documented negative between firm performance and the probability of forced CEO turnover, the effectiveness of boards of directors in monitoring CEOs remains controversial. It may due to the breakdown in corporate governance; in particular, CEO becomes entrenched. It may also due to the fact that it takes the board time to learn about the CEOs true ability. This paper argues that the performance-forced turnover relation varies over a CEO’s tenure.

Most top level managers lose their jobs after a firm files for bankruptcy. More managers were able to retain their positions when firms were successfully reorganized. Bankruptcy costs to managers are most likely greater than those for the diversified investor.


Excess returns are significantly positive, which is consistent with the internal corporate control hypothesis that management change following poor performance is associated with gains to shareholders. Cross-sectional tests of the effects reveal a significant title effect and significant interactions between title and appointment of an outside successor and title and firm size.


The paper documents a strong positive relation between the percentage of outside directors and the frequency of outside CEO succession.


Repricers are young, rapidly growing firms that experience a deep, sudden shock to growth and profitability. Repricers exhibit normal CEO compensation levels and changes compared to peers, and abnormally high CEO turnover rates, contrary to an entrenchment hypothesis. The empirical evidence supports incentive and retention explanations for repricing, but provides little support for the view the repricing primarily reflects managerial entrenchment or ineffective governance in firms.


The firm’s board creates managerial incentives consistent with those of the firm’s owners, both by setting compensation and following management change policies that benefit shareholders. Takeovers, one mechanism to solve the agency problems between managers and shareholders, will cause management changes. Then managers should have incentive to maximize the firm value to void the hostile takeovers. Capital markets provide one solution for the problem of bad management. Then any solution in China now?

H1: the executive compensation decisions of boards produce a positive correlation between changes in executive compensation and abnormal stock price performance.

H2: inclusion of sales growth as a predictor of changes in executive compensation along with stock price performance will not make the relation between pay and stock price performance insignificant.

H3: the frequency of CEO turnover is related to past stock price performance.
Corporate boards control top management behavior by making compensation and management termination decisions related to the firm’s stock price performance.


During the 1990s, the global economy appears to have suffered an outbreak of “outside director mania” - at least 18 countries have witnessed publication of guidelines that stipulate floors for the representation of outside directors on corporate boards. The apparent (largely untested) premise underlying this movement is that boards with significant outside directors will make different (and perhaps better) decisions than boards dominated by inside directors. As the first mover in this movement, the U.K. provides a laboratory for a “natural experiment” to examine this presumption empirically. We investigate one key board task - the appointment of the CEO - to determine whether boards are more likely to appoint an outside CEO after they have increased the representation of outside directors to comply with the exogenously imposed standards. We find that the (coerced) increase in outside directors does alter the CEO selection decision. Additionally, announcement period stock returns indicate that the decisions are not only different, they also appear to be better.


In 1992, the Cadbury Committee issued the Code of Best Practice which recommends that boards of UK corporations include at least three outside directors and that the positions of chairman and CEO be held by different individuals. The underlying presumption was that these recommendations would lead to improved board oversight. We empirically analyze the relationship between CEO turnover and corporate performance. CEO turnover increased following issuance of the Code; the negative relationship between CEO turnover and performance became stronger following the Code’s issuance; and the increase in sensitivity of turnover to performance was concentrated among firms that adopted the Code.


Relative performance evaluation (RPE) is likely to improve boards of director’s ability to identify unfit CEOs, and competition is likely to enhance the usefulness of RPE. Consistent with our hypotheses, the frequency of CEO turnover is greater in highly competitive industries than in less competitive industries. RPE is more useful in competitive environments because CEOs are more likely to be subject to similar uncertainties, have more peers, and any given CEO’s actions are unlikely to affect other CEO’s output.

We present evidence that forced top management changes are preceded by large and significant operating performance declines and followed by significant improvements in operating performance. In contrast, normal retirements are not preceded by significant changes in operating performance, but are followed by small increases in operating income.


The announcement of a forced CEO resignation is hailed favorably by the market with a small but significantly positive abnormal return of 0.5%. Whereas voluntary resignations do not cause price reactions, age-related turnover triggers a small negative price reaction. The nomination of an external manager following the performance-related forced resignation of a CEO causes a strong increase in abnormal returns of more than 2%.


Outside directors who are not aligned with the CEO and own relatively large equity stakes are rewarded when they remove a poorly performing CEO and replace him or her with a CEO that improves firm performance.


We study management turnover in the set of top 5 executives for a sample of 443 large firms from 1993-1998. Using information from news articles and severance disclosures in proxy statements, we find that the rate of forced turnover for non-CEOs is at least as great as the rate for CEOs, but the sensitivity of turnover to aggregate firm performance is relatively smaller for non-CEOs. The probability that a non-CEO leaves office is highly elevated around CEO dismissals, particularly when the replacement CEO is an outsider. We find that the labor market penalties from a job dismissal are quite severe for both CEOs and non-CEOs. While many dismissed executives gain new employment in an executive capacity, on average their new positions appear to be significantly inferior to their old positions as measured by compensation, seniority, and firm size. Our results suggest that: (1) the turnover process is effective at eliminating lower ability managers across the corporate hierarchy, (2) aggregate firm performance is a less informative signal of ability for executives below the CEO, and (3) the management team is evaluated, at least partially, as a team.


The essence of corporate control includes the hiring and firing of key managers. Management changes signal shifts in company policy and raise shareholder wealth. Internal promotions confirm the soundness of investment by large companies in firm-
specific human capital while external appointments do not. Promotions occur more often than external appointments but decline in importance as firm size decreases, and dismissal is not a favored means to handle managerial underperformance but is associated with stock price increases when used.


CEOs of emerging market firms are more likely to lose their jobs when their firm’s performance is poor, suggesting that corporate governance is not ineffective in emerging markets. For the subset of firms with a large domestic shareholder, there is no link between CEO turnover and firm performance.


Managers incur significant personal costs when their firms become financially distressed. Almost all turnovers in the sample take place because of firm’s financial distress or poor financial performance. Managers who resign from these firms are not employed by an exchange-listed firm for at least three years after their departure.


First, all mangers choose higher levels of project risks when they are competing for leadership. Second, an overconfident manager, one who underestimates his project risk, has a higher probability of being chosen as the leader than an otherwise identical rational manager. Third, an overconfident leader may be better for the firm’s shareholders than a rational leader.

Goyal, V. and C.W. Park, 2002, Board leadership structure and CEO turnover, Journal of Corporate Finance 8, 49-66

The results are consistent with the view that the lack of independent leadership in firms that combine the CEO-chairman title makes it difficult for the board to remove poorly performing managers.


We find the nature of CEO turnover activity has changed over time. The frequencies of forced CEO turnover and outside succession both increased. However the relation between the likelihood of forced CEO turnover and firm performance did not change significantly from the beginning to the end of the period we examine, despite substantial changes in internal governance mechanisms. The evidence also indicates that changes in
the intensity of the takeover market are not associated with changes in the sensitivity of CEO turnover to firm performance.


A good survey about the internal control mechanism!!
Patterns of stock ownership by insiders and outsiders can influence managerial behavior, corporate performance, and stockholder voting in election contests. Corporate leverage, inside stock ownership by managers and the control market are interrelated. Departures from one share/one vote affect firm value and efficiency. Takeover resistance through defensive restructuring or poison pill provisions is associated with declines in share price. Top management turnover is inversely related to share price performance.


The likelihood of nonroutine turnover is significantly related to industry-adjusted return on assets, excess stock returns, and negative operating income, but is not related to industry performance. The performance is improved subsequent to nonroutine turnover and outside succession.


Traditional economic theory holds that the market for management control acts as a disciplinary device on non-value maximizing management. Through this mechanism, takeovers of inefficiently managed companies (or companies in which non-value-maximizing behavior dominated) would result in the replacement of senior management and lead to a more efficient use of resources. Jensen (1986) suggests that the market ‘serves as a court of last resort … when the corporation’s internal controls and board level control mechanisms are slow, clumsy or deficient’.


A company pays greenmail when it repurchases a block of stock from a particular shareholder or shareholders, usually at a substantial premium above the market price. Management entrenchment hypothesis assumes that managers work for their own benefit at the expense of shareholders. The management turnover rate should increase significantly after the greenmail if the internal monitoring mechanism is effective.
Shareholder interest hypothesis assumes that management pays greenmail to benefit nonparticipating shareholders. Then management turnover rate will not change significantly after the greenmail. The study shows that firms paying greenmail experience above-average management turnover within one year of the payment, which is consistent with the management entrenchment hypothesis. An SEC 13D form must be filed by companies or individuals who have accumulated at least 5% of the outstanding shares of any listed stock.


Which performance measure does the best job of predicting the turnover of CEOs? Our results thus suggest that labor markets evaluate CEOs more on the basis of their EVA and MVA performance than on the basis of more conventional accounting measures.


A firm that requires no formal record of actions and events would hardly be considered well managed. Nevertheless, recording actions and filling out reports cost time and effort and organizations that force their employees to do so are often labeled “bureaucratic” and “inefficient”. They argue that the thin line between bureaucratic rules and efficient rules is crossed when a firm introduces a managerial turnover policy to curb agency problems in a multiplayer organization. Bureaucratic rules then arise as a way to minimize the costs of managerial turnover. Their model predicts that bureaucracy should increase upon managerial turnover and it establishes a link between bureaucracy, incentive schemes, and the frequency of managerial turnover in a cross-section of firms.


The results suggest that there is a relationship between CEO turnover and lagged performance rather than current performance as found in the US.


Mechanisms to remove inefficient managers and encouraging managers to act in shareholders’ interests.

External mechanisms: takeover market, etc

Internal mechanisms: board of directors (Fama 1980), other top managers (Fama and Jensen 1983), and large share blocks (Shleifer and Vishny 1986).

If these mechanisms are effective, and if stock price performance reflects information on managers’ efficiency, there will be a negative relation between the probability of a top management change and share of performance.

I find that there are two central inter-temporal events that may affect Founder-CEO succession: the completion of product development and the raising of each round of financing from outside directors.


There is a stronger association between prior performance and the probability of a resignation for companies with outsider-dominated boards than for companies with insider-dominated boards.

Incentives of Incoming and Outgoing CEOs

Discretionary Variables = g (CEO Turnover, Firm Performance …) + v

Greater frequencies of asset write-offs

Elliott, J. and W. Shaw, 1988, Write-offs as accounting procedures to manage perceptions, Journal of Accounting Research, 26, 91-119


Income-reducing accounting method changes


Two explanations for the accounting changes during CEO turnover:
1. earnings management explanation (blaming hypothesis)
2. different perspectives explanation (changing because of different perspectives)

This paper reports evidence that is inconsistent with blaming hypothesis and consistent with the different perspective hypothesis.


Using a univariate test of independence, it documents a significantly greater incidence of income reducing discretionary accounting changes for a sample of firms with changes in top management compared to a sample of firms without such changes in management. Two reasons: first, the reported low earnings may be blamed on the old management; second, future income would be relieved of these charges. (Blaming hyp)
Divestitures of previous acquisitions

Weisbach, M., 1992, The CEO and the firm’s investment decisions (University of Rochester, Rochester, NY).

Growth rates in R&D expenditures surrounding CEO turnover are declining


Three contributions to existing research.
First, it documents the existence of the horizon problem. Earnings-based performance measures provide executives with incentives to focus on short-term performance.
Second, it identifies mechanisms that mitigate the horizon problem. The more stock and options executives own in their firm, the less likely they are to reduce discretionary expenditures prior to their departure. The second mechanism is ‘relay process’ of CEO succession.
Third, the results add to evidence in accounting literature on earnings management.

Others


The results in this paper suggest that CEOs’ career concerns do not necessarily end with retirement. Many CEOs remain active during retirement serving on corporate boards. We also find a strong relation between the likelihood of board service and performance while on the job. This finding suggests that the prospect of continued board service can reduce horizon problems in the final year of a CEO’s tenure.


Repricing is formally executed either by cancelling old options and replacing them with new grants at more favourable terms, or by simply rewriting the terms of the existing option contracts.
It is a young, rapidly growing firm that experiences an abrupt and relatively permanent shock to growth and profitability.
The top management turnover rate is relatively high for the repricing firms, contradicting with the management entrenchment hypothesis.

A problem with the prior, context-specific earnings management research is that it has been unable to distinguish between management opportunism and management attempts to reflect firms’ underlying economic performance (requiring recognition of necessary write downs) as explanations for results obtained (see Dechow and Sloan, 1991). The year of change is the first year the incoming CEO could realistically control the preparation of the accounting numbers and choices relating to the selection and construction of graphs in the annual report. We use a date three months after the financial reporting year-end date as the cut off point. For instance, in the case of a firm with a 31 December year-end, 1997 would be considered to be the year of change if the new CEO was appointed prior to 1 April 1998. (Actually if we can get the issuing date of the financial report, we should use the issue date as the cut off point.)


Substantial documentation inconsistent with the following three manager discretionary reasons from above paper:
[Horizon problem] [Cover up] [Big bath]

“After controlling for both firm performance and endogenous CEO turnover, we find little evidence to support the hypothesis that outgoing CEOs exercise their discretion over accounting or investment variables to increase their earnings-based compensation in years –1 and 0. Rather the changes of discretionary variables are better explained by the overall performance of the firm. We find some evidence consistent with the hypothesis that incoming CEOs take a big bath: after controlling for firm performance, market-adjusted accounting accruals are lower in the fiscal year in which the incumbent CEO is replaced by his successor.”


Executive Compensation


Contracting view: the shareholders set CEO pay using the incentive contracts
Skimming view: CEOs set their own pay
Better-governed firms behave according to the contracting view while worse governed firms behave according to the skimming model.

We model CEO and director compensation using firm characteristics, CEO characteristics, and governance variables. We find that director compensation is related to variables that proxy for the level of monitoring and effort required by directors. After controlling for monitoring proxies, we find a significant positive relation between CEO and director compensations. We hypothesize that this relation could be due to unobserved firm complexity (omitted variables), and/or to excessive compensation of directors and managers. We find that these excessive compensations are associated with firm underperformance. Thus, we conclude that excessive compensation may be associated with firm performance. Thus, we conclude that excessive compensation may be associated with an environment of ineffective monitoring, which we term *cronyism*.


Oil and gas firms using the full cost method during 1985-1986 faced a choice between taking a write-down in oil and gas properties or changing to the successful efforts method. In a time-series analysis, the executive bonuses of firms switching to the successful efforts method are found to be associated with accounting income, suggesting the effects of bonus plans on the switch decision.


Corporate governance is generally considered to be the set of complementary mechanisms that help align the actions and choices of managers with the interests of shareholders.

From economic perspective, compensation contracts are efficient to align the interests of management and shareholders. However there are different findings in the literature. On one hand, Jensen and Murphy (1990) demonstrate that the compensation contracts are not efficient. On the other hand, Fama (1980) argues that labor market discipline eliminates agency problem with CEOs and management will have no opportunistic behavior. Some researchers incorporate these polar extremes. Our assumption is that whether the contracts are efficient depends on the specific situation and deserves more research.

Three mechanisms to provide management incentives:
1. flow compensation, which is the total of the CEO’s annual salary, bonus, new equity grants, and other compensation
2. changes in the value of the CEO’s portfolio of stock and options
3. the possibility that the market’s assessment of the CEO’s human capital will decrease following termination due to poor performance or a change-in-control.

We provide empirical evidence that the standard predictions of agency models commonly employed in the empirical compensation literature are not descriptive of performance measure use in CEO compensation contracts. Consistent with prior empirical research, we document that the relative weight on price and non-price measures in CEO cash pay is a decreasing function of the relative variances. Agency theory speaks to the weights in total compensation (total annual pay and changes in the CEO’s equity portfolio value), however, and here they document that very little of CEOs’ total incentives comes from cash pay. We also document that, counter to the standard predictions of agency models, variation in the relative weight on price and non-price measures in CEO total compensation is an increasing function of the relative variances. These results indicate that existing findings using cash pay are misleading. Based on our results, we suggest approaches for future research on performance measure use in CEO total compensation.


Findings: measures of board and ownership structure explain a significant amount of cross-sectional variation in CEO compensation, after controlling for standard economic determinants of pay. Moreover, the signs of the coefficients on the board and ownership structure variables suggest that CEOs earn greater compensation when governance structures are less effective.

Overall, weaker governance → greater agency problem → greater compensation → firm performs worse

Total compensation = cash compensation (salary + annual bonus) + values of stock options, performance plans, phantom stock, and restricted stock

Economic determinants of the level of CEO compensation: larger firms with greater growth opportunities and more complex operations will demand higher-quality managers with higher equilibrium wages. The proxy for the firm’s investment opportunity set is the firm’s year-end market-to-book ratio averaged over the previous five years.

CEO compensation = f (Economic determinants, Board composition, Ownership)

Board composition (effectiveness): CEO is board chair; Board size; Inside directors; Outside directors assigned by CEO; Gray outside directors; Interlocked outside directors; Outside directors over age 69; Busy outside directors;

The level of total CEO compensation is cross-sectional related to firm size, investment opportunities, prior performance, and firm risk.

Contrary to many recent governance prescriptions, total compensation has a significant negative association with the percentage of inside directors on the board.

Overall they found significantly association between CEO compensation and board composition. Does this reflect the entrenchment of CEO? There are two alternative interpretations: one is that certain board and ownership structures enable managers to exercise influence over the board and extract rents from the firm, including compensation in excess of their equilibrium wage rate, which is what the authors want. The other is that the board and ownership structure variables may proxy for some dimension of the firm’s demand for a high-quality CEO not captured by the other
economic determinants. In order to determine whether the observed associations between the level of compensation and the board and ownership structure variables are proxies for the effectiveness of the governance structure or are due to a misspecified model of the economic determinants of the level of CEO compensation, they estimate the association between our measure of predicted excess compensation and subsequent firm financial performance. If the association between compensation and board and ownership structure reflects the degree of managerial entrenchment, we expect to observe a negative association between the measure of predicted excess compensation and subsequent performance.


The principal objective of this commentary is to foster research in performance evaluation and compensation by reviewing and linking some of the relevant theoretical and empirical research that relies on agency theory.


Paying people on the basis of how their performance relates to a budget or target causes people to game the system and in doing so to destroy value in two main ways: 1. both superiors and subordinates lie in the formulation of budgets and therefore gut the budgeting process of the critical unbiased information that is required to coordinate that activities of disparate parts of an organization, and 2. they game the realization of the budgets or targets and in doing so destroy value for their organizations.

The key lies not in destroying the budgeting systems, but in changing the way organizations pay people. In particular to stop this highly counterproductive behavior we must stop using budgets or targets in the compensation formulas and promotion systems for employees and managers.

I believe the absence of such budget/target systems is an important part of the increased productivity of entrepreneurial firms and LBO firms. Moreover, eliminating this budget/target-induced gaming from the management system will eliminate one of the major forces leading to the general loss of integrity in organizations.


The relentless focus on how much CEOs are paid diverts public attention from the real problem – how CEOs are paid. In most publicly held companies, the compensation of top executives is virtually independent of performance. One average, corporate America
pays its most important leaders like bureaucrats. Is it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?

The main findings:
1. Despite the headlines, top executives are not receiving record salaries and bonuses.
2. Annual changes in executive compensation do not reflect changes in corporate performance.
3. Compensation for CEOs is no more variable than compensation for hourly and salaried employees.
4. With respect to pay for performance, CEO compensation is getting worse rather than better.

Three basic policies will create the right monetary incentives for CEOs to maximize the value of their companies:
1. Board can require that CEOs become substantial owners of company stock.
2. Salaries, bonuses, and stock options can be structured so as to provide big rewards for superior performance and big penalties for poor performance.
3. The threat of dismissal for poor performance can be made real.


A examination of the executive compensation structure of 153 randomly-selected manufacturing firms in 1979-1980 provides evidence supporting advocates of incentive compensation, and also suggests that the form rather than the level of compensation is what motivates managers to increase firm value. Firm performance is positively related to the percentage of equity held by managers and to the percentage of their compensation that is equity-based. Moreover, equity-based compensation is used more extensively in firms with more outside directors. Finally, firms in which a higher percentage of the shares are held by insiders or outside blockholders use less equity-based compensation.


Level and structure of executive compensation

Pay levels vary by industry.
Compensation has increased substantially between 1992 and 1996.
The increase in pay is largely attributable to increases in the grant-date value of stock option grants.
CEO pay is higher in larger firms but the relation weakened over time.
US executives are paid more than their international counterparts. US CEOs receive a larger fraction of their pay in the form of stock options, and a lower fraction in the form of salaries.
US CEOs exceeds pay in other countries even after adjusting for these differences (tax rates, purchasing power, and public benefits). However there is no significant difference between US vs. international pay practices for lower-level executives and production workers.

[Base salaries] [Annual bonus plan] [Stock options]
Performance measures: while companies use a variety of financial and non-financial performance measures, almost all companies rely on some measures of accounting profits.

Performance standards: budget, prior-year, discretionary, peer group, timeless standards, cost of capital

Pay-performance structures: Under a strict 80/120 plan, no bonus is paid unless performance exceeds 80% of the performance standard, and bonuses are capped once performance exceeds 120% of the performance standard.

Incentive effects of pay-performance structures: since bonuses are based on cumulative annual performance, and since managers can revise their daily effort and investment decisions based on assessments of year-to-date performance, the non-linearities in the typical bonus plan causes predictable incentive problems.

Stock options: most options expire in ten years and are granted with exercise prices equal to the “fair market value” on date of grant.

“Outsiders” are typically defined as directors who are neither current nor past employees, and who have no strong business ties to the corporation.

Relation between pay and performance

Compensation plans are designed to align the interests of risk-averse self-interested executives with those of shareholders.

Optimal contract mimics a statistical inference problem: the payouts depend on the likelihood that the desired actions were in fact taken. This “informativeness principle” suggests that payouts are based on stock-based measures, $x$, not because shareholders desire higher stock prices but rather because realizations of $x$ provide information useful in determining which actions the CEO took. And non-stock-based measures will be used to the extent that they provide information relevant in assessing whether the CEO indeed took the desired action.

Year-to-year performance-related changes in total compensation are typically modeled as: $(\text{CEO PAY})_t = R_t + A_t + P_t(\text{Performance})$.

Neither the sensitivity nor elasticity approach strictly dominates the other. The primary advantage of the elasticity approach is that it produces a better “fit” in the sense that rates of return explain more of the cross-sectional variation of logarithms of CEO pay than changes in shareholder value explain of changes of CEO pay. In addition, while pay-performance sensitivities vary monotonically with firm size (larger firms having smaller $b$’s), the elasticity is relatively invariant to firm size.

The primary advantage of the sensitivity approach is that sensitivities have a more natural economic interpretation. The pay-performance sensitivity represents the executive’s “share” of value creation. Since agency costs arise when agents receive less than 100% of the value of output, the “sharing rate” seems a natural measure of the severity of the agency problem; elasticities have no corresponding agency-theoretic interpretation.

About sensitivity and elasticity: firstly there has been a general increases in the relation between cash compensation and company stock-price performance over the past 25 years; secondly there appears to be more year-to-year variation in pay-performance sensitivities and then elasticities, and the variance in both appears to have increased in the 1990s.
Relative Performance Evaluation (RPE)

Gibbons and Murphy (1990) document the strongest support for the RPE hypothesis, finding that changes in CEO pay are positively and significantly related to firm performance, but negatively and significantly related to industry and market performance, ceteris paribus. In addition they found that CEO performance is more likely to be evaluated relative to aggregate market movements than relative to industry movements.

Executive Turnover and Company Performance

There is an inverse relation between net-of-market performance and the probability of management turnover. The magnitude of the turnover-performance relation is strongest in companies dominated by independent outside directors. Companies performing poorly relative to their industry are most likely to hire a replacement CEO from outside the firm. Following management changes there are greater frequencies of asset write-offs, income-reducing accounting method changes, incoming-reducing accounting accruals, and divestitures of previous acquisitions.

Departure rate for poorly performing CEOs exceeded those for better performing CEOs in all but three of the 26 years in the sample, suggesting that the probability of CEO departure is higher following bad performance than following bad. Poor performance increases departure probabilities, although the economic significance of the turnover-performance relation (measured by the increased departure probability associated with poor performance) is fairly small. Outside hires are more likely following poor performance than following good performance.


I show that companies choose external standards when prior-year performance is a noisy estimate of contemporaneous performance. In addition, companies using budget-based and other internally determined performance standards have less-variable bonus payouts, and are more likely to smooth earnings from year to year, than companies using externally determined standards.


We examine the role of discretion in executive incentive contracts, and explore the trade-offs firms face in choosing among imperfect objective measures of individual performance, potentially more accurate but non-verifiable subjective measures, and overly broad objective measures of company-wide performance that include the performance of all agents in the firm. We generate implications and test the model empirically using a proprietary dataset of executive bonus plans. Consistent with our model, we find that discretion is less important in determining CEO pay than the pay of other executives. We also find that discretion is relatively important in determining executive bonuses at larger and privately held firms and that more diversified firms are
relatively less likely to compensate their business unit managers based on firm-wide performance. Finally, we consider (and largely dismiss) tax-related explanations for our results.


The paper reviews empirical findings on executive compensation in light of marginal productivity and contract theories. The executive labor market performs three functions. First, control must be distributed and assigned among executives. Second, executive contracts must provide incentives for managers to act in the interests of shareholders. Third, the market must identify new talent and reassign control over careers from older to younger generations.

Penalties for misbehavior:
1. bonding solutions to agency problems
2. loss of reputation as bond
3. the stock market and corporate control

Rewards to elicit efficient action
1. risk sharing and incentives
2. the optimal piece rate


I study incentives received by outside directors in Fortune 500 firms from compensation, replacement, and the opportunity to obtain other directorships. Changes over time in the value of equity compensation create considerable variation in director pay. Board members of the most successful firms earn millions of dollars within their first five years, a marked change in the historical pattern of rewards for directors. I also find statistically significant evidence that outside directors’ replacement and total board seats held are associated generally with company performance. Previous research had only shown these relations to apply under extreme circumstances such as financial distress.

Corporate Governance Related


Seven mechanisms to control agency problems between managers and shareholders: shareholdings of insiders, institutions, and large blockholders; use of outside directors; debt policy; the managerial labor market; and the market for corporate control. First, since alternative control mechanisms exist, greater use of one mechanism need not be positively related to firm performance. Second, the extent to which several of the control mechanisms are used is decided within the firm.

Measurements of the seven mechanisms. Measurement of firm performance (Tobin’s Q)

We extend the standard agency framework to allow for complex information, trustworthiness of the principal, and incomplete contracts and show that contractual incompleteness arises endogenously when there is enough complexity and trust.


Agency costs are found to be: i) significantly higher when an outsider rather than an insider manages the firm; ii) inversely related to the manager’s ownership share; iii) increasing with the number of non-manager shareholders, and iv) to a lesser extent, lower with greater monitoring by banks.

Two measurements for agency costs:
1. the expense ratio, which is operating expense scaled by annual sales. Operating expenses are defined as total expenses less cost of goods sold, interest expense, and managerial compensation. Excessive expense on perks and other nonessentials should be reflected in the operating expenses. This ratio is a measure of how effectively the firm’s management controls operating costs, including excessive perquisite consumption, and other direct agency costs.
2. the assets utilization ratio, which is annual sales divided by total assets. This ratio is a measure of how effectively the firm’s management deploys its assets.


We examine whether firms belonging to Korean business groups (chaebols) benefit from acquisitions they make or whether such acquisitions provide a way for controlling shareholders to increase their wealth by increasing the value of other group firms (tunneling). We find that when a chaebol-affiliated firm makes an acquisition, its stock price on average falls. While minority shareholders of a chaebol-affiliated firm making an acquisition lose, the controlling shareholder of that firm on average benefits because the acquisition enhance the value of other firms in the group. This evidence is consistent with the tunneling hypothesis.


Decision rights in organizations are not contractible: the boss can always overturn a subordinate’s decision, so formal authority resides only at the top. Although decision rights cannot be formally delegated, they might be informally delegated through self-enforcing relational contracts.

The paper analyses the value creation benefits of the holding form of organization in France by empirically examining the effects of non-controlling stake purchases on target shareholder wealth, operational performance and bidder shareholder returns for a sample of 122 stake purchases in French listed companies. The evidence puts into question the ability of holding companies to create value for the firms they purchase stakes in or their own shareholders, adding to the current debate on the relative role played by large shareholders and the external market for corporate control as ultimate disciplining devices.

The study proceeds in three stages. First, market-based evidence is used to evaluate the effect of stake acquisitions on target company values. Second, accounting-based performance variables are used to complement the event-study evidence. Finally, the effect of the stake purchase on the block acquiror is used to test the wealth expropriation hypothesis. By assessing the impact of stake-acquiror type (holding companies versus non-holding companies) on both target and acquiror shareholders’ wealth and company performance, the paper attempts to shed new lights on the role played by holding companies in the corporate governance process in France.


We identify negotiated trades of large-percentage blocks of stock as corporate control transactions. When a block trades and the firm is not fully acquired, cumulative abnormal returns average 5.6%, and 33% of the chief executives are replaced within a year. Stock-price increases are larger when control passes to the new blockholder, when management does not resist the blockholder’s effort to influence corporate policy, and when the block purchaser eventually fully acquires the firm. These findings suggest that the specific skills and expertise of blockholders, and not just the concentration of ownership, are important determinants of firm value.

Two broad conclusions emerge from these findings. First, although block trades sometimes precede more conventional control transactions, in most cases the block trade is the final outcome, with control passing from the block seller to the block purchaser. Thus we argue that negotiated block trades should be added to the list of corporate control events. Second, the increases in firm value and extensive managerial turnover associated with block trades suggest that the managerial skills and incentives of blockholders are not homogeneous. Firm value, therefore, depends in part on the blockholder’s specific skills and not just on his fractional ownership.

The abnormal stock-price increases, combined with the extensive post-trade managerial and board turnover, suggest that most of these blocks convey sufficient votes for the block purchaser to influence, if not determine, the composition of the top management team. Such power is seen as the essence of corporate control. Furthermore, although the literature often assumes that corporate control is predicted on majority ownership, our evidence suggests that blocks as small as 10-15% often convey significant corporate control.

The law on trades of large-percentage blocks of common stock in public corporations raises three questions that have remained controversial despite considerable academic research and numerous court decisions. First, should block sellers be allowed to retain any premium over the exchange price that is paid for their blocks or should the premiums be shared with minority shareholders? Second, should block sellers be allowed to facilitate the transfer of corporate offices to block purchasers, or should the purchasers be required to follow the normal succession process, with minority shareholders voting on the proposed management changes? Third, should block purchasers be allowed to buy out the minority shareholders in a merger or tender offer at a lower price per share than they paid for the stock?

A persistent belief that minority shareholders are injured by large-block trades has led recently to laws and corporate-charter amendments curtailing the rights of block purchasers, who may be denied the vote until minority shareholders have given their approval or be required to wait several years before acquiring the minority’s shares. We investigate the validity of this belief, as well as broader implications of the law on large-block trades, by analyzing 106 trades of at least 5 percent of the common stock of exchange-listed firms between 1978 and 1982. In general, our empirical findings support the long-established law (benefit shared with minority shareholders) on block trades and contradict the many calls (the persistent belief mentioned above) for legislation that would require the sharing of control premiums with minority shareholders, prohibit contracts that facilitate the transfer of corporate offices, and change the compensation of large and small shareholders in reorganizations.

We find that, when block sellers receive premiums, stock prices typically increase but not to the price per share received by the blockholder. This pattern implies that blockholders use their voting power simultaneously to improve firm management (hence the stock-price increases) and to consume corporate benefits to the exclusion of minority shareholders (hence the premiums). Stock prices likewise increase when corporate offices are sold with blocks and when there is director and officer turnover following a trade. Although securities law does not explicitly require that minority shareholders receive the same price per share in a merger or tender offer as was paid for a block, most block purchasers pay minority shareholders at least as much per share as they report paying the block seller. Thus, although the “hands-off” attitude of the law on block trades appears to favor large-block shareholders, the evidence suggests that minority shareholders benefit as well.

We have two contributions to add to this debate. First, we refocus the debate by emphasizing that block purchasers can conceivably improve firm management, expropriate corporate resources, or both. We then present evidence that minority shareholders generally benefit from block trades priced at a premium to the exchange price.


There are two ways to buy a large-percentage block of stock – from another shareholder or directly from the corporation. Because the trade asset is the same, one might expect the pricing of these transactions to be similar. Block trades, however, are priced at an 11% premium to the post-announcement exchange price, while private placements are priced at a 19% discount. This difference reflects what happens after the transactions.
Most block-trade purchasers become involved in management, suggesting that their premiums reflect anticipated private benefits. Most private-placement purchasers remain passive, firm value declines, and there are few acquisitions. This suggests that private-placement discounts often reflect compensation to external blockholders for helping to entrench management.


Tobin’s Q, board composition and managerial ownership are jointly determined. However results depend strongly on the specification of the simultaneously model and instruments. We conclude that results using simultaneous equations methods must be interpreted cautiously, OLS estimates should not be casually dismissed, and that sensitivity analysis is essential when estimating an empirical model whose structure is uncertain.

Beasley, M.S., an Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud, Accounting Review 71, 443-465.

The inclusion of larger proportions of outside members on the board of directors significantly reduces the likelihood of financial statement fraud. However, the presence of an auditing committee does not significantly affect the likelihood of financial statement fraud.


In many countries, controlling shareholders are accused of tunneling, transferring resources from companies where they have few cash flow rights to ones where they have more cash flow rights. Quantifying the extent of such tunneling, however, has proven difficult because of its illicit nature. This paper develops a general empirical technique for quantifying tunneling. We use the responses of different firms to performance shocks to map out the flow of resources within a group of firms and to quantify the extent to which the marginal dollar is tunneled. We apply our technique to data on Indian business groups. The results suggest a significant amount of tunneling between firms in these groups.


This study documents the relationship between purchases of large share blocks and corporate performance. Our results are largely consistent with the view that the market for partial corporate control identifies and rectifies problems of poor corporate performance. Specifically, we find that activist investors typically target poorly performing firms. Block share purchases by activists are followed by increases in divestitures and share repurchases and by declines in mergers and acquisitions. Furthermore, activist block share purchases are associated with improvements in profitability and shareholder value.
We find that financial and strategic investors also target underperforming firms, but do not systematically target highly diversified firms. In contrast to firms that experience activist block share purchases, firms targeted by financial and strategic investors do not undergo extensive operational changes and experience smaller ex post improvements in profitability; these findings suggest that although financial and strategic investors target firms where performance improvements are possible, performance is less likely to improve.

Nonetheless, our results should be interpreted with some caution. For one, it is possible that the improvements observed following activist block share purchases were not the consequence of activism, but rather were simply anticipated by intuitive and knowledgeable investors. If would, however, be difficult to explain the time pattern of earnings improvements using the “prescient investor” story. If blockholders invest based on superior information, we would expect rapid performance improvements. In our sample, however, the greatest profitability improvements are observed two and three years after block purchases. In addition, the real changes noted after activist block purchases would normally be difficult to anticipate, even for expert investors. These changes are very easy to explain, however, with a story that investors themselves catalyze change in target firms.

A second reason to interpret our results with caution is that the greatest profitability improvements occurred in firms that divested assets after block purchases. We cannot rule out the possibility that profitability improvements were compositional, due to divestitures of poorly performing assets rather than improvements in overall efficiency. However, the volume of post-purchase asset divestitures appears to be too small to explain the magnitude of the observed improvements. Moreover, share prices rose after activist share purchases, irrespective of whether divestitures followed. Future researchers might explore this question more extensively, particularly by investigating performance across business segments.

Finally, we do not know if our results are unique to the 1980s. It may be that the effectiveness of blockholder activism during this period was atypical. It would be interesting to investigate the relationship between blockholder activity and corporate performance during other time periods and in other countries.


It is a good survey!!!

There is no convincing evidence that greater board independence correlates with greater firm profitability or fast growth. To the contrary, there is some evidence that firms with supermajority-independent boards are less profitable than other firms. It may be useful to have a moderate number of inside directors. But most commentators applaud the trend toward greater board independence.

Inside directors: currently officers of the company.

Affiliated outside directors (grey directors): former company officers, relatives of company officers, and persons who are likely to have business relationships with the company, including commercial bankers, investment bankers and lawyers.

Independent directors: outside directors without such affiliations.

Majority-independent board: at least 50% independent directors.

Supermajority-independent board: only one or two inside directors.
Why might having a reasonable number of inside directors add value?
One possibility is that an optimal board contains a mix of inside, independent, and perhaps also affiliated directors, who bring different skills and knowledge to the board. A second possibility is that having a few insiders on the board may make it easier for other directors to evaluate them as potential future CEOs. Third, inside directors may be better at strategic planning decisions. Fourth, there is a tradeoff between independence and incentives. How can independent directors be made to perform better?
One possibility is the greater share ownership. A second possibility is that today’s “independent” directors are not independent enough. It should be not only independent of management but also accountable to shareholders. A third possibility is that some directors who are classified as independent are beholden to the company or its current CEO in ways too subtle to be captured in customary definitions of “independence”.
Fourth, perhaps some types of independent directors are more valuable than others. A fifth possibility is that independent directors can add value, but only if they are embedded in an appropriate committee structure.


The boards of directors of American public companies are dominated by independent directors. Moreover, many commentators and institutional investors believe independent directors should be even more numerically dominant on public company boards than they are today. We conduct the first large sample, long-horizon study of whether board independence (proxied by proportion of independent directors minus proportion of inside directors) correlates with the long-term performance of large American firms. We find evidence that firms suffering from low profitability respond by increasing the independence of their board of directors, but no evidence that this strategy works – that firms with more independent boards achieve improved profitability. Our results do not support the conventional wisdom that greater board independence improves firm performance.


The purpose of the corporation is to maximize it value to its owners. A company’s reputation for ethical behavior, including its integrity in dealing with non-investor stake-holders, is part of its brand-name capital. Considerable emphasis in corporate ethics programs is put on misplaced efforts to change employees’ preferences by attempting to persuade them to put the interests of the organization or its customers ahead of their own. Even if ethical guidelines and training programs are unlikely to alter fundamental preferences, they have the potential to add value by explicitly communicating the firm’s expectations to its employees.
Organizational architecture is an important determinant of the success or failure of firms. Three important aspects: the assignment of decision rights within the firm; the methods of rewarding individuals; the structure of systems to evaluate the performance of both individuals and business units.


This paper disentangles the incentive and entrenchment effects of large ownership. Using data for 1,301 publicly traded corporations in eight East Asian economies, we find that firm value increases with the cash-flow ownership of the largest shareholder, consistent with a positive incentive effect. But firm value falls when the control rights of the largest shareholder exceed its cash-flow ownership, consistent with an entrenchment effect. Given that concentrated corporate ownership is predominant in most countries, these findings have relevance for corporate governance across the world.


We find that previous work has generally focused on examining subsets of governance mechanisms, typically studying one or two governance variables in any one study. Our view is that the most critical issue still to examine is the ability of firms to choose among a number of different governance mechanisms in order to create the appropriate structure for that firm, given the environment in which it operates. We identify a sample of firms and examine CEO compensation, CEO tenure, board composition, leadership structure and ownership structure and their contribution to both market performance, Market Value Added, and risk-adjusted accounting performance, Economic Value Added. In addition, we control for ownership by blockholders, industry performance, and firm size. We examine these measures both individually and as interactions. Our results indicate that while some of the traditional agency variables do impact performance, both individually and as interactions, industry performance is a strong and significant driver of performance for our sample of firms.


Stockholder wealth declines on average when managers respond to attempted hostile takeovers with defensive changes in asset and ownership structure.

Proxy contests are typically followed by managerial resignations, even when dissidents fail to obtain a majority of board seats, and are often followed by sale or liquidation of the firm. The average stockholder wealth gains associated with proxy contests are largely attributable to gains by companies in which dissident activity leads to sale or liquidation.


This paper argues that the structure of corporate ownership varies systematically in ways that are consistent with value maximization. Among the variables that are empirically significant in explaining the variation in ownership structure for 511 US corporations are firm size, instability of profit rate, whether or not the firm is in the mass media or sports industry. Doubt is cast on the Berle-Means thesis, as no significant relationship is found between ownership concentration and accounting profit for this set of firms. The logistic transformation \( \log\left(\frac{p}{100-p}\right) \) is made to convert an otherwise bounded dependent variable into an unbounded one.


This paper investigates the relation between the ownership structure and the performance of corporation if ownership is made multi-dimensional and also is treated as an endogenous variable. For data that reflect market-mediated ownership structures, no systematic relation between ownership structure and firm performance is to be expected. Our analysis suggests that none of the studies we examine treat ownership structure appropriately. It should be modeled not only as an endogenous variable but, simultaneously, as an amalgam of shareholdings owned by persons with different interests. Management holdings include shares owned by members of the corporate board, the CEO, and top management. Exclusive reliance on this measure to track the severity of the agency problems suggests that all shareholders classified as management have a common interest. This is not likely to be true. The fraction of shares owned by a corporation’s largest shareholders is not reliable measure of the degree to which investors are protected from abuse by management if professional management often holds enough shares to put them in this category of shareholders.


A substantial fraction of firms exhibit large changes in ownership and board structure in any given year. Ownership and board changes are strongly related to top executive turnover, prior stock price performance, and corporate control threats, but only weakly related to changes in firm-specific determinants of ownership and board structure. Large
ownership changes are typically preceded by economic shocks and followed by asset restructurings.


Agency problems are an important determinant of corporate liquidity. For a sample of more than 11,000 firms from 45 countries, we find that corporations in countries where shareholders’ rights are not well protected hold up to twice as much cash as corporations in countries with good shareholder protection. In addition, when shareholder protection is poor, factors that generally drive the need for liquidity, such as investment opportunities and asymmetric information, actually become less important. These results strengthen after controlling for capital market development. In fact, consistent with the importance of agency costs, we find that managers actually hold larger cash balances when capital markets are better developed. Our evidence indicates that investors in countries with poor shareholder protection cannot force managers to disgorge excessive cash balances.


Which is better for a small firm: debt financing or equity financing? A simple intertemporal model suggests that the two have very different potential incentive problems. With equity financing, the manager (an employee) may expend too little effort, while with debt financing, the manager (the owner) may keep the entire cash flow and default on the debt. Depending on the relative severity of these two incentive problems, either debt or equity may dominate the other. These problems are exacerbated by the possibility of an MBO and are reduced by sinking funds, stock or option compensation and non-vested pensions.


Before this paper, the literature only considered the agency problems of entrepreneurs (owner-manager) but not between of pure agent and shareholders. This paper attempts to explain how the separation of security ownership and control, typical of large corporations, can be an efficient form of economic organization. The firm is disciplined by competition from other firms, which forces the evolution of devices for efficiently monitoring the performance of the entire team and of its individual members. Individual participants in the firm, and in particular its managers, face both the discipline and opportunities provided by the markets for their services, both within and outside the firm.


The form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs.
The characteristics of residual claims are important both in distinguishing organizations from one another and in explaining the survival of organizational forms in specific activities. This paper develops a set of propositions that explain the special features of the residual claims of different organizational forms as efficient approaches to controlling agency problems.


Separation of decision and risk bearing functions survives in these organizations in part because of the benefits of specialization of management and risk bearing but also because of an effective common approach to controlling the implied agency problems. **Open corporations:** stockholders are not required to have any other role in the organization; their residual claims are alienable without restriction; and because of these provisions, the residual claims allow unrestricted risk sharing among stockholders. **Closed corporations:** generally smaller and have residual claims that are largely restricted to internal decision agents. **Public corporations:** government-owned corporations. **Close corporations:** not very descriptive.

Decision process: initiation; ratification; implementation; monitoring. Initiation and implementation are decision management; ratification and monitoring are decision control. Separation of residual risk bearing from decision management leads to decision systems that separate decision management from decision control, and then the agency problem arisen.

A feasible solution to the agency problem that arises when the same agents manage and control important decisions is to restrict residual claims to the important decision agents. But it will sacrifice the benefits of unrestricted risk sharing and specialization of decision functions. It will also lead to decisions that tend to penalize the organization in the competition for survival. However this solution may be more efficient in small organizations than in large ones.

**Separation of ownership and control** means separation of decision management from residual risk bearing. This separation will cause serious agency problems, which can be resolved by separation of decision management and decision control. Question here is that who plays the role of decision control. This paper provides three ways: decision hierarchy; mutual monitoring; board of directors.

The central hypotheses: i) Separation of residual risk bearing from decision management leads to decision systems that separate decision management from decision control. ii) Combination of decision management and decision control in a few agents leads to residual claims that are largely restricted to these agents.


The investment decisions of open corporations, financial mutuals and nonprofits can be modeled by the value maximization rule. However, the decision of proprietorships, partnerships, and closed corporations cannot in general be modeled by the market value rule.

In a study of the ownership of German corporations, we find a strong relation between board turnover and corporate performance, little association of concentrations of ownership with managerial disciplining, and only limited evidence that pyramid structures can be used for control purposes. The static relationship to control in Germany is therefore similar to the UK and the US. However, there are marked differences in dynamic relations involving transfers of ownership. There is an active market in share blocks giving rise to changes in control, but the gains are limited and accrue solely to the holders of large blocks, not to minority investors. We provide evidence of low overall benefits to control changes and the exploitation of private benefits of control.


This paper is a study of the evolution of ownership and control of corporations over the last hundred years. It uses individual firm data to examine how ownership and board control of UK firms incorporated at twenty-year intervals throughout the twentieth century evolved from incorporation until the end of the century. It constructs measures of growth of issued capital, dispersion of ownership and mutation of ownership and control which allow evolution to be tracked both at different points in time and in relation to particular events such as acquisitions, private placements and public offerings. It records that the origination and evolution of the corporation is quite at variance with conventional views. The highest rates of growth of issued capital and dispersion of ownership occur before firms are floated on a stock market. Most growth in issued capital and much dispersion of ownership occur through acquisitions prior to public listings. The highly dispersed nature of ownership of UK firms does not therefore have its origins in the stock market. In contrast, there is little mutation of ownership and control by insiders prior to flotation but a high level after flotation.


Corporate governance deals with the ways in which the rights of outside supplies of equity finance to corporations are protected and receive a fair return. Good practices reduce the risk of expropriation of outsiders by insiders and thus the cost of capital for issuers.


The “property rights” literature begins with the presumption that modifications must be made in the conventional analytical framework if economic models having wider applicability are to be developed. Thus, several crucial changes are introduced into the theory of production and exchange.
First, an entirely new interpretation is given to the role of individual decision-makers within the production organization.
Second, account is taken of the fact that more than one pattern of property rights can exist and that profit maximization is not assured.
Third, transactions costs are recognized as being greater than zero in virtually all cases of practical importance.
The property rights approach can be understood as an attempt to formulate empirically meaningful optimization problems by associating the utility function with the individual decision maker and then introducing specific content into the function. The other key idea in the analysis is that different property rights assignments lead to different penalty-reward structures and, hence, decide the choices that are open to decision makers.

Some general observations:

i) Maximizing behavior is accepted as the norm; each decision maker is assumed to be motivated by self-interest and to move efficiently to the most preferred operating position open.

ii) The institutional environment in which economic activity takes place tends to be specified with precision.

iii) There is confidence that the market logic can be applied fruitfully to a very great range of practical problems.

iv) Strong concern is shown for the individualist basis of choice; the preferences or values of an individual are assumed to be revealed only through his market or political behavior.

v) A central objective is to establish operationally meaningful propositions about the economy.


Path dependency may take three forms: 1) present conditions are sensitive to their starting point but with no efficiency implications, i.e., history matters; 2) present conditions are sensitive to their starting point and they are now inefficient, but one could not have known at the outset that an alternative starting point would have been better; and 3) that the initial starting point has resulted in inefficiency that could have been remedied by choosing a different starting point originally, or by changes now, but the inefficiency nonetheless remains.

Any successful system must find a way to replace poorly performing senior managers. If formal institutional characteristics matter, then the monitoring of managers should be dictated by the information made available by the two systems. Because one can manage only what one can measure, the tenure of American senior managers should be more sensitive to short-term changes in stock price and accounting earnings than that of German and Japanese managers, because only short-term results are said to be observable in the United States while German and Japanese monitors receive sufficient information to evaluate longer-run strategies.

Despite the striking differences in institutional form that still remain among the three governance systems, we do not observe the predicted differences among the three systems of monitoring management. Rather, we observe functional convergence. Regardless of whether the capital market is bank or stock market centered, the tenure of
senior management in all three countries is equally sensitive to poor performance, whether measured by stock market returns or accounting earnings. This functional convergence is driven by selection: a system that allows poor managers to remain in control will not succeed. We do not observe formal convergence because each system’s governance institutions have sufficient flexibility to find a solution within their path dependent limits.


Corporate-governance provisions related to takeover defenses and shareholder rights vary substantially across firms. In this paper, we use the incidence of 24 different provisions to build a “Governance Index” for about 1,500 firms per year, and then we study the relationship between this index and several forward-looking performance measures during the 1990s. We find a striking relationship between corporate governance and stock returns.

Studies of *agency problems due to the separation of ownership and control* date back to Berle and Means (1932), with its modern development by Jensen and Meckling (1976), Fama and Jensen (1983a, 1983b), and Jensen (1986). Empirical evidence of agency costs is surveyed by Shleifer and Vishny (1997).

Like most examples of legal origin and change, the governance structures of a firm are not exogenous, so it is difficult in most cases to draw causal inferences. For this reason, we make no claims about the direction of causality between governance and performance. Instead, we analyze whether governance is a useful variable for explaining cross-sectional variation in performance that is not already incorporated into market prices or other firm characteristics. We find economically significant explanatory power along many dimensions, and in the conclusion to the paper we discuss several causal interpretations of these findings and the corresponding policy conclusions for each case.

**The Wacky World of M & A**

the Investing Guys ([Investopedia.com](http://www.investopedia.com))

For many investors words like Dawn Raid, Poison Pill, and Shark Repellent can be scary things to read about. Though they might sound reminiscent of old James Bond movies, there is nothing entertaining about them from an investor's perspective. Owning stock in a company means you are part owner, with mergers and acquisitions occurring every week it is important to know what these terms mean for your holdings.

Mergers, acquisitions, and takeovers have been a part of the business World for centuries. In today's dynamic economic environment, companies often face decisions concerning acquisitions or mergers. The job of management is to maximize shareholder value. In most cases using mergers and acquisitions can help a company develop a competitive advantage and ultimately increase shareholder value.

There are several ways that two or more companies can combine their efforts. They can partner on a project, mutually agree to join forces and merge, or one company can
outright acquire another company. Here are some more intriguing ways that takeovers can take place:

**Hostile Takeover** - A takeover attempt that is strongly resisted by the target firm. These types of takeovers are usually bad news since the employee moral of the target firm can quickly turn to animosity against the acquiring firm. There is usually a reason why the acquirer had to resort to a hostile takeover rather than a friendly one.

**Dawn Raid** - This is when a firm or investor buys up a substantial amount of shares in a company first thing in the morning when the stock markets open. Usually a brokerage does the buying on behalf of the acquirer (the predator) to avoid drawing attention to the buying. It builds up a substantial stake in its target (the victim) at the current stock market price. Because this is done early in the morning the target firm usually doesn't get informed about this until it is too late and the acquirer has already scooped up controlling interest.

**Saturday Night Special** - A sudden attempt by one company to take over another by making a public tender offer. The name comes from the fact that this practice used to be done over the weekends.

Takeovers are announced practically everyday, but announcing them doesn't necessarily mean everything will go ahead as planned. In many cases the target company does not want to be taken over. What does this mean for investors? Everything! There are many strategies that management can use during M&A activity, and almost all of them will affect the value of stock in some way. Let's take a look at some more popular ways that companies can protect themselves from an unruly predator, we call these types of "shark repellent":

**Golden Parachute** - a measure used to discourage an unwanted takeover attempt by giving lucrative benefits to top executives in the event a company is taken over by another firm and they lose their job. Benefits include items such as stock options, bonuses, severance pay, etc. Golden parachutes can be in the millions of dollars and can cost the firm a lot of money.

**Greenmail** - a spin-off of the term blackmail. Greenmail is when a large block of stock is held by an unfriendly company, who then forces the target company to repurchase the stock at a substantial premium if they want to prevent a takeover.

**Macaroni Defence** - a defensive strategy where the target company issues a large number of bonds with the condition that they must be redeemed at a high price if the company is taken over. Why is it called Macaroni Defence? Because if a company is in danger, the redemption price of the bonds expands, kind of like Macaroni in a pot! This is a highly useful tactic, but the company must be careful that it doesn't issue so much debt that it can not make interest payments.

**People Pill** - another defensive strategy used to ward off a hostile takeover. Basically management threatens that, in the event of a takeover, the entire management team will resign. This is especially useful if they are a good
management team, losing them could seriously harm the company.

Poison Pill - a strategy used by corporations to discourage a hostile takeover by making its stock less attractive to the acquirer. There are two types of poison pills. 1) A "flip-in", which allows existing shareholders (except the acquirer) to buy more shares at a discount. 2) The "flip-over" allow stockholders to buy the acquirers shares at a discounted price after the merger. If investors fail take part in the poison pill and purchase stock at the discounted price then the outstanding shares will not be diluted enough to ward off a takeover.

Sandbag - another tactic used by management to try stalling a company that is showing interest in taking them over. The company stalls in the hope that another more favourable company will try to take them over. If management sandbags too long then you might begin to worry that they are not spending much effort trying to run the company.


We determine firms’ equity ownership structures and provide a theory of hostile takeovers by distinguishing the roles of two types of blockholder: rich investors and institutional investors. Rich investors have their own money at stake while institutional investors are run by professional managers and hence face agency conflicts. Because rich investors face no agency problems they are better at monitoring managers.

Gorton, G. and M. Kahl, 2000, the Allocation of Scarce Corporate Governance Ability, Working Paper

The restructuring specialists’ (large investors’) investment strategy is an important determinant of corporate ownership structures. Initially dispersed ownership can be optimal only if sufficient liquidity trading allows these special monitors to benefit from state-contingent block acquisitions.

Guillen, M.F., 2000, Corporate Governance and Globalization: is there Convergence across Countries? Working Paper


As predicted by Berle and Means (1932), we find that CEOs do not maximize firm value when they are not the residual claimants: our firms have higher Tobin’s Q, the higher are CEO shareholdings.


“Financial Contracting” might be described as the theory of what kinds of deals are made between financiers and those who need financing.
Modigliani-Miller (MM): in an ideal world, where there are no taxes, incentive or information problems, the way a project or firm is financed does not matter.

“**You better cut the pizza in four pieces because I am not hungry enough to eat six.”**

“What is missing in MM?” Taxes and Incentives

Debt financing is preferred because of the taxes shields but in reality we cannot observe 100% debt financing.

**Incentives** are presented by Jensen and Meckling (1976). The optimal debt-equity ratio or capital structure for the firm is determined at the point where the marginal benefit of keeping the manager from taking perks is offset by the marginal cost of causing risky behavior.

But according to the agency theory, the agency problems can be solved by perfect incentive schemes, which means why use financial structure rather than an incentive scheme to solve what is really just a standard agency problem.

The recent financial contracting literature adds a new ingredient to the stew: decision (control) rights.

The **financial contracting** (incomplete contract) literature takes the view that, although the contracting parties cannot specify what decisions should be made as a function of (impossible) hard-to-anticipate-and-describe future contingencies, they can choose a decision-making process in advance. And one way they do this is through their choice of financial structure. Take equity. One feature of most equity is that it comes with votes. That is, equity-holders collectively have the right to choose the board of directors, which in turn has the (legal or formal) right to make key decisions in the firm-specifically, the kinds of decisions described above.

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The paper argues that (a) although norms are undoubtedly very important both inside and between firms, incorporating them into the theory has been very difficult and is likely to continue to be so in the near future; (b) so far norms have not added a great deal to our understanding of such issues as the determinants of firms boundaries (the “make-or-buy” decision)- that is, at this point a norm-free theory of the firm and a norm-rich theory of the firm do not seem to have very different predictions.


By using panel data and our instrumental variables approach, we control for these potential spurious relations between ownership, board composition, and performance.

The most striking is that there appears to be no relation between board composition and performance. One obvious explanation for this result is that board composition simply does not matter. Inside and outside directors are equally bad (or, possibly, good) at representing the shareholders’ interests. This explanation is certainly consistent with top management’s control of the board-selection process.

**Hermalin, B.E. and M.S. Weisbach, 1998, Endogenously chosen boards of directors and their monitoring of the CEO, American Economic Review 88, 96-118.**
The resulting governance system has been criticized as ineffective in controlling management. Before any criticism of current practice is taken too seriously, a thorough understanding of the market forces that have led to its existence seems necessary. Independence is important because a director’s willingness to monitor the CEO increase with his or her independence. They develop a model in which board effectiveness is a function of its independence. The model predicts that:

1. a CEO who performs poorly is more likely to be replaced than one who performs well.
2. CEO turnover is more sensitive to performance when the board is more independent.
3. the probability of independent directors being added to the board rises following poor firm performance.
4. board independence declines over the courses of a CEO’s tenure.
5. accounting measures of performance are better predictors of management turnover than stock-price performance.
6. there should be long-term persistence in corporate governance.
7. the stock-price reaction to management changes should be negative if the CEO is fired based on private information, but positive if the manager is fired on the basis of public information.
8. a CEO salary should be insensitive to past performance at relatively low levels of past performance, but sensitive at relatively high levels of past performance.

Hermalin, B.E. and M.S. Weisbach, 2000, Boards of Directors as an endogenously determined institution: a survey of the economic literature, Working Paper

The primary findings from the empirical literature on board are:

1. board composition is not related to corporate performance, while board size is negatively related to corporate performance (and also the replacement of poor CEOs).
2. both board composition and size are correlated with the quality of the board’s decisions regarding CEO replacement, acquisitions, poison pills, and executive compensation.
3. boards appear to evolve over time as a function of the bargaining power of the CEO relative to the existing directors.
4. firm performance, CEO turnover, and changes in ownership structure appear to be important factors affecting changes to boards.

Board composition is measured by the insider/outsider ratio. Inside directors are employees or former employees of the firm. Outside directors are not employees of the firm and usually do not have any business ties to the firm aside from their directorship. About 10% of directors fall into neither category: often they are attorneys or businesspeople that have a longstanding relationship with the firm. These directors are usually referred to as “affiliated” or “gray” directors.

Two important issues complicate empirical work on the boards of directors:

1. endogeneity is an important consideration that is often difficult to address empirically in these studies. Firm performance is both a result of the actions of
previous directors and, itself, a factor that potentially influence the choice of subsequent directors.

2. empirical results on governance can often be interpreted as either equilibrium or out-of-equilibrium phenomena. While it is generally difficult to distinguish between the two interpretations in a given study, they often have drastically different implications for policy.

Why are there boards?

1. boards are required by the regulation. Were boards a deadweight cost to the firm, then we should expect them to all be at minimum size as fixed by regulation. Yet, in practice, boards are generally much larger than required by law.

2. boards are a market solution to an organizational design problem, an endogenously determined institution that has arisen to ameliorate the agency problems that plague any large organization.


Both managerial ownership and performance endogenously determined by exogenous (and only partly observed) changes in the firm’s contracting environment. We extend the cross-sectional results of Demsetz and Lehn (1985) and use panel data to show that managerial ownership is explained by key variables in the contracting environment in ways consistent with the predictions of principal-agent models. A large fraction of the cross-sectional variation in managerial ownership is explained by unobserved firm heterogeneity. Moreover, after controlling both for observed firm characteristics and firm fixed effects, we cannot conclude (economically) that changes in managerial ownership affect firm performance.

First, proxies for the contracting environment faced by the firm (i.e., observable firm characteristics) strongly predict the structure of managerial ownership. We also show that many of our results are robust to the inclusion of observed determinants of managerial ownership, industry fixed effects, or firm fixed effects.

Second, we show that the coefficient on managerial ownership is not robust to the inclusion of fixed effects in the regression for Tobin’s Q. Our formal statistical test rejects the null hypothesis of a zero correlation between managerial ownership and the unobserved determinants of Tobin’s Q, thus supporting our conjecture that managerial ownership is endogenous in Q regressions. That is, managerial ownership and firm performance are determined by common characteristics, some of which are unobservable to the econometrician.

Third, we explore the use of instrumental variables as an alternative to fixed effects to control for the endogeneity of managerial ownership in the Q regression. We find some evidence to support a causal link from ownership to performance, but this evidence is tentative because of the weakness of our instruments. We argue that future progress will require a more structural approach to the model.

A good survey of ownership structure focus on Blockholders! Adam Smith, in “Wealth of Nations”, mentioned the “negligence and profusion” that will result when those who manage enterprises are “rather of other people’s money than of their own”. Adolf Berle and Gardiner Means, in their famous book, mentioned that enterprises faced “the dissolution of the old atom of ownership into its component parts, control and beneficial ownership”. Jensen and Meckling (1976), in their seminal paper, firstly modeled the conflict between diffuse shareholders and professional managers. After the JFE 1983 (a collection of 16 papers about market for corporate control), was published, researchers began to discover that there were some large shareholders in the public listed firms. Ownership concentration (Blockholders), such large portion of shares hold by the manager or directors, became a hot issue. Demsetz and Lehn (1985) address the question of the types of public corporations that are likely to have high levels of managerial stock ownership. Holderness and Sheehan (1988) address the question of whether major corporate decisions are different when a corporation has a large-percentage shareholder. Morck, Shleifer, and Vishny (1988) address the question of the impact of firm value of different levels of managerial stock ownership. Another collection of papers published in JFE 1988 and the conclusion identified “ownership structure and the allocation of voting rights” as a direction for future research (Jensen and Warner 1988). This paper is going to survey the empirical literature about blockholders and corporate control by answering four questions related.

How Prevalent are Blockholders?
Holderness, Kroszner, and Sheehan (1999) find that in 1995, insiders on average owned 21 percent of the common stock of a randomly selected firm (median 14%). It is an open question whether the dollar value of holdings may provide a better indication of a manager’s incentive and willingness to make decisions than does percentage value of holdings. Holthausen and Larcker (1991) argue that “if it is equally difficult to affect firm value by a given percentage, say 5 percent of equity value, then dollar value of holdings is the appropriate measure, not percentage ownership. However, if it is equally difficult to get a given dollar magnitude change in the value of the equity, say $1,000, then the manager’s percentage ownership is the appropriate measure of incentive.” Hanka (1994) finds that both the percentage and the dollar value affect the magnitude of corporate charitable donations.

What Motivates Block Ownership?
The shared benefits of control arise from the superior management or monitoring that can result from the substantial collocation of decision rights and wealth effects that come with large-block ownership. Blockholders have the incentive and the opportunity to increase a firm’s expected cash flows that accrue to all shareholders. Blockholders also have the incentive to use their voting power to consume corporate resources or to enjoy corporate benefits that are not shared with minority shareholders. These are the private benefits of control.
Are Major Corporate Decisions Affected by Blockholders?
Surprisingly few major corporate decisions have been shown to be different in the presence of a blockholder. One exception is that external blockholders appear to monitor the form and level of managerial compensation. Conversely, there is little evidence that blockholders affect leverage.

What is the Impact of Block Ownership on Firm Value?
Ownership concentration appears to have little impact on firm value.


Corporate managers who own a majority of the common stock in their company or who represent another firm owning such an interest appear to be less constrained than managers of diffusely held firms, yet their power to harm minority shareholders must be circumscribed by some organizational or legal arrangements. Empirical investigations reveal that boards of directors in majority-owned firms are little different from firms with diffuse stock ownership. Another source of constraints on majority shareholders – capital market activity – also appears to be no different from firms with diffuse ownership. Finally, there is little evidence that new organizational mechanisms have evolved to constrain managers who own large blocks of stock. The frequency and associated wealth effects of reorganizations of majority shareholder firms, however, indicate that the law constrains managerial majority shareholders, both in their day-to-day management and when they redeem the ownership interest of minority shareholders.

Jensen, M.C., 1985, the Efficiency of Takeovers, the Corporate Board, Sep/Oct, 16-22.

The market for corporate control that has arisen in the last two decades is generating large benefits for shareholders and for the economy as a whole. The corporate control market generates these gains by loosening the control over vast amounts of resources and making it possible for those resources to move more quickly to their highest-valued use. This occurs through takeovers (both hostile and friendly), divestures, spin-offs, split-ups, leveraged buyouts, and going-private transactions.

The market for corporate control is part of the managerial labor market where teams compete for the right to manage resources. Some takeovers occur because the internal processes for change are too slow, costly, and clumsy.

Management must recognize that many of its old practices and strategies are no longer viable. Takeovers are an important source of external control, which protect investors when internal corporate controls break down.

There is scientific evidence on the effects of the takeover market. Takeovers do not cause managers to behave myopically.

If the managers are wrong, it is desirable to remove them for a change in strategy and more efficient use of resources.

Managers are not driven by maximization of the value of the firm, but rather by the maximization of “corporate wealth”, defined as the aggregate purchasing power available to management for strategic purposes during any given planning period. In practical terms it is cash, credit, and other corporate purchasing power by which management commands goods and services.

Managers have incentives to cause their firms to grow beyond the optimal size. Growth increases managers’ power by increasing the resources under their control. It is also associated with increases in managers’ compensation. The tendency of firms to reward middle managers through promotion rather than year-to-year bonuses also creates a strong organizational bias toward growth to supply the new positions that such promotion-based reward systems require.

Product and factor market disciplinary forces are often weaker in new activities and activities that involve substantial economic rents or quasi rents (free cash flow). In these cases, monitoring by the firm’s internal control system and the market for corporate control are more important.

Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. (this definition is different from that in accounting?)

Issues: how to motivate managers to disgorge the cash rather than investing it at below the cost of capital or wasting it on organization inefficiencies.


The modern (third) industrial revolution started from the time of the oil price increases beginning in 1973.

The decade of the 1980s: capital markets provided an early response to the modern industrial revolution.

Causes of excess capacity: demand-reduction; capacity-expanding; obsolescence-creating; lack-of-foresight.

Current forces leading to excess capacity and exit: macro policies; technology; organizational innovation; globalization of trade; revolution of political economy.

The difficulty of exit: asymmetry between growth and decline; information problems; contracting problems.

Four control forces operating on the corporation: capital markets; legal/political/regulatory system; product and factor markets; internal control system headed by the board of directors.

The era of the control market came to an end in late 1989 and 1990.

Direct evidence of the failure of internal control systems: we cannot simply measure the performance of a corporation by the change in its market value over time because this measure does not take account of the efficiency with which the management team manages internally generated cash flows. How to measure the productivity of R&D?

What are the problems with the internal control systems?
The job of the board is to hire, fire, and compensate the CEO, and to provide high-level counsel. The available evidence does suggest that CEOs are removed after poor performance, but the effect, while statistically significant, seems too late and too small to meet the obligations of the board.

The great emphasis on politeness and courtesy at the expense of truth and frankness in boardrooms is both a symptom and cause of failure in the control system. Without accurate positive theories of cause and effect relationships, normative propositions and decision based on them will be wrong. Therefore, the two objectives are completely consistent.


The production functions, i.e., the boundary of the firm, are dependent on the structure of property rights and contracting rights within which the firm exists.

**Jensen, M.C. and W.H. Meckling, 1994, the Nature of Man, Journal of Applied Corporate Finance, summer, V7, No2, 4-19**

Resourceful, Evaluative, Maximizing Model (REMM): i) Every individual cares; he or she is an evaluator. ii) Each individual’s wants are unlimited. iii) Each individual is a maximizer. iv) The individual is resourceful (creative).

Economic Model (Money Maximizing Model): REMM takes the assumptions that people are resourceful, self-interested, maximizer, but rejects the notion that they are interested in only money income or wealth.

Sociological Model (Social Victim Model): REMM takes on the assumption that “society” imposes costs on people for violating social norms, which in turn affect behavior; but it also assumes that individuals will depart from such norms if the benefits are sufficiently great. Indeed, this is how social change takes place.

Psychological Model (Hierarchy of Needs Model): REMM takes the assumption that income elasticity of demand for various goods has certain regularities the world over. Nevertheless, in taking on this modified notion of a hierarchy of needs, it does not violate the principle of substitution by assuming people have “needs”.

Political Model (Perfect Agent Model): REMM takes on the assumption that people have the capacity for altruism. They care about others and take their interests into account while maximizing their own welfare. REMM rejects, however, the notion that individuals are perfect agents.


Tunneling is defined as the transfer of assets and profits out of firms for the benefit of their controlling shareholders. They describe the various forms that tunneling can take, and examine under what circumstances it is legal.


Alaska Native Claims Settlement Act (ANCSA) established thirteen diffusely held profit-seeking corporations that were saddled with unusual organization restrictions, the most important of which is that stock cannot be traded. Mechanisms that impose costs on most managers for opportunistic behavior and/or incompetence include:

i) Threat of corporate control transfer such as hostile tender offer.
ii) The managerial labor market’s evaluation.
iii) Performance-based incentive contracts.
iv) Imposition of legal and market penalties for opportunism.
v) Nonpecuniary rewards to managers that are contingent on performance.


We find robust evidence of *de jure* similarity in governance. Interestingly, this is not driven by convergence to U.S. standards. Rather pairs of economically interdependent countries – especially if the countries are both economically developed – appear to adopt common corporate governance standards, even after accounting for the effects of common legal origin. In contrast to the *de jure* results, we find virtually no evidence of *de facto* similarity in corporate governance in a battery of estimations at the country, industry and firm levels. This is consistent with either the proposition that complementarities result in different national systems appropriately having different corporate governance systems, or the proposition that globalization is not strong enough to overcome local vested interests. We conclude that globalization may have induced the adoption of some common corporate governance standards but that there is little evidence that these standards have been implemented. (2002 version)

We find strong evidence of *de jure* convergence in form that is correlated with several of our proxies for governance. Further, the *de jure* convergence does not appear to be driven by convergence to the US system. Finally, we find virtually no evidence of *de facto functional* convergence or convergence in form. An interpretation is that, even though countries might mimic the tenets of each other’s systems, their implementation is subject to significant lags. We conclude that globalization may have induced the adoption of some common corporate governance standards but that there is little evidence that these standards have been implemented. (2001 version)

In Shleifer and Vishny (1986), the large shareholders are good monitors and can reduce the agency problems that arise from the divergence of interests between managers and shareholders. However this is a ‘necessary’ rather than ‘sufficient’ condition especially in emerging markets. Some reasons provided:
1. the absence of specialized intermediaries that perform monitoring services.
2. the poor availability of information.
3. even if monitors with the appropriate skill levels exist and have the appropriate incentives to perform their function, there are impediments to their doing so.

In China, there are block shareholders: state shareholders, legal person shareholders, other big shareholders, director shareholders, foreign shareholders, staff shareholders. The question is that who is/are the monitor(s). I predict that the state shareholders would be the best monitor among the other shareholders. The legal person, other large shareholders, directors will have no effective monitoring effects. This prediction is consistent with the “insiders control” phenomenon in China. Among many Chinese listed companies, the legal person shareholders are major shareholders and they should be good monitors. But they are insiders, once they are in the position, they will not give the power to the others. However, for the state shareholders, although there are serious agency problems, they have much more incentives to monitor the company than the other shareholders. Also state shareholders have political power and become easier to monitoring the company. From the empirical investigate of the top management selection in China, we can prove my predictions. The preliminary results are consistent with my prediction. The question is how to derive the hypothesis. I think this paper in India gives me a very good example and I should read it carefully and learn how to motivate the research.


Except in economies with very good shareholder protection, relatively few of these firms are widely held, in contrast to the Berle and Means image of ownership of the modern corporation. Rather, these firms are typically controlled by families or the State. Equity control by financial institutions is far less common. The controlling shareholders typically have power over firms significantly in excess of their cash flow rights, primarily through the use of pyramids and participation in management.


“Outcome” model means dividends are paid because minority shareholders pressure corporate insiders to disgorge cash, which predicts that stronger minority shareholder rights should be associated with higher dividend payouts.
“Substitute” model means insiders interested in issuing equity in future pay dividends to establish a reputation for decent treatment of minority shareholders, which predicts that stronger minority shareholder rights should be associated with lower dividend payouts. The evidence supports the “outcome” model.

The effect of greater competition on corruption depends on the complementarity or substitutability of the two instruments available to decrease information rents, namely low powered incentives and greater competition.


A liquid stock market reduces large shareholders’ incentives to monitor because it allows them to sell their stocks more easily. Even though this is true, a liquid market also makes it less costly to hold larger stakes and easier to purchase additional shares. We show that this fact is important if monitoring is costly: market liquidity mitigates the problem that small shareholders free ride on the effort of the large shareholder. We find that liquid stock markets are beneficial because they make corporate governance more effective.


We investigate the relationship between management ownership and market valuation of the firm, as measured by Tobin’s Q. In a 1980 cross-section of 371 Fortune 500 firms, we find evidence of a significant nonmonotonic relationship.

Hypotheses:

H1: (convergence-of-interest hypothesis), market value increases with management ownership.
H2: (entrenchment hypothesis), market value decreases with management ownership.

Method:

Piecewise linear regression:

\[
\text{BRD.0to}5 = \begin{cases} 
\text{board ownership if board ownership < 0.05,} \\
0.05 \text{ if board ownership } \geq 0.05;
\end{cases}
\]

\[
\text{BRD.5to}25 = \begin{cases} 
0 \text{ if board ownership < 0.05,} \\
\text{board ownership minus 0.05 if 0.05 } \leq \text{ board ownership } < 0.25, \\
0.20 \text{ if board ownership } \geq 0.25;
\end{cases}
\]

\[
\text{BRD.OVER}25 = \begin{cases} 
0 \text{ if board ownership < 0.25,} \\
\text{board ownership minus 0.25 if board ownership } \geq 0.25.
\end{cases}
\]

Measurements:

Performance: average Tobin’s Q = (market value)/ (replacement cost of its physical assets)

Two hypotheses for positive reactions to stock repurchase:  
**Information signaling hypothesis** argues that a company’s willingness to pay a premium to purchases its own shares sends a strong signal to lesser-informed outside investors that the company’s future prospects are improving. We should see a tangible improvement in operating performance following the repurchase, relative to what was expected.  
**Free cash flow hypothesis** argues that firms with excess cash and a poor portfolio of investment opportunities will face sizeable agency costs if the excess cash is not distributed to shareholders. Investors should react to the repurchase announcement but the repurchasing firms may or may not exhibit improved performance.  
This paper found that operating performance following repurchases improves only in low growth firms, and that these gains are generated by more efficient utilization of assets, and asset sales, rather than improved growth opportunities. This evidence leads us to conclude that the positive investor reaction to repurchases is best explained by the free cash flow hypothesis.


In social democracies – nations (mainly European Continental Nations) committed to private property but whose governments play a large role in the economy, emphasize distributional considerations, and favor employees over capital-owners when the two conflicts – public policy emphasizes managers’ natural agenda and demeans shareholders’ natural agenda.  
Social democracies not only widen the gap between manager and shareholders, but make the gap-closing tools – shareholder value norms, transparent accounting, incentive compensation, and hostile takeovers and proxy fights – harder to employ.  
A nation must enforce ordinary contracts satisfactorily before it can build complex private institutions.  
Bad law sufficiently explains weak securities markets where law is so weak that even basic contracts cannot be enforced. The insight is important to understanding finance in nations with decrepit law systems, but it cannot be extended to advanced nations to conclude the converse, that if they lack a good securities market, it is because their law is not advanced enough.  
When contract law, corporate law, and court systems are decrepit, politics is irrelevant. But when either contract or basic corporate law becomes satisfactory, as it is in several western European nations and the United States, then whether a nation builds on what it has, becomes a question of whether the underlying politics make it profitable for the players to do so. The best hypothesis is that the institutions did not arise because there was demand for them just was not there or because politics squelched the capital-market players who would build them.

Agent selection
Requiring potential agents to bid for the right to serve as the agent is one means by which the principal can identify the best agent, while simultaneously limiting his rents. Much like bidding competition before the contract is granted, the threat of competition after the contract is granted can also serve to discipline an agent. Proper selection of the most desirable agents can require subtle balancing of the policy instruments to attract them.


Indian corporate governance system is a hybrid of the outsider-dominated market-based systems of the UK and the US, and the insider-dominated bank-based systems of Germany and Japan.

Some findings in this paper:
1. blockholdings by directors to increase company value after a certain level of holdings
2. no evidence that institutional investors, typically mutual funds, are active in governance
3. support evidence for the efficiency of the German/Japanese bank-based model of governance; lending institutions start monitoring the company effectively once they have substantial equity holdings in the company and that this monitoring is reinforced by the extent of debt holdings by these institutions
4. the foreign equity ownership has a beneficial effect on company value


It arises from the free-rider problem of deep diversified shareholders. This paper argues that the presence of a large minority shareholder provides a partial solution to this free-rider problem.


In this paper, we extend the work of Ang et al. [J. Finance 55 (2000) 81] to large firms. We find that managerial ownership is positively related to asset utilization but does not serve as a significant deterrent to excessive discretionary expenses. Outside block ownership may only have a limited effect on reducing agency costs. Furthermore, smaller boards serve the same role, but independent outsiders on a board do not appear to protect the firm from agency costs. Thus, this paper reports complementary evidence to Ang, Cole and Lin. In large publicly traded corporations, managerial ownership significantly alleviates principal-agent conflicts even in the presence of other agency deterrent mechanisms.

Takeover pressure can be damaging because it leads managers to sacrifice long-term interests in order to boost current profits. The magnitude of the problem depends on a variety of factors, including the attitudes and beliefs of shareholders, the extent to which corporate raiders have inside information, and the degree to which managers are concerned with retaining control of their firms.


An increase in the fraction of voting rights controlled by management decreases the probability of a successful tender offer and increases the premium offered if a tender offer is made.


Try to incorporate everything in one model. Admire you!!!
The paper first develops an economic analysis of the concept of shareholder value, describes its approach, and discusses some open questions. It emphasizes the relationship between pledgeable income, monitoring, and control rights using a unifying and simple framework.
The paper then provides a first and preliminary analysis of the concept of the stakeholder society. It investigates whether the managerial incentives and the control structure described in the first part can be modified so as to promote the stakeholder society. It shows that the implementation of the stakeholder society strikes three rocks: dearth of pledgeable income, deadlocks in decision-making, and lack of clear mission for management.
While it fares better than the stakeholder society on those three grounds, shareholder value generates biased decision-making; the paper analyzes the costs and benefits of various methods of protecting noncontrolling stakeholders: covenants, exit options, flat claims, and enlarged fiduciary duty.


This paper studies the determinants of executive turnover and firm valuation as a function of ownership and control structure in Italy, a country that features low legal protection for investors, firms with controlling shareholders, and pyramidal groups. The results suggest that there is poor governance, as measured by a low sensitivity of turnover to performance and a low Q ratio, when (i) the controlling shareholders are also top executives, (ii) the control is fully in the hands of one shareholder and is not shared by a set of core shareholders, and (iii) the controlling shareholders own less than 50% of the firm’s cash-flow rights.

The results suggest that institutional monitoring is associated with valuation effects when both observable and unobservable aspects of the relationship between institutions and firms are taken into account. Moreover, the valuation effects vary according to the objective functions of institutions’ administrators. Thus, other shareholders do not necessarily benefit from relationships between institutions and managers, and they could be hurt when the institutional agents watching firm agents have conflicts of interest with other shareholders.

A system of simultaneous equations:

Performance = f (Ownership, Predetermined variables for Performance, Control variables, Year effects, error) -----------------------------------------------(1)

Ownership = f (Performance, Predetermined variables for Ownership, Control variables, Year effects, error) -----------------------------------------------(2)

Hence, a two-stage least squares solution for Eq.(1) is analyzed by estimating Eq.(2), with instrumental variables, and getting fitted values of Ownership. These fitted values are used as instruments for Ownership in Eq.(1). The coefficient for Ownership can be interpreted as the marginal effect of a change in Ownership on Performance.

To estimate the regression coefficients for the system of equations, each equation needs at least one instrumental variable that does not appear in the other equation (Greene, 1997). Control variables are the common variables for both equations and Predetermined variables are those that are only related to either Performance or Ownership and, therefore, appear as determinants in only one of the equations.


Managerial ownership, while substantially different across firms, typically changes slowly from year to year within a company. With rational managers maximizing long-term utility, small, one-year changes in ownership are not likely to reflect notable changes in incentives that would lead to substitutive within-year changes in performance. By relying on within variation, fixed effects estimators may not detect an effect of ownership on performance even if one exists.

China’s Issues

Berkman, H., R. Cole, and J. Fu, 2002, From State to State: Improving corporate governance where the government is the controlling block holder, Working Paper

They examine stock returns for a sample of publicly traded firms around announcements of block share transfers from government agencies to corporatized firms where the state is the ultimate controlling shareholder. They provide the evidence that these transfers improve corporate governance and firm value by partially reattaching cash-flow rights to control rights. They find that cumulative abnormal returns average 7.5% during the announcement period, and that more than 40% of the CEOs were replaced within 12 months. Moreover, they find that both the change in firm value and the likelihood of CEO turnover are functions of the incentives and managerial expertise of the new block holder. We conclude that corporate governance can be improved at
state-controlled firms by including private block holders in the ultimate ownership structure, which more closely aligns cash-flow rights with control rights. In summary, the cross-sectional analysis of abnormal returns indicates that different State shareholding regimes have differential impacts on firm value even though they all represent the state as the controlling owner. Among the three state-shareholding regimes, LPSOE provide the most effective monitoring, followed by SSOEs an then GAs. Here are some questions about this paper.

1. how about the firms’ profitability before transfer? The observed evidence is that almost all the transferred firms experienced large losses before the transaction and thus the investors may speculate the transfer no matter who will come into power. The observed CAR cannot be attributed to “improved corporate governance” by the coming blockholders.

2. the Chinese block transfers are different from others because there are usually good assets injection following the transfers. Thus how can we attribute investors’ valuation on the injected good assets to “improved corporate governance”? The transfer may reveal the information that the firm will get better-quality assets injected from blocker purchaser and thus leads positive abnormal CAR.

3. how about the background of the leaving and incoming CEOs? With absence of professional labor market in China, it is likely that the new blockholder will fire current CEO (usually from the current blockholder) and hire new CEO (usually from the incoming blockholder). Thus the CEO turnover rate also cannot be attributed to “improved corporate governance”. We should check both the current and incoming CEOs’ background.


Chinese SOE reforms that have centered on the use of incentive contracts have been successful in motivating managers and employees to make and keep profits, but they have failed in preventing these insiders from passing losses and liabilities to the State.

Boradman, H., 1997, China’s Management of Enterprise Assets: the State as Shareholder, the World Bank country study

China’s reform of industrial state-owned enterprises seeks to maintain state ownership of the key enterprises and improve their performance by establishing market-oriented incentives. Most other countries in transition have turned to systemic, widespread privatization of SOEs. In China, the State, or its agents, carry out “shareholder” functions performed by private owners in market economic systems. There have been payoffs to China’s strategy. Reforms have boosted SOE total factor productivity growth rates. SOEs remain key drivers of the nation’s industrial sector, accounting for one-third of production, over one-half of total assets, two-thirds of urban employment and almost three-quarters of investment. But industrial SOEs profits have declined from 6 percent to below 1 percent of the gross domestic product in recent years. Many of them continue to be technologically inefficient, remain obligated to provide “cradle-to-grave” social services to workers and their families, and carry a rising
proportion of redundant employees and retirees on their payrolls. The result is that an increasing proportion are losing money: in 1996 about 50 percent of industrial SOEs incurred net losses (up from one-third just two years ago) – amounting to 1.3 percent of GDP. Factory capacity utilization rates for major industrial products have also fallen below 60 percent. Yet SOEs continue to absorb more than three-fourths of domestic credit, and their borrowing comprises about 60 percent of the total nonfinancial public sector deficit. This crowds out investment by nonstate firms, which have been the engines of growth. It also undermines a weak state-dominated banking system: 20 percent of bank portfolios contain nonperforming loans to SOEs, resulting in state banks with negative net worth.

Despite past progress, SOE reforms have not met the policy aspirations of the government. Many experiments carried out have been genuinely creative, but few have fundamentally tackled the core of public enterprise reform. Some of China’s SOE reforms have provided temporary relief, but few are enduring successes. Worse still, some reforms have created new problems, such as asset-stripping, tax evasion, decapitalization and wage manipulation. By spilling over to the fiscal and financial sectors, they jeopardize other critical elements of the government’s economic reform program and undermine resource allocation and macroeconomic stability. These problems are the product of and are compounded by the complex transition process China’s economy is undergoing. In their call for establishing a “modern enterprise system” early in the next century, China’s authorities have focused attention on the need for clearer property rights within a sound economic legal framework; organizational reform; strengthened corporate governance; and international-based financial accounting systems. These are all critical components for reform of China’s management of state assets in the enterprise sector, and the focus of this study.


Overall, the essence of the “SOE problem” is that China has a relatively concentrated industrial structure – where the top approximately one percent of firms accounts for just over one-quarter of national output – dominated by many inefficient, badly-structured and poorly-run SOEs. This situation leads to misallocation of resources and macroeconomic imbalances – most notably in recent years the problem of overcapacity and deflation.

The universal problem of a modern corporation’s owners – whether in China or elsewhere – is how to establish an internal incentive structure of the enterprise so that managers attain owners’ goals, and at the same time ensure that the firm is exposed to various external incentives that influence the conduct of managers in such a way to enhance firm performance. The extent of China’s “SOE problem” suggests that implementation of the modern corporate form in China is still evolving. Internal incentives are blunted because of the ill-defined relationship between an enterprise’s owners (the state, represented by government) and its management (also the government) and the co-mingling of social and productive functions. Discipline from external incentives is not fully operable due to insulation from market pressures, including competition in product markets, weak labor mobility, a nascent “market for corporate control”, banks that do not operate fully according to commercial principles, and poor implementation of bankruptcy procedures.
Some degree of managerial autonomy has been introduced. In 1992 a regulation was issued to cede to SOE managers *Fourteen Autonomous Management Rights*. They are: production autonomy; pricing autonomy; selling autonomy; purchasing autonomy; import and export rights; investment autonomy; use of retained earnings; right to dispose of assets; autonomy to establish JV, mergers, and acquisitions; right to hire workers; right to manage personnel; right to determine wages and bonuses; right to decide on organizational structure; right to refuse unregulated government collections.

Government agencies often exercise both the shareholder and regulator roles. This creates conflicts of interest. Moreover there are often multiple government agencies exercising the role of owner, overlapping with one another. The result is that across agencies—both horizontally and vertically—there is fragmentation and partial exercise of the ownership function, with no single entity responsible for an SOE’s “bottom line”. Consequently SOE managers are de-facto enjoying more autonomy than otherwise formally indicated. But they are doing so largely not by design, but because property rights are poorly defined. The result is that to the extent subsidies make their way to SOEs, to the extent SOEs are protected from competition in product and factor markets by policy barriers to entry or similar institutional constraints, or to the extent that debt-service obligations go unmet because the state-owned banks themselves do not yet fully operate according to commercial principles, SOE managers face few checks and balances in abiding by property rights.

The organizational reforms have concentrated on different ways of discharging State shareholder functions in SOEs. The State Council (or Cabinet) acts as the “ultimate owner” of SOE assets on behalf of the people of China. The administrative arm of the State Council to carry out its state ownership functions is the National Administrative Bureau of State Owned Property (NABSOP). For enterprise groups and holding companies, the representation of the state’s ownership interests is often direct: a ministerial-level official serves as chairman of the board or as chief executive or both. But there have also been more elaborate shareholder schemes—which have begun to substantially decline in importance—where at each branch of government (national, provincial, municipal and district) state assets management had typically encompassed three levels of institutions: (a) an “upper-tier” state asset management organization, operating as an executive body; (b) an “intermediate tier” state asset management organization, entrusted by the upper-tier institution to manage the state-owned assets; and (c) the “operational enterprises”—the SOEs. Analogous to NABSOP, upper-tier executive bodies were established at sub central levels of government, such as municipal-level state asset management bureaus (SAMBs). Intermediate tiers, generally comprised of provincial- and municipal-level State Asset Operating Companies (SAOCs), modeled on the concept of the modern holding company, also established.


In 1994, China began a quit reform in privatizing and restructuring its SOEs under the slogan “grasping the large and letting go the small” (*zhuada fangxiao*). This reform has proceeded in three areas: (i) privatization of small SOEs at the county level; (ii) mass layoffs of SOE workers at the city level; and (iii) mergers, groupings/conglomerations, corporatizations, and initial public offerings of some large SOEs which often involve the central government.
In China, there are two separate worlds in the state sector: one of small and medium SOEs under the supervision of local governments, and another of large SOEs under the central government.

Che, Jiahua, From the Grabbing Hand to the Helping Hand, Working Paper.

Using its control of regulated inputs, a government agency extracts rents from a manager who undertakes an investment. Such a government rent seeking activity leads to a typical hold-up problem. Government ownership is shown to serve as a second best commitment mechanism through which the government agency will restrain itself from the rent seeking activity and even offer the manager support and favor such as tax breaks and subsidies. This mechanism works at a cost as government ownership compromises ex post managerial incentives and creates distortion in resource allocation. Nevertheless, under some fairly general conditions, government ownership Pareto dominates private ownership. The analysis corresponds to a host of stylized empirical observations concerning local government-owned firms during China’s transition to a market economy. Based on this analysis, I suggest that local government owned firms will be transformed to private ownership as China’s input markets become more liberalized.


In China, listed companies had to achieve a minimum return on equity (ROE) of 10 percent before they could apply to the state’s regulators for permission to issue additional shares in 1996-1998. This requirement resulted in a heavy concentration of ROEs in the area just above 10 percent. This paper shows that earnings management is quite easy to detect from China’s standardized income statement. In 1996-1998, China’s regulators did increase gradually the scrutiny of earnings management in their approval process. As a result, their ability to identify firms that subsequently perform better improved during the study period. However, since the scrutiny was limited, many firms were able to gain rights issue approval by earnings management. The study shows that these firms subsequently performed worse than those did not. Thus, capital resource could have been better allocated had the Chinese regulators examined more closely earnings management in their approval process.


The new incentives were effective: productivity increased with increases in bonus payments and in contract workers. The increase in autonomy raised workers’ incomes (but not managers’ incomes) and investment in the enterprise, but tended not to raise remittances to the state.

Costs of hierarchy arise from the fact that information becomes distorted within the firm as it is transmitted from production floor to management, and in the case of firms subject to central planning, the information is further distorted in the communications
between the firm and state agencies, as has been noted by observers of Chinese enterprises. Industrial reforms, it is commonly argued, are more difficult than agricultural reforms, because of the greater complexity of the industrial management system and the multiple constraints to which enterprise managers are subject. The industrial reforms in China in fact met with significant success.


China’s reform worked and produced one of the most impressive growth in the largest developing and transition economy in the world in the past twenty-two years. That China has managed to grow so rapidly despite the absence of many conventional institutions such as rule of law and secure private property rights is puzzling. To understand how reform works in a developing and transition economy that has great growth potential, it is not enough to study the conventional “best-practice institutions” as a desirable goal. One should also study how feasible, imperfect institutions have evolved to complement the initial conditions and to function as stepping stones in the transition toward the goal. Underlying China’s reform is a serial of institutional changes concerning the market, firms, and the government in the novel form of “transitional institutions”. These institutions succeed when they achieve two objectives at the same time: to improve economic efficiency by unleashing the standard forces of incentives and competition on the one hand, and to make the reform a win-win game and thus interest compatible for those in power on the other.

Can I classify my “corporate state shareholders” as the “transitional institutions” mentioned by Qian (2002)? I should send my research to him and get his advice.


The reform of the Chinese economy has been accompanied by the emergence of a legal system designed both to protect the independence of enterprises and facilitate their regulation. To a limited extent the enterprises are the product of legislation. They have also been influenced by Western legal models of business organization. Deng Xiaoping’s famous maxim of the 1960s – “It doesn’t matter whether the cat is black or white. If it catches mice, it’s a good cat.” – once seemed a protest against dogmatism; today it seems an excuse for unprincipled expedience.

The leadership rejects large-scale privatization of the sort occurring in Eastern Europe, in which state assets are auctioned to the wealthy or given away to the masses, on several grounds. First, mass privatization would likely produce an undesirable concentration of capital in private (especially foreign) hands. Second, given the difficulties of valuing state assets, the dangers of shortchanging the state are great. Third, the distributive and allocative consequences of stock trading by masses of uninformed citizens in informationally inefficient markets are likely to be undesirable. Insiders and speculators would grow rich at the expense of ordinary citizens, and the
stock market would not play a useful role in corporate monitoring. Fourth, China lacks a
developed system of tax collection and the social conventions that support it. At least
until it can develop these things, the revenues of the state enterprises are the most
plausible form of government finance.
Property in China has never been held by “the state” – it always has been held by
thousands of separate government jurisdictions, from villages right up to the central
ministries.

Su, Dongwei, 2000, Corporate Finance and State Enterprise Reform in China, Working
Paper, U. of Akron.

The paper uses the political cost approach in studying the stock dividend puzzle and
rights issues puzzle. It finds that the extent of political interference, managerial
entrenchment and institutional control affect corporate financing choices and dividend
distribution decisions.
Proxies for agency/political cost: the portion of shares hold by managers and board
members; the portion of shares hold by top ten shareholders; the portion of shares
retained by state; the welfare expense ratio.

London Business School.

It was found that firms under the control of the government shareholders are valued
lower than the comparable firms under the control of a non-government shareholder, but
the continuous relationship between state shareholding and corporate value is non-
monotonic.
Corporate value is lower with a larger stake of government ownership when the
government is a small shareholder, but it increases with increased state shareholding
when the government is a large shareholder. This paper interprets it with the grabbing
and helping hands of the government shareholder.

Zhang, W.Y., 2000, China’s SOE Reform: a Corporate Governance Perspective,
Working Paper, Peking University.

Good corporate governance is designed to solve two basic problems within firm:
incentive problem and management selection problem.
China has solved the short-term incentive problem but not the long-term incentive
problem and management selection problem.
What’s an efficient corporate governance system? Firstly the residual claim and the
control right should be matched as much as possible. Secondly managerial
compensation should be more closely linked to performance of the firm, rather than
fixed by contract. Thirdly the authority of management selection should be assigned to
capitalists. Fourthly the optimal corporate governance should be characterized by a
state-contingent control structure. Fifthly in order to mitigate the free-rider problem of
investors, concentration of ownership with large investors is preferred.

Privatization and Transition

Using a data set for 162 largest Hungarian firms during the period of 1994-1999 this paper explores the determinants of equity shares held by foreign investors and by Hungarian institutional investors. We find evidence of a post-privatization evolution towards more homogeneous equity structures, where dominant categories of owners aim at achieving controlling stakes. Here, the foreign investors and Hungarian institutional investors play the major role. In addition, focusing on firm level characteristics we find that the exporting firms attract foreign owners, who acquire controlling equity stakes. Similarly, the firm size measurements are positively associated with the presence of foreign investors. However, they negatively associated with 100% foreign ownership, since the marginal costs of acquiring additional equity are growing with the size of the assets. We interpret the results in light of the existing theory. In particular, following Demsetz and Lehn (1985) and Demsetz and Villalonga (2001) we argue that equity should not be treated as an exogenous variable. As for specific determinants of equity levels, we focus on informational asymmetries and (unobserved) ownership specific characteristics of foreign investors and Hungarian investors.

This paper can give some hints on my current research: the determinants of ownership structure for Chinese listed companies.


First, mass privatization is likely to lead to massive self-dealing by managers and controlling shareholders unless (implausibly in the initial transition from central planning to markets) a country has a good infrastructure for controlling self-dealing.

Second, profit incentives to restructure privatized businesses and create new ones can be swamped by the burden on business imposed by a combination of (among other things) a punitive tax system, official corruption, organized crime, and an unfriendly bureaucracy.

Third, while self-dealing will still occur (through perhaps to a lesser extent) if state enterprises aren’t privatized, since self-dealing accompanies privatization, it politically discredits privatization as a reform strategy and can undercut longer-term reforms.

A principal lesson: developing the institutions to control self-dealing is central to successful privatization of large firms.

Self-dealing: transactions between insiders and the company, in which the insiders profit at the company’s expense.


Based on the experience of China, a number of researchers have argued that federalism could play a central role in development. We agree, but with an important caveat. We believe the experience of Russia indicates that another ingredient is crucial, namely political centralization. For federalism to function and to endure, it must come with political centralization.
Boubakri, N. and J-C Cosset, 1998, the Financial and Operating Performance of Newly Privatized Firms: Evidence from Developing Countries, Journal of Finance, 1081-1110

We use accounting performance measures adjusted for market effects in addition to unadjusted accounting performance measures. Both unadjusted and market-adjusted results show significant increases in profitability, operating efficiency, capital investment spending, output, employment level, and dividends.

First, we consider a large set of newly privatized firms (79) headquartered in 21 developing countries that experience full or partial privatization during the period from 1980 to 1992.

Second, in addition to companies privatized through public share issues considered by MNR, our sample also includes companies privatized through direct sales to one or several investors, and those privatized with a combination of both techniques.

Third, some of the differences between pre-privatization and post-privatization performance could be due to economy-wide factors. We use both raw and market-adjusted accounting performance measures to control the factors.

We estimate the market index for each year as the median ratio for all financial or nonfinancial firms in the country on the Disclosure databases (excluding all privatized firms, whether in our sample or not). Hence, the market-adjusted accounting performance measure of a firm is the difference between its accounting performance measures and the market median accounting performance measure of its country.

Only non-parametric analysis is provided in this article!


We document changes in the performance of over 6000 privatized and state-owned manufacturing enterprises in seven Eastern European countries over the initial transition period. We find that privatization is associated with significant increases in sales revenues and labor productivity, and, to a lesser extent, with fewer job losses. The positive effect of privatization is stronger in economic magnitude and statistical significance as the time elapsed since privatization increases. Enterprises privatized for less than 2 years have labor productivity growth similar to that of state-owned enterprises. In contrast, enterprises privatized for 3 or more years significantly outperform state-owned enterprises. The results are robust to the use of alternative econometric specifications (fixed effects, cluster effects, and random effects), and survive in six of the seven individual country samples (the exceptions being Hungary for sales growth and Romania for labor productivity growth).


A positive theory of the firm is incomplete unless it incorporates and explains the role of legal variables.

More importantly, standard economic models of financial contracting within firms do not fit the privatization context.
“Law on the books” is often different from, and less important than, the “law in practice”. What really count are not the content of the substantive law, but the adequacy of the enforcement mechanisms that underlie it. Thus only consider the law content difference is not sufficient (common vs code), we should also consider the enforcement of the law. The enforcement differences between UK and US are probably as great as the US and France.


The quantitative variables are to be trusted more (even with the mis-reporting and accounting difficulties that are rife in transition countries). They measure directly the prime output of enterprise restructuring, economic performance. On the other hand, there is also the view that quantitative performance might suffer when an enterprise is investing in large-scale reorganization and that the results of this process might be observed earliest in qualitative variables. Typical cases of selection bias occur when either the level of ownership or the use of managerial incentives is systematically related to some unobserved enterprise characteristic that also affects performance measures. These problems have been thoroughly recognized in the literature, but solutions are not always easy to obtain. Use meta-analysis to deal with various papers with different research quality.

In early transition debates, there was agreement on the goal of an economy dominated by private ownership, but conflicting views on how best to attain this, through fast privatization (Sachs 1992, Boycko, Shleifer, and Vishny 1995) or through stimulation of a nascent private sector (Kornai 1990, Murrell 1992, 1995). The relative emphasis on the differing strategies waxed and waned with events. With deep crisis in Eastern Europe in the early 1990’s, fast privatization gained emphasis. However, after the recovery of Poland, a relatively slow privatizer, that emphasis declined (Pinto et al. 1993, Aghion, Blanchard, and Burgess 1994, and Brada 1996). But Poland is only one of many transition countries, an outlier at that. Now there are fast privatizers performing well (Estonia) and fast privatizers performing badly (Russia), with similar variation across slow privatizers (Poland versus Romania), giving sustenance for a variety of opinions about the results of privatization (Pohl et al. 1997, Havrylyshyn and McGettigan 2000, Stiglitz 1999, Black et al. 2000). To referee this debate, it is necessary to turn to the microeconomic empirical literature.

From table 1, the first conclusion is that privatization has economically significant effects. A second conclusion is that these effects are far from uniform. Privatization done in the right way, or under the right circumstances, can have positive effects, but privatization can also be hugely detrimental. This large variation in results suggests that an overall judgment on the effects of privatization can only be reached by employing methods that aggregate the results of the many papers under consideration.

Why do many American city governments directly provide public transportation, water and even power and light? Government ownership is almost invariably linked with waste and inefficiency. Yet, government provision in these areas remains common.

1. Natural monopolies create a case for government ownership, or at least significant regulation. But it is not obvious that most public services are really natural monopolies.

2. More recently, Hart, Shleifer and Vishny (1997) argue that the advantage of government ownership is that it limits perverse incentives. The weaker incentives of government operators mean that there is less incentive to cut costs and therefore cut quality. For example, public provision of water may be explained by the huge problems associated with unclean water. However, this theory works much less well in explaining public transportation and electricity.

3. A less benign view of public ownership is that it is an example of empire-building politicians obtaining power at the expense of public welfare.

4. The history of American’s cities provides a fourth theory of public ownership that is complementary to the other three: public ownership may reduce bribery and corruption. This is the point of this paper.


Since control rights have not been transferred to private owners it is widely contended that partial privatization process has had little impact on firm behavior. We find however that even the sale of minority stakes has a positive impact on firm performance and productivity. As the government remains the controlling owner in these firms, we infer that the improvement is attributable to the role of the stock market in monitoring managerial performance rather than to a change in owners’ objectives.

Ownership structure should not matter if complete contracts can be written and enforced (Coase 1960; Williamson 1985; and Grossman and Hart 1986). Public sector firms are generally argued to be less efficient than private sector firms because of low-powered managerial incentives. There are two non-mutually exclusive perspectives on the causes of poor incentives (Laffont and Tirole 1993). First, the political perspective argues that a government pursues multiple objectives and some of these objectives, unlike profit maximization, are hard to contract on.


Empirical studies almost invariably show privatized enterprises outperform state enterprises. Moreover, the literature identifies de novo(new) firms as being clearly the best performers, followed by outsider-dominated firms, while insider-dominated firms are the least efficient among those newly privatized.

Four key changes needed for the transitions:

1. forcing a move from seller’ to a buyers’ market (via price liberalization)
2. enforcing a hard budget constraint (via privatization and elimination of various government support mechanisms)
3. reallocation of resources from old to new activities (via closures and bankruptcies combined with establishment of new enterprises)
4. restructuring within surviving firms (via labor rationalization, product line change, and new investment)


“rule of law”: well defined and enforced property rights, broad access to those rights, and predictable rules for resolving property rights disputes
“no rule of law”: a legal regime that does not protect investors’ returns from arbitrary confiscation, does not protect minority shareholders’ rights from tunneling, and does not enforce contract rights.

Big Bang preassumption: once stripping has occurred, the strippers will say “enough” and by supporting the rule of law seek public protection of their gains. However, that did not happen in Russia and some other post-communist countries.
The reason is that uncertainty about the legal regime can lead to asset stripping, and stripping can give agents an interest in prolonging the absence of the rule of law.

Effective privatization requires enforceable investor protection.
Three important Coasian positions:
1. law does not matter (strongest position). If this is true, we should expect to see no significant correlation between legal rules and economic outcomes around the world. The evidence decisively rejects this hypothesis. Legal origin plays an important role. Pay attention to the measures of the extent of protection of minority.
2. the second Coasian view is that even if legal rules matter and are weak in some countries, other governmental or private institutions should adapt to protect investors. The empirical evidence is mixed for this position.
3. all of the work supports the third Coasian view that international contracts can get around some of the deficiencies of domestic investor protection.


The paper highlights the conditions for successful privatization: strong political commitment combined with wider public understanding and support for the process; creation of competitive markets – removal of entry and exit barriers, financial sector reforms that create commercially oriented banking systems, effective regulatory framework – to reinforce the benefits of private ownership; transparency in the privatization process; and measures to mitigate the social and environmental impact.


We study a sample of U.S. corporations in which the federal government held 35–100 percent of the outstanding common stock for between 1 and 23 years during and following World War II. We find that although the firms experienced abnormally high
turnover among corporate board members, the tenure of senior management was relatively stable. Moreover, the performance of the government-owned companies was not significantly different than that of private-sector firms in the same industry. Hence, the interim government custodianship of the firms in our case does not have the effects normally attributed to government ownership.


Privatization is followed by a 24-percentage-point increase in the mean ratio of operating income to sales as firms catch up with industry-matched control groups. Criticisms of privatization have centered on the possibility that the observed higher profitability of privatized companies has come at the expense of the rest of society through the exploitation of market power (social view).

In contrast, more recent economic literature has taken a much less flattering view of SOEs and a more favorable view of privatization. This literature emphasizes agency conflicts as the source of the inefficiency of SOEs (agency view). There are two complementary strands of the literature according to whether the critical agency conflict is with the manager or with the politician. Vickers and Yarrow (1988) argue that SOE managers may lack high-powered incentives or proper monitoring (managerial view). In turn, Shleifer and Vishny (1994) stress that political interference in the firm results in excessive employment, poor choices of product and location, lack of investments, and ill-defined incentives for managers (political view). In sum, the theoretical literature points to some benefits of privatization – especially higher profitability – but also recognizes its potential costs.


A very good survey about privatization!!!

World Bank’s definition of State-Owned Enterprises (SOEs): government-owned or government-controlled economic entities that generate the bulk of their revenues from selling goods and services.

By the time of the Industrial Revolution in the western industrialized societies and their colonies, the private sector was the most important producer of commercial goods and was also important in providing public goods and services.

The Depression, World War II, and the final breakup of colonial empires pushed government into a more active role, including ownership of production and provision of all types of goods and services, in much of the world.

The theoretical arguments for the advantages of private ownership of the means of production are based on a fundamental theorem of welfare economics: under strong assumptions, a competitive equilibrium is Pareto optimal.

1. the impact of privatization depends on the degree of market failure.
2. contracting ability impacts the efficiency of state and private ownership
3. ownership structure affects the ease with which government can intervene in firm operations.
4. a major source of inefficiency in public firms stems from less-prosperous firms being allowed to rely on the government for funding, leading to “soft” budget constraints.

5. privatization can impact efficiency through its effect on government fiscal conditions.

6. at a macroeconomic level, privatization can help develop product and security markets and institutions.

Many of the theoretical arguments for privatization are based on the premise that the harmful effects of state intervention have a greater impact under state ownership than under state regulation, not that the harmful effects can be eliminated through privatization.

There are two methodological difficulties that are especially pronounced in attempts to isolate the impact of ownership on performance. First, in comparing SOEs to privately owned firms, it is difficult, if not impossible, to determine the appropriate set of comparison firms or benchmarks, especially in developing economies with limited private sectors. Second, there are generally fundamental reasons why certain firms are government-owned and others are privately owned, including the degree of perceived market failure within the particular industry. These factors that determine whether the firm is publicly or privately owned likely also have significant effects on performance. Thus, it is difficult to evaluate the effects of government ownership in cases where the ownership structure is itself endogenous to the system that includes both political and performance goals.

Potentially the best way to improve performance in SOEs is the use of incentive contracts for management and workers to improve the performance of the firms. China is the best example using the incentive contracts with minimal privatization. The evidence from China suggests that enterprise restructuring, concentrating on improving the allocation of property rights and incentives, can yield benefits even without privatization.

Methods of privatization:

1. privatization through restitution
2. privatization through sale of state property (direct sales or share issue privatizations SIPs)
3. mass or voucher privatization
4. privatization from below

Some steps such a government must take in developing a divestment program:

1. setting up a structure for privatization
2. providing adequate performance records for SOEs being sold
3. developing any necessary new regulatory structures
4. determining the appropriate post-sale relationship between the firm and the government

Early advice from the World Bank was that governments should restructure SOEs prior to divestment, since governments are better able than private owners to cushion the financial blow to any displaced workers by using unemployment or pension payments. But small and medium-sized SOEs should be sold as is at the best price possible, as quickly as possible.

Drawbacks for empirical studies comparing pre- versus post-privatization performance for SIPs:
1. selection bias probably causes the greatest concern, since by definition a sample of SIPs will be biased towards the very largest companies sold during any nation’s privatization program.

2. since governments have a natural tendency to privatize the “easiest” firms first, those SOEs sold via share offerings may well be among the healthiest state-owned firms.

3. it will examine only simple, universally available accounting variables.

4. ignore changes in the macroeconomy or industry.

5. the studies cannot account for the impact on privatized firms of any regulatory or market-opening initiatives.

Some thoughts on the current privatization literature:

1. the privatization programs of the last 20 years have significantly reduced the role of state-owned enterprises in the economic life of most countries.

2. research now supports the proposition that privately owned firms are more efficient and more profitable than otherwise-comparable state-owned firms.

3. governments use three basic techniques to privatize their SOEs, share issue privatizations (SIPs), asset sales, and voucher or mass privatizations.

4. governments attempt to craft the offering terms of SIPs to balance competing economic, political, and financial objectives.

5. we know that privatization “works”, in the sense that divested firms almost always become more efficient, more profitable, increase their capital investment spending, and become financially healthier.

6. investors who purchase initial SIP shares at the offering price and then sell those shares at the first post-issue trading price earn significantly positive excess returns.

7. though it is difficult to pinpoint causality, it appears that countries that have launched large-scale SIP programs have experienced rapid growth in their national stock market capitalization and trading volume.

8. emerging evidence suggests that adopting a large-scale SIP program is often a major spur to modernizing a nation’s corporate governance system.

Murphy, K., A. Shleifer, and R. Vishny, 1992, The Transition to a Market Economy: Pitfalls of Partial Reform, Quarterly Journal of Economics 107, 889-906

The most natural implication of the analysis in this paper is that the price reform should take the form of a big bang, with all prices being freed at once. However the evidence of China after 1992 (double tracking system of price liberation) embarrasses their argument.


Worldwide, evidence is increasing that privatization improves firm performance. But in some institutionally-weak transition economies, ownership change has so far not delivered on its promise. In an institutional vacuum privatization can and has led to stagnation and decapitalization rather than to better financial results and increased efficiency.
In these instances, the speedy, massive, insider-oriented forms of privatization have generally not, so far, led to the restructuring required to allow firms to survive and thrive in competitive market operations.


Investor confidence is a necessary condition for the development of emerging markets. Investors recognize that since market-oriented reform policies may be reversed or hindered, they face the risk of ex post policy changes with redistributive impact on investment returns. We argue that a sustained privatization or liberalization program represents a major test of political commitment, and contributes to reduced policy risk. The evidence from our panel study suggests that progress in privatization gradually leads to increased confidence. Moreover, increased confidence has a strong effect on local market development and is a significant determinant of excess returns. We conclude that, just as financial liberalization, the resolution of policy risk resulting from successful privatization has been an important source for the broadening and deepening of emerging stock markets.


Using data on 376 medium and large enterprises, it finds that ownership concentration is positively associated with enterprise performance in Ukraine. The paper also finds that concentration of ownership by foreign companies and banks is associated with better performance than ownership concentrated by the domestic owners. Ownership by Ukrainian investment funds and holding companies does not have a positive effect on performance. In contrast to predictions by many observers of early transition, privatization methods had a lasting effect on ownership structure in Ukraine. This paper is motivated by the debate on the effects of privatization. For the market economies, there is strong evidence of the positive effects of privatization on enterprise restructuring and performance (see for example La Prota and Lopez-de-Silanes (1999); Megginson, Nash, and van Randenborgh (1994); Vining and Boardman (1992)). However, the empirical evidence in the literature on privatization in transition economies is less conclusive. Consider some examples of firm-level studies. For the Czech Republic, Hungary and Poland, Frydman, Hessel, Gray and Rapaczynski (1999) find that while privatization has no effect on profit margin in the short run, it does lead to improvement of revenue performance. For the Slovak Republic, Djankov and Pohl (1998) find that privatization is associated with greater productivity and profitability as well as a number of other indicators of restructuring. For a group of Central European countries, Pohl, Anderson, Claessens and Djankov (1997) find that privatization had a positive and significant impact on enterprise productivity. For Russia, Earle and Estrin (1997) find no significant differences between performance of state- and privately-owned enterprises. For small stores in Russia, Barberis, Boyko, Shleifer and Tsukanova (1996) find significant improvement in restructuring after privatization. For six CIS
countries, Djankov (1999) finds that state ownership is associated with less restructuring, but the result is not statistically significant. For Mongolia, Anderson, Lee and Murrell (2000) find that state owned enterprises perform better than privatized firms do.


After a decade of transition, there is still no consensus among economists as to what the most appropriate recipe is to place the transition countries onto a path of sustainable economies growth. As a step towards achieving a better reform paradigm for transition, we first need to have a systematic understanding of the various paths the transition countries have taken over the transition period. Developing a set of economic indicators to provide such an understanding is the central task of this paper.

The paper begins by presenting a framework for evaluating transition. The framework identifies categories of influences or “determinants of transition” and how they interact to produce short-term impacts, intermediate outcomes, and long-term socio-economic performance. Among the determinants are the so-called “initial conditions” of transition. The paper then uses the initial conditions to create a country cluster typology, which is used throughout the rest of the paper. Focusing on the “cluster” as the central unit of analysis allows us to control specifically for commonalities in the initial conditions, and to evaluate the effectiveness of the alternative policies that countries have taken within the cluster.

Besides the initial conditions, there are six additional determinants of transition that together explain the transition paths taken over the decade and for which we develop indicators. These include policies, institutions, government objectives, donor assistance, economic fundamentals, and exogenous “shocks”.

The first set of indicators measures depth of privatization. This recognizes that “true” privatization is more than purely a change in title (ownership). It must include considerations of “agency” issues (ability of shareholders to monitor and exert effective control over management), the “hardness” of the firm’s budget constraint, and the nature of the firm’s objective function.

The second set of indicators measures progress-in-transition. The aggregate indicator of this set is a comprehensive measure of the progress in reform performance.

The third set of indicators focuses on country economic performance. They examine performance from several levels, including micro, mezzo, and macro dimensions.

In summary, by highlighting the differences between and within clusters of transition countries according to these constructed measures, the paper helps both to identify country progress in reform made to date as well as areas for targeting additional donor assistance.


In industrialized nations, state ownership was viewed as the remedy for market failures such as externalities and monopoly, which at that time were considered widespread. In developing nations the state-owned enterprises (SOEs) facilitated “economic independence” and planned development. Alchian (1965) made a theoretical prediction that SOEs will be inherently less efficient than private firms.

Three schools about the private vs. public ownership

1. product market competition, not property rights (public or private ownership), is the primary determinant of enterprise performance.
2. property rights or ownership is the primary determinant
3. regardless of government’s goals, private firms will be more successful than SOEs in addressing problems of corporate governance.

The Role of Competition

If the introduction of competition is sufficient to equalize public and private performance, then there is little need to consider the nature of ownership. Competition will introduce two effects, i.e., incentive and information. China’s reform of SOEs is a good example. But it is not proper to claim the competition is the only factor. Two points emerges. One is that political interference in SOEs will overwhelm competition effects. In China, it will not be the case. We have gotten some empirical evidence for the governmental grabbing and helping hands. The other is that the inherent difficulties in SOE management negate the competition effects. The corporate governance problem is really a big problem for the SOEs, just like in China. But in a transition economy without effective investor protection, the government may control the insider control problem that is tremendous serious in Chinese listed companies. I am trying to provide some empirical evidence for this and give some suggestions.

Government Behavior and SOEs

Welfare government: whether the social welfare will make up the loss of efficiency. No conclusion.

Self-Interested Government: the literature yields two possible frameworks in which political pressures affect SOE operations. The first assumes that there is a hierarchy of control from voters to politicians to firms, and that this hierarchy faces principal/agent problems at multiple levels (Alchian 1965, Vickers and Yarrow 1989). A second theory abandons the idea of such a hierarchy, treating politicians, firm managers, and related interest groups as essential equal actor who bargain and swap favors.

Five conditions under which politicians will use SOE operations to meet political goals:

1. the degree of such behavior depends on the degree of imperfection in the political markets.
2. a second influence on political intervention in SOE is the ease with which budgets and regulations can be arbitrarily manipulated.
3. a third factor influencing the degree of political intervention is the nature of the institutional relationship between the government and the enterprises.
4. a fourth determinate of political intervention is the prevalence of corruption.
5. finally, as is made clear by historical evidence on the timing of reforms, the degree of political intervention depends on the opportunity cost of SOE inefficiency.

Corporate Governance

There are important differences between public and private governance, and that these differences impact performance.

Overall, the literature just reviewed suggests that competition cannot substitute for private ownership; that politicians in inefficient political markets may distort SOE operations for their own interests; and that even if they don’t, the task of motivating managers is even more daunting in the public sector than in the private sector.

It is a further question whether a privatized firm, a firm which has been moved from public to private ownership, will perform in the same way as firms that have always been private.


Private ownership should generally be preferred to public ownership when the incentives to innovate and to contain costs must be strong. In essence, this is the case for capitalism over socialism, explaining the “dynamic vitality” of free enterprise. The great economists of the 1930s and 1940s failed to see the dangers of socialism in part because they focused on the role of prices under socialism and capitalism and ignored the enormous importance of ownership as the source of capitalist incentives to innovate. Moreover, many of the concerns that private firms fail to address “social goals” can be addressed through government contracting and regulation without resort to government ownership. The case for private provision only becomes stronger when competition between suppliers, reputational mechanisms, and the possibility of provision by private not-for-profit firms, as well as political patronage and corruption, are brought into play. The weak incentives of government employees with respect to both cost reduction and quality innovation underlie the basic case for the superiority of private ownership, a case that has been confirmed by the variety of empirical studies and general observation.

There is, however, a class of cases where the argument against government ownership is not as straightforward. Ironically, the government sometimes becomes the efficient producer precisely because its employees are not motivated to find ways of holding costs down.


The protection of property rights is more and more recognized as a core issue for improvement of the investment climate in Russia. In many post-privatization Russian enterprises, shareholder rights have been severely disregarded by self-dealing transactions of the management, share dilution, exclusion of outside shareholders from
the Board of Directors and even from shareholder meetings. A more recent development is the abuse of the bankruptcy procedure for the arbitrary redistribution of property. This article reviews the results of the privatization process and concentrates then on the current structure of ownership and control in the Russian industry and on corporate governance mechanisms in the enterprises. It reviews the legal foundations of corporate governance and gives a detailed view of the state and the institutions of law enforcement. Special attention is paid to the connection between corporate governance and restructuring enterprises and improved performance.

Research Methods


In the choice of statistical test, the nonparametric Wilcoxon test statistics are uniformly more powerful than parametric t-statistics, regardless of the operating performance measure employed. Concerning the choice of an expectation model, test statistics using the change in a firms’ operating performance relative to an appropriate benchmark consistently yield more powerful test statistics than do those based on the level of a firm’s operating performance relative to the same benchmark. In random samples or samples of large firms, all expectation models based on changes in a firm’s performance relative to an industry benchmark are well specified and powerful. Test statistics are well specified only when sample firms are matched to control firms with similar pre-event performance. Matching sample firms to control firms on industry and performance is generally much more important than matching on industry alone, or on industry and size.


The paper evaluates a new nonparametric rank test for abnormal security-price performance in event studies. Simulations with daily security-return data show that the rank test is better specified under the null hypothesis and more powerful under the alternative hypothesis than the parametric t-test. Unlike previous nonparametric tests, this rank test does not require symmetry in cross-sectional excess returns distributions for correct specification.


Multiple-performance-measure agency models predict that optimal contracts should place greater reliance on performance measures that are more precise and more sensitive. While this prediction has been extensively studied in the context of executive
compensation and general corporate governance practices, few studies to date have asked whether boards’ decisions about the continued employment of a CEO conform to this theory. Using proxies for the usefulness of accounting-based performance measures developed by Ball, Kothari and Robin (2000) and Bushman, Chen, Engel and Smith (2000), we document that CEO turnover decisions appear to be more sensitive to accounting information when these accounting-based measures are more useful. We also present some evidence suggesting that turnover is less sensitive to market-based performance measures when accounting-based measures are more useful, and that turnover is less sensitive to market-based measures when the market-based measures are more variable. (2001 version)

Multiple-performance-measure agency models predict that optimal contracts should place greater reliance on performance measures that are relatively more precise and more sensitive to the agent's effort. While this prediction has been extensively studied in the context of executive compensation and general corporate governance practices, few studies to date have asked how boards' decisions about the continued employment of a CEO are related to properties of firm-level performance measures. Using proxies for the signal and noise in accounting-based performance measures developed in the compensation and governance literatures, we document that accounting information appears to receive greater weight in CEO turnover decisions when accounting-based measures are relatively more precise and more sensitive. We also present evidence suggesting that market-based measures of performance receive less weight in turnover decisions when accounting-based measures are relatively more precise and more sensitive. (2002 version)


Using measurement error-consistent generalized method of moments estimators, we find that most of the stylized facts produced by investment-q cash flow regressions are artifacts of measurement error.


This paper assesses the measurement quality of different measures of Q. we find most proxies for Q are poor: although careful algorithms for calculating Q can improve measurement quality, the improved proxies nevertheless still contain a great deal of measurement error.


The primary advantage of survival analysis, relative to regression and qualitative response models such as logistic regression and probit, lies in the manner in which it handles censored observations and time-varying covariates.

Censoring occurs when knowledge of the time that the individual spends in the origin state is incomplete and the exact duration of time (‘lifetime’) is known for only a portion of a sample. Survival analysis models use methods of estimation that
incorporate information from censored and uncensored observations to provide consistent parameter estimates. In contrast, statistical methods such as regression analysis cannot incorporate information from censored observations. The ability of event history analysis to handle right censored observations is its major advantage over traditional statistical methods.

The major contribution of survival analysis methods in this area is that the estimation procedures consider changes in the value of covariates over time. Cross-sectional studies only examine the level of a variable at a given point in time. Cross-sectional analysis uses a ‘snapshot’ methodology because it only views the individual at a ‘snapshot’ in time. Survival analysis, relying on longitudinal data rather than cross-sectional data, incorporates changes in the covariates over time in the estimation process.


We document that two approaches yield well-specified test statistics in random samples. The first uses a traditional event study framework and buy-and-hold abnormal returns calculated using carefully constructed reference portfolios. The second approach is based on calculation of mean monthly abnormal returns using calendar-time portfolios and a time-series t-statistic. Though both approaches perform well in random samples, misspecification in nonrandom samples is pervasive. Thus, analysis of long-run abnormal returns is treacherous.


Clinical research commonly refers to empirical work in which a relatively small number of events are examined intensively.

**Accounting Related**


We study a large sample of U.K. private and public company earnings reports. The predominance of private companies makes their financial reporting practices interesting in their own right, but a feature of the UK institutional setting makes them especially interesting: private and public companies face the same regulations on auditing, accounting standards and tax laws. We hypothesize that private-company financial reporting nevertheless is lower in quality because that is what the market demands. Using time-series measures, we demonstrate that earnings quality (measured as timely loss incorporation) indeed is lower in private companies, despite them facing the same regulations. This result is not affected by size and industry differences, and holds for firms with Big-5 auditors. The result assists in understanding the economic role of accounting standards, an issue that is surprisingly neglected in the literature.


In this paper we examine the accounting method choice of a sample of non-U.S. firms that purport to prepare their financial statements in accordance with US GAAP. We assess compliance using data on major accounting method choices provided by Worldscope. We compare the level of compliance for a sample of foreign firms voluntarily adopting US GAAP to that of two matched samples of foreign and U.S. firms. These ‘control’ samples are obtained based on matches of country (for the foreign sample), industry, calendar year, and market value. We find that compliance levels of sample firms are greater than that of their foreign matched counterparts, but less than that of their U.S. counterparts. We also examine the time-series of accounting compliance for our sample firms, noting a significant increase in compliance in the year US GAAP is adopted. However, the level of compliance remains well below 100%. Subsequent analyses for a subsample of the firms that have actively traded ADRs document foreign firms adopting US GAAP reporting reconciling items on their form 20-Fs. This indicates that, at least for this subsample, the firms are aware that their accounting methods choices are not compliant with US GAAP. Finally, we examine cross-sectional determinants of the level of compliance, and find some evidence that big 5 auditors and clean audit opinions are positively associated with the level of US GAAP compliance.


The governance role of financial accounting information is defined as the use of externally reported financial accounting information in control mechanisms that promote the efficient governance of corporations.

(I) Accounting information and managerial incentive contracts

Overall it documents that financial accounting measures, especially measures of profitability, are extensively used in executive compensation contracts.

External mechanisms: market for corporate control, product market competition, external labor market pressure, debt contracts, outside owners, and security law.

Internal mechanisms: board of directors, internal labor pressure, compensation contracts, concentrated ownership, corporate bylaw and charters.

Although the incentive coefficient on accounting earnings before special items remains basically constant over the entire time period (1970-1995), there is a significant average increase in the coefficient on stock returns in compensation models which include both stock returns and earnings, a significant decline in the ratio of the coefficient on earnings to the coefficient on stock returns, and a significant increase in the incremental R2 of stock returns over and above earnings without a corresponding increase in the incremental R2 of earnings over and above stock returns. These results imply that
accounting information has progressively become relatively less important in determining the cash compensation of CEOs at large US public companies. Not only have earnings apparently become relatively less important in determining cash compensation, the contribution of cash compensation to the overall intensity of top executive incentives appears to have diminished drastically in recent years.

(II) The role of accounting information in specific governance mechanisms

(III) Future research into financial accounting information and economic performance

1. channels through which financial accounting information affects economic performance (Project Identification; Governance Role; Reducing Adverse Selection and Liquidity Risk)


The role of “gatekeepers” as reputational intermediaries who can be more easily deterred than the principals they serve has been developed in theory, but less often examined in practice. Initially, this article seeks to define the conditions under which gatekeeper liability is likely to work – and, correspondingly, the conditions under which it is more likely to fail. Then, after reviewing the recent empirical literature on earnings management, it concludes that the independent auditor does not today satisfy the conditions under which gatekeeper liability should produce high law compliance. A variety of explanations – poor observability, implicit collusion, and high agency costs within the gatekeeper – provide overlapping explanations for gatekeeper failure. What remedy should work best to minimize such failures? As a more appropriate and supplementary remedy to reliance on class action litigation, this article recommends fundamental reform of the governance of the accounting profession. In particular, it contrasts the structure of self-regulation within the broker-dealer industry with the absence of similar self-discipline in the accounting profession. While such reform may be unlikely, its absence strongly implies that earnings management is likely to remain a pervasive phenomenon.


Essentially, it predicts that individual markets will specialize, either (1) becoming more transparent and imposing higher listing standards to foster dispersed ownership and attract portfolio investors or (2) becoming lower cost, non-transparent exchanges that service firms with concentrated ownership in which the private benefits of control will remain high. Firms will choose between these listing options depending on their individual strategies, but the persistence of such a dual equilibrium reflects the likelihood that both firms with concentrated and dispersed ownership are also likely to persist, side by side, in many regions of the world. Predicting that consolidation will occur is only a little more risky than predicting that the sun will rise tomorrow. More interesting and uncertain questions involve, however,
the likely mechanisms of consolidation and the factors that will determine which markets survive.


The major findings are that error and bias in balance sheet accrual estimates are pervasive and economically significant across a broad cross section of firms. Most importantly, the bias contaminates computations of discretionary accruals, and can lead to erroneously concluding that earnings management exists, especially in studies where the partitioning event is correlated with either mergers and acquisitions or discontinued operations. Other findings show that when discretionary and non-discretionary accruals are used as regressors in a second stage regression, the resulting coefficient bias is likely to affect statistical inferences about the equality of parameter estimates. Finally we demonstrate that tests of market mispricing of accruals calculated under the balance sheet approach tend to understate the true extent of the mispricing by roughly 35% due to misclassification of extreme accruals firms.

The presumed articulation between changes in working capital balance sheet accounts and accruals on the income statement breaks down when nonoperating events such as reclassifications, acquisitions, divestitures, accounting changes and foreign currency translations occur.

Balance sheet method (indirect method)

\[ TACC = \Delta CA - \Delta CL - \Delta Cash + \Delta STDEBT - DEPTN \]

CA (Current Assets) CL (Current Liabilities) STDEBT (Current maturity of long-term debt and other short-term debt included in current liabilities) DEPTN (Depreciation and amortization expense)

Cash Flow Statement Method (Direct method)

\[ TACC = EBXI - CFO \]

EBXI (Net income before extraordinary items and discontinued operations)


DeAngelo, H., L. DeAngelo, and D. Skinner, 1994, Accounting choice in troubled companies, *Journal of Accounting and Economics*


We find no significant association between non-audit service fees and impaired auditor independence, where auditor independence is surrogated by auditors’ propensity to issue going concern audit opinions.

A major concern is that pro forma earnings disclosures affect less sophisticated and more sophisticated investors differently. This paper presents an experiment that examines the effect of pro forma earnings disclosures on the judgments of nonprofessional investors and analysts. The results indicate that nonprofessional investors who see an earnings announcement that contains both pro forma and GAAP disclosures assess a higher stock price than do nonprofessionals who see an earnings announcement that contains only GAAP disclosures, whereas analysts’ stock price judgments are not affected.


The Enron case challenges some of the core beliefs and practices that have underpinned various positions in the debates about corporate law and governance, including mergers and acquisitions, since the 1980s.

First, it provides another set of reasons to question the strength of the efficient market hypothesis, here, the company’s dizzyingly high stock price despite transparently irrational reliance on its auditors’ compromised certification.

Second, it undermines faith in the corporate governance mechanism – the monitoring board – that has been offered as a substitute for unfettered shareholder access to the market for corporate control. In particular, the board’s capacity to protect the integrity of financial disclosure has not kept pace with the increasing reliance on stock price performance in measuring and rewarding managerial performance.

Third, it suggests the existence of tradeoffs in the use of stock options in executive compensation because of the potential pathologies of the risk-preferring management team.

Fourth, it shows the poor fit between stock-based employee compensation and employee retirement planning. More generally, it raises questions about the shift in retirement planning towards defined contribution plans, which make employees risk bearers and financial planner, and away from defined benefit plans, which impose some of the risk and fiduciary planning obligations on firms.


Critics suggest FD has increased volatility by causing firms to (a) disclose less information, resulting in increased noise trading and pricing errors; or (b) substitute essentially continuous communication to the market through professional analysts with infrequent public announcements, precipitating large price swings. While we find generally higher volatility in the fourth quarter of 2000 (after FD’s implementation) than in the fourth quarter of 1999 (before FD’s implementation), additional analyses suggest Regulation FD is unlikely the cause. Specifically, we find an increase in neither the proportion of extreme return days nor in negative serial correlation in returns post-
FD. We find increased volatility around earnings pre-announcements, but we find an appropriately offsetting decrease in volatility around announcements of actual earnings, such that we find no significant in volatility attributable to all earnings information release days.


Comprehensive income is defined as” the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners”.


Empirists have documented pricing regularities pertaining to a variety of supplemental disclosures accompanying earnings announcements and forecasts over which firm managers have considerable discretion. An interesting question is whether these findings can be rationalized as a reflection of equilibrium behavior. In this paper, we model and entrepreneur’s acquisition and voluntary disclosure of precision information as a supplement to primary disclosure of an estimate of a tradable asset’s value. Our analysis shows that equilibrium disclosure can be characterized by four regions depending on the realization of the estimate and of its precision. For estimates above (below) the prior expectation of the asset value, the entrepreneur discloses (withholds) high (low) precision information. The basic idea is to enhance confidence in estimates that improve upon prior beliefs and diminish confidence in estimates that detract from prior beliefs.


Although pro forma firms appear to have traded at a market premium during our sample period, the magnitude of this premium is unrelated to characteristics of the pro forma disclosures themselves. We also find no evidence of a stock return premium for pro forma firms at the second quarter 2000 earnings announcement date. Collectively, the results suggest that investors are not misled by pro forma earnings disclosures.


This paper provides evidence that insiders possess, and trade upon, knowledge of specific and economically-significant forthcoming accounting disclosures as long as two years prior to the disclosure. Stock sales by insiders increase three to nine quarters prior to a break in a string of consecutive increases in quarterly earnings. Insider stock sales are greater for growth firms, before a longer period of declining earnings, and when the earnings decline at the break is greater. Consistent with avoiding an established
legal jeopardy, there is little abnormal selling in the two quarters immediately prior to the break.


This paper develops a model in which firm managers maximize their own compensation by using accruals to manage reported earnings. The results of the model suggest that the form of the managerial compensation function and managerial time preferences may have an important influence on the relationship between accruals and latent earnings.


Prior research shows that extant discretionary accrual models are misspecified when applied to firms with extreme performance. Nonetheless, use of such models in tests of earnings management and market efficiency is commonplace in the literature. We examine the specification and power of the test based on a performance-matched discretionary accrual measure and compare it with traditional discretionary accrual measures (e.g., Jones and Modified-Jones Models). Performance matching is on return on assets and industry and is designed to control for the effect of performance on measured discretionary accruals. The results suggest that our performance-matched discretionary accrual measure is a viable alternative to existing discretionary accrual models for use in earnings management research.


We provide descriptive evidence on two questions – (1) has accounting worldwide become more comparable over time and, (2) has the quality of accounting measures improved. Our results suggest that earnings multiples have become more comparable and that the convergence is driven by the valuation of accruals consistent with the effects of accounting changes, but that significant predictable difference remain. Based on corrections between cash flows and accruals, earnings management appears to have been mitigated. Book-to-market ratios also appear to have converged, but less than earnings. However, there is little systematic evidence of changes in value relevance.


We provide evidence on the characteristics of local-GAAP reported earnings for firms choosing to cross list in US markets relative to both a matched sample of foreign firms currently not choosing to cross list and a matched sample of US firms. Our evidence suggests that cross-listing firms differ from other firms in their local markets in terms of earnings performance, riskiness, the time series properties of earnings and accruals, and the degree of association between accounting data and share prices. Based on local-GAAP earnings, cross-listing firms appear to be better performing, less risky, and less aggressive in terms of earnings management. They also report accounting data that is
more strongly associated with share price (different stock markets, thus not comparable!!). On all dimensions, cross-listed firms appear to be more similar to US firms than do other firms in their local markets (that is because listed in US. If listed in London, should be more similar to UK firms, I guess). Further, the evidence suggests a shift in accounting quality around the time of cross listing, suggesting that firms may change in anticipation of the cross-listing decision. Our results have potential implications for regulators in providing evidence on the extent to which firms that choose to cross list under current requirements are likely to be representative of firms that might cross list in the absence of such requirements.


It finds that differences in the bid-ask spread (information asymmetry) and trading volume (liquidity) are economically and statistically insignificant between IAS and US GAAP.
To test the significance of differences between two groups, we use two-tailed t statistic for mean and Mann-Whitney-Wilcoxon Test for median.


This paper examines the relation between outside investor protection and earnings management across 31 countries. According to the “diversion hypothesis”, earnings management decreases in legal protection because strong investor protection leads to less asset diversion, which reduces insiders’ hiding incentives. The “penalty hypothesis” predicts that earnings management increases in legal protection because insiders’ incentives to hide asset diversion are stronger when outsiders can effectively penalize them. Our evidence supports the “diversion hypothesis” and suggests that the quality of financial reports increase in investor protection.


This paper estimates a model that supplies probabilities of the sustainability of earnings. The model aggregates information in the financial statements into a composite score that serves as a “red flag” about the sustainability of earnings. In out-of-sample prediction tests, the scoring reliably identifies non-sustainable earnings, and also explains cross-sectional differences in P/E ratios.


Security regulators and the business press have alleged that firms play an “earnings-guidance game” where analysts make optimistic forecasts at the start of the year and then ‘walk down’ their estimates to a level the firm can beat by the end of the year. We examine whether the ‘walk down’ to beatable targets is associated with managers’ incentives to sell stock after earnings announcements on the firm’s behalf (via new
equity issuance) or from their personal accounts (insider trades). Consistent with these hypotheses, we find that the ‘walk down’ to beatable targets is most pronounced in firms that are either net issuers of equity or in firms where managers are net sellers of stock after an earnings announcement. These findings provide new insights on how capital market incentives affect communications between managers and analysts.


“Our present object, however is to show, not the methods of practical bookkeeping, but merely the application of economic principles to such bookkeeping. The chief is to find the philosophical basis of accounting. Careful examination shows that accounting is at the bottom no a mere makeshift but a complete, consistent, and logical system. When thus conceived and understood it will be seen to be of importance, not alone to the accountant but also to the economist.”


Earnings Persistence: Accruals < Cash Flows for the discretionary of accruals. Overpriced stocks with higher portion of Accruals and Underpriced with higher portion of Cash Flows, which leads to predictable negative abnormal returns for the higher portion accruals portfolio.


This paper examines regulatory competition as a model for writing and implementing corporate financial standards. Under this model, two or more approved standard setting bodies are allowed to compete for the allegiance of the reporting entities. Each corporation can choose which of the two or more sets of competing standards it wishes to use in preparing its financial reports.


This study examines reporting practices of a sample of foreign listed and domestic-only listed companies from the United Kingdom, France, Germany, Japan and Australia to determine the extent to which companies are voluntarily using "international" standards. Two types of use of non-national standards in the accounts presented to the public are considered: adoption of "international" standards instead of national standards, and supplementary use where "international" standards are used in conjunction with national standards. "International" standards are defined as US GAAP or IAS. The study tests for a preference for either set of standards and considers the relationship of choice of regime with firm attributes.

The results show significant voluntary use of "international" standards in all five countries and among foreign listed and domestic-only listed companies. Companies using "international" standards are likely to be larger, have more foreign revenue and to be listed on one or more foreign stock exchanges. US GAAP is the predominant choice,
but IAS is used by many firms in Germany and some in Japan. Firms listed in the United States' regulated market (NYSE and NASDAQ) are more likely to choose US GAAP, but companies traded in the OTC market show considerable support for IAS. The study demonstrates for managers and regulators that there is considerable support for "international" standards, and that choice of IAS or US GAAP relates to specific firm characteristics which differ according to a firm's country of origin. Most use of "international" standards reflects individual countries' institutional frameworks, confirming the key role of national regulators and standard setters in assisting companies to achieve more comparable international reporting.


We find that the negative relation between accruals and future abnormal returns documented by Sloan (1996) is due mainly to inventory changes. We propose three explanations for this result, derived from the prior literature, but find evidence inconsistent with all three explanations. To assist future investigations in formulating additional explanations, we document several empirical regularities for extreme inventory change deciles. We speculate that demand shifts explain our results, and examine the feasibility of alternative reasons for the stock market’s apparent inability to recognize the impending profitability reversals. Our evidence is consistent with earnings management masking the implications of demand shifts.

Watts, R., 2002, Conservatism in Accounting, Working Paper

This paper examines conservatism in accounting. Conservatism is defined as the differential verifiability required for recognition of profits versus losses. In its extreme form the definition incorporates the traditional conservatism adage: "anticipate no profit, but anticipate all losses." Despite criticism, accounting conservatism appears not only to have survived for many centuries, but also to have increased in the last 30 years. The paper investigates the alternative explanations for conservatism: contracting; shareholder litigation; taxation and accounting regulation. In the process it provides new links in those explanations. The paper also summarizes the empirical evidence on the existence of conservatism and its consistency with the alternative explanations. The evidence is consistent with both the existence of conservatism and its increase in recent years. Contracting, shareholder litigation and tax explanations are consistent with these results. The evidence on the regulatory effect is weaker. Earnings management could also produce some of the evidence on conservatism, but is unlikely to be the major explanation.

The explanations and evidence have important implications for accounting regulators. First, the contracting explanation implies that conservatism will exist even in the absence of formal contractual use of financial statements. As long as income and net asset measures have meaning and are used in a way that affects management's welfare, conservatism is likely to be an optimal accounting principle. Absent differential verifiability, financial measures such as income and net assets are likely to be subject to sufficient manipulation to render them meaningless. Second, attempts to apply rules, such as mark-to-market without appropriate concern for verifiability, are likely to be detrimental to the FASB's survival and to the efficient allocation of capital. Third,
attempts to introduce unverifiable estimates of future cash flows into the financial statements are likely to have the same effects. The explanations and evidence also have important implications for accounting researchers. Not only do they provide fertile research areas, they also suggest the costs of accounting manipulation are an important consideration in financial reporting.


In three-quarters of fraud cases the chief executive officer is directly involved. Rather than starting with dishonesty, fraudulent financial reporting starts with a certain kind of environment … in which two things are present. The first is an aggressive target of financial performance. The second is a vivid realization that a failure to attain that target would be viewed as unforgivable. On other words, fraudulent financial reporting starts with pressure.

People can commit fraud in financial statements in one of five interrelated ways: fictitious revenues, fraudulent timing differences, improper or fraudulent disclosures or omissions, and fraudulent asset valuations.

Accounts receivable are a wonderful thing for a fraudster. They immediately increase profits. But they also do something else – they explain why my company does not have any cash; it’s all tied up in accounts receivable.

Revenue is actual or expected cash inflows (or the equivalent) that have occurred or will eventually occur as a result of the enterprise’s ongoing major or central operations.

Three common ways to create fictitious revenues: false journal entries; false sales to existing customers; false sales to fake customers.


This paper reports evidence that RFD has had its desired effect of reducing selective disclosure of information about future earnings to individual analysts without reducing the total amount of information disclosed.

Finance Related


A key assumption in the existing theoretical work on firm financial constraints is that these constraints translate entirely into higher costs of funds. This approach poses two types of difficulties to the research on that topic. First, it inadvertently narrows our understanding about financial constraints since, in practice, firms often face credit rationing. Second, it is a matter of debate whether such an approach can deliver unambiguous implications for corporate investment. The current paper develops a theory explaining the relationship between corporate investment and cash flow when firms face credit quantity constraints. We show that when firms' investments and use of external finance are endogenously related, investment-cash flow sensitivities increase as credit constraints are relaxed. From an empirical perspective, our analysis suggests a
consistent way of identifying the impact of financial constraints on corporate investment. Our predictions, however, are markedly different from those examined in most empirical studies in this area.


A growing body of work suggests that cross-country differences in legal origin help explain differences in financial development. This paper empirically assesses two theories of why legal origin influences financial development. First, the “political” channel stresses that (i) legal traditions differ in the priority they give to the rights of individual investors’ vis-à-vis the state and (ii) this has repercussions for the development of property rights and financial markets. Second, the “adaptability” channel holds that (i) legal traditions differ in their ability to adjust to changing commercial circumstances and (ii) legal systems that adapt quickly to minimize the gap between the contracting needs of the economy and the legal system’s capabilities will foster financial development more effectively than would more rigid legal traditions. We use historical comparisons and cross-country regressions to assess the validity of these two channels.


Using a firm-level survey database covering 48 countries, this paper investigates whether differences in financial and legal development affect the way firms finance their investment. Our results indicate that external financing of investment is not a function of institutions, although the form of external finance is. We identify two explanations for this result. First, legal and financial institutions affect different types of external finance in offsetting ways. Second, firm size is an important determinant of whether firms can have access to different types of external finance. Larger firms with financing needs are more likely to use external finance compared to small firms. Our results also indicate that these firms are more likely to use external finance in more developed financial systems, particularly debt and equity finance. Finally, we find evidence consistent with pecking order theory in financially developed countries, particularly for large firms.

Fama, E. and K. French, 2002, Disappearing dividends: changing firm characteristics or lower propensity to pay? Journal of Financial Economics 60, 3-43

The proportion of firms paying cash dividends falls from 66.5% in 1978 to 20.8% in 1999, due in part to the changing characteristics of publicly traded firms. Fed by new listings, the population of publicly traded firms tilts increasingly toward small firms with low profitability and strong growth opportunities – characteristics typical of firms that have never paid dividends. More interesting, we also show that regardless of their characteristics, firms have become less likely to pay dividends. This lower propensity to pay is at least as important as changing characteristics in the declining incidence of dividend-paying firms. My god, they included so many things in one paper. Admire!

In the late 1960s and early 1970s, a series of papers by Amos Tversky and Daniel Kahneman revolutionized academic research on human judgment. The central idea of the “heuristics and biases” problem – that judgment under uncertainty often rests on a limited number of simplifying heuristics rather than extensive algorithmic processing – soon spread beyond academic psychology, affecting theory and research across a range of disciplines including economics, law, medicine, and political science. The message was revolutionary in that it simultaneously questioned the descriptive adequacy of ideal models of judgment and offered a cognitive alternative that explained human error without invoking motivated irrationality.


In many countries, banks lend to firms controlled by the bank’s owners. We examine the benefits of related lending using a newly assembled dataset for Mexico. Related lending is prevalent (20 percent of commercial loans) and takes place on better terms than arm’s length lending (annual interest rates are 4 percentage points lower). Related loans are 33 percent more likely to default and, when they do, have lower recovery rates (30 percent less) than unrelated ones. The evidence for Mexico in the 1990s supports the view that in some important settings related lending is a manifestation of looting.


We test the cash flow signaling and free cash flow/overinvestment explanations of the impact of dividend announcements on stock prices. We use Tobin’s Q ratios less than unity to designate overinvestors. The average return associated with announcements of large dividend changes is significantly larger for firms with Q’s less than unity than for other firms. This evidence, the results of further tests involving a finer partition of the data, and an analysis of changes in analysts’ earning forecasts surrounding dividend announcements support the overinvestment hypothesis over the cash flow signaling hypothesis.


We examine a sample of 12,023 acquisitions by public firms from 1980 to 2001. Shareholders of these firms lost a total of $218 billion when acquisitions were announced. Though shareholders lose throughout our sample period, losses associated with acquisition announcements after 1997 are dramatic. Small firms gain from acquisitions, so that shareholders of small firms gained $8 billion when acquisitions were announced and shareholders of large firms lost $226 billion. We examine the cross-sectional variation in the announcement returns of acquisitions. Small firm shareholders earn systematically more when acquisitions are announced. This size effect
is typically more important than how an acquisition is financed and than the organizational form of the assets acquired. The only acquisitions that have positive aggregate gains are acquisitions of subsidiaries.


Analysts’ Forecast


This paper investigates the relation between cross listing in the US, with its resulting commitment to increased disclosure, and the information environment of non-US firms. We find that firms that cross-list on US exchanges have greater analyst coverage and increased forecast accuracy relative to firms that are not cross listed. A time-series analysis shows that the change in analyst coverage and forecast accuracy occurs around cross listing. We also document that firms that have more analyst coverage and higher forecast accuracy have higher valuations. Further, the change in firm value around cross listing is correlated with changes in analyst following and forecast accuracy suggesting that cross listing enhances firm value through its effect on the firm’s information environment. Our findings support the hypothesis that cross-listed firms have better information environments, which are associated with higher market valuations.


We find that analysts’ forecast errors are predicted by past accounting accruals among both equity issuers and non-issuers. Analysts are more optimistic for the subsequent four years for issuers reporting higher issue-year accruals. The predictive power is greater for discretionary accruals than non-discretionary accruals, and is independent of the presence of an underwriting affiliation.

Public Offerings


Three flotation method choices:
1. uninsured rights: rights offers without an accompanying underwriter guarantee.
2. standby rights: a rights offer where the issuer elects to insure the proceeds through an underwriter, the underwriter guarantees the unsubscribed portion of the rights issue that remains at the end of the rights subscription period.
3. firm commitment: if the issuer wants to insure the proceeds without using rights, it can employ a firm commitment guarantee, in which the underwriter assumes full responsibility for selling the shares to the public.
International comparisons of flotation method choices are interesting, as the relative frequencies differ substantially across countries.

**Books (28 books)**


Good econometric book


Behavioral Accounting Research


Talk about the collinearity problem of regressions


First book to investigate the ownership structure of US companies


Free talks


Theory of contracts (part I)


About positive philosophy

Good book for theory of finance


Bible of balanced scorecard

Laffont, Jean-Jacques, 1989, the Economics of Uncertainty and Information, the MIT Press.

You should know this author!


Predict the bubble of Internet stocks

Sahai, Hardeo and Mohammed I. Ageel, 2000, the Analysis of Variance, Birkhauser Boston.

With many intelligent applications (SAS)

Scheffe, Henry, 1999, the Analysis of Variance, John Wiley & Sons, Inc.

For advancers only


Don’t know this book? Impossible!


The argument of this book is that China decidedly cannot continue sidestepping SOE reform.
The fascinating thing that emerges from a micro study of Chinese SOEs is the extent to which outside governance institutions in China not only malfunction but also distort the internal operations of the individual firm. As long as property rights are clearly delineated and prices are allowed to float according to supply and demand, transfers become possible and efficient allocation results. This, in effect, is the Coase theorem. Privatization advocates go further by suggesting not only that property rights are too dispersed in the SOE but also that those rights are distributed to the wrong kind of people. Control is granted to political rather than economic actors, to people who care more about patronage than profitability. All of these fundamental incentive problems are then compounded by the fact that, under state ownership, assets cannot generally be transferred on the open market. From this perspective, state ownership per se is ineffective, regardless of whether it exits in a command or free-market economy.


About business ethics


Good book for CEO turnover


Positive Accounting Theory Bible

Williamson, Oliver E., 1983, Markets and Hierarchies: Analysis and Antitrust Implications, the Free Press.

Economics of internal organization

Williamson, Oliver E., 1987, the Economic Institutions of Capitalism, The Free Press.

Firms, markets, relational contracting, Transaction costs

Williamson, Oliver E., 1996, the Mechanisms of Governance, Oxford University Press.