Journal of Banking & Finance 45 (2014) 255–269

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Mutual monitoring and corporate governance ☆

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ARTICLE INFO

Article history:
Available online 19 December 2013

JEL classification:
G34
G32
D23
J33

Keywords:
Corporate governance
Mutual monitoring
Authority differential
No. 2 executive
Firm performance

ABSTRACT

Mutual monitoring in a well-structured authority system can mitigate the agency problem. I empirically examine whether the number two executive in a firm, if given authority, incentive, and channels for communication and influence, is able to monitor and constrain the potentially self-interested CEO. I find strong evidence that: (1) measures of the presence and extent of mutual monitoring from the No. 2 executive are positively related to future firm value (Tobin's Q); (2) the beneficial effect is more pronounced for firms with stronger incentives for the No. 2 to monitor and with higher information asymmetry between the boards and the CEOs; and (3) mutual monitoring is a substitute for other governance mechanisms. The results suggest that mutual monitoring provides important checks and balances on CEO power.

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1. Introduction and overview

In this paper, I rely on the notion that mutual monitoring among managers in a well-structured authority system mitigates the agency problem. Alchian and Demsetz (1972), Jensen and Meckling (1976), Fama (1980), and Fama and Jensen (1983) all stress mutual monitoring as an important control mechanism. Most of previous research is theoretical (e.g., Baker et al., 1988; Acharya et al., 2011) and a few empirical studies focus on employees or general "work group" (e.g., Drago and Garvey, 1998; Core and Guay, 2001; Hochberg and Lindsey, 2010). To my knowledge, this paper is the first one to examine mutual monitoring in the executive suite. To frame the nature of mutual monitoring among members of an executive team, I note the following.

Although the CEO is the focal point for leadership and decision making, managing the firm requires significant teamwork (Hambrick and Mason, 1984). First, top executives other than the CEO often possess a set of responsibilities that only modestly intersect with those of the CEO. For example, the CFO often leads on financial reporting (Jiang et al., 2010) and the COO often presides over the day-to-day operations (Marcel, 2009). Second, the CEO needs collaboration from other team members. A top executive can withhold effort or information as a means of passive monitoring (Acharya et al., 2011). Or an executive can damage or effectively veto a CEO initiative by impeding implementation, termed "optimal dissent" by Landier et al., 2009. In the extreme, an executive may leave the company due to disagreement with the CEO. Third, a non-CEO can influence the CEO by providing expertise, advice, and perspective. Often the information on product markets, operations, marketing, accounting, and finance flows through top executives to the CEO. And executives will bring different aptitudes, training, and experience to the various aspects of management (Bertrand and Schoar, 2003). Fourth, executives possess resources and mechanisms to influence the CEO indirectly. Some have channels to the board and some themselves serve on the board. An executive can bring CEO behavior that is self-serving, fraudulent, unethical, or otherwise illegal to the attention of other employees or the board or, in the extreme, to regulators, the media, or even law enforcement authorities (Dyck et al., 2010). In terms of incentives to monitor the CEO, the second-in-command not only has a fiduciary obligation to provide important and accurate information to the board, but also monitors the CEO for her own

☆ I am grateful to an anonymous referee, Viral Acharya, Ilona Babenko (committee), Sreedhar Bharath (committee), Jeffrey Coles (committee chair), Peter DeMarzo, Ulrich Hege (discussant), Michael Hertzel (committee), Michael Lemmon (discussant), Laura Lindsey, Ulrike Malmendier (discussant), Ike Mathur (the editor), Hatice Uzun (discussant), and seminar participants at Arizona State University, University of Wyoming, Saint Louis University, University of Kansas, University of Kentucky, University of Cincinnati, Villanova University, University of Western Ontario, North Carolina State University, Fudan University, Shanghai University of Finance and Economics, the China International Conference in Finance (CICF) 2011, the European Finance Association (EFA) meeting 2011, and the Financial Management Association (FMA) meeting 2011. All errors are mine.

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http://dx.doi.org/10.1016/j.jbankfin.2013.12.008

sake. The fact that the CEOs are generally much older than the No. 2s generates divergent horizons. Mutual monitoring should be more intense when old CEOs are about to retire and have less career or reputation concerns and young No. 2s still care about the future of their firms (Acharya et al., 2011). After all, their compensation and promotion within the firm are linked to the performance of the entire company. Even if they seek outside options, they will be more competitive on the job market if their firms have performed well (Fee and Hadlock, 2003).

In theory and practice, mutual monitoring can lead to better executive decisions pertaining to investment and financial policy and to a lower likelihood of unfortunate or illegal events or corporate disaster. Of course, the presence and effectiveness of mutual monitoring will vary in the authority, credibility, and influence of team members, whether team members have access to relevant information, and proximity of team members to decision-making processes. My measures of mutual monitoring reflect these tensions.

To measure mutual monitoring, I focus on executives I surmise to be second-in-command to the CEO.[1] In the framework of mutual monitoring, conferring authority on the No. 2 executive is particularly important, because such executives can closely observe the CEOs on a routine basis whereas even the most diligent boards cannot. Alchian and Demsetz (1972) suggest the No. 2 executive in the firm, if given proper authority and channels, is able to constrain the self-serving actions of the CEOs. Of course, the second-in-command can be extremely powerful in some firms, even to the point of ousting the CEO, whereas her influence can be insignificant in other firms.

I identify the No. 2 executive as the highest paid employee other than the CEO.[2] First, I use the gap between the compensation of the CEO and that of the second-highest-paid executive scaled by CEO total compensation, as a proxy for the authority differential between the two executives, and, thus, as a proxy for the relative monitoring capacity of the No. 2. This pay gap, hereafter known as the "*GAP*," is likely to be correlated with various attributes of the second-in-command relative to the CEO, including skill, power, and influence (as distinct from formal authority), all of which determine monitoring capability.

Second, I create a variable that indicates whether the No. 2 executive also serves as a director on the company board. *Director-No. 2* is a dummy that takes the value one if the No. 2 is a board director in her firm, zero otherwise. The presence of the executive on the board reduces the information asymmetry between the board and the CEO, which is likely to enhance the monitoring effectiveness of the board (Inderst and Mueller, 2009).[3] Board membership provides the executive with formal and informal channels for monitoring authority and information transmission.

Third, because titles are likely to represent structural power, influence, and access to information (Finkelstein, 1992), I consider whether the No. 2 executive also holds the title of "President." *President-No. 2* is a dummy equal to one if the No. 2 is the president of the firm, zero otherwise. Generally, the No. 2 executive can supply more checks and balances relative to the CEO if she is the president of the firm than if she is one of the vice presidents and the CEO is the president (Worrel et al., 1997).

Finally, if the No. 2 joined the firm after the CEO, she is more likely to be loyal to or serve at the pleasure of the CEO (Landier et al., 2013). A No. 2 appointed prior to the CEO is less likely to be co-opted[4] and is more likely to monitor the CEO. The measure I employ indicates whether the No. 2 was appointed prior to the CEO. *Independent-No. 2* is a dummy that equals one if the No. 2 joined the company before the CEO, zero otherwise. Mutual monitoring will be more effective when the *GAP* is smaller and when one or more of the three indicator variables takes the value of one.

I use these four proxies to test the implications of mutual monitoring for firm performance and policy, and to examine the relation between mutual monitoring and other governance characteristics. My analysis yields four classes of results.

First, I empirically identify executive, board, and firm characteristics that are associated with the measures of mutual monitoring. I find the strength of mutual monitoring is negatively correlated with governance quality measures, suggesting mutual monitoring allows the firm to substitute away from more expensive governance mechanisms, such as direct monitoring by the board.

Second, I find a significant relation between firm performance and the measures of mutual monitoring. For an increase in the *GAP* of one standard deviation, Tobin's *Q* one period forward is lower by the equivalent of $20 million. Moreover, Tobin's *Q* one period forward is significantly and positively related to the three indicator variables for mutual monitoring, specifically *Director-No. 2*, *President-No. 2*, and *Independent-No. 2*. These results are consistent with the presence of mutual monitoring and the relevance of mutual monitoring for firm performance.

Third, my four measures of mutual monitoring interact with CEO duality, horizon difference between the top two executives, industry homogeneity, and firm tangibility in a way that suggests the effect of mutual monitoring on firm performance is more prominent in firms where the No. 2 executive has sufficient incentive to monitor and where the information asymmetry between the board and the CEO is high.

Endogeneity in performance-on-structure and structure-on-structure experiments is a common and difficult problem (e.g., Roberts and Whited, 2011). In my empirical context, if shareholders can optimally assign the monitoring capacity to the No. 2 executive and adjust it in an instantaneous and costless way, there should be no empirical relation between mutual monitoring and firm performance.[5] It is plausible, however, that the transaction costs of altering the authority system of mutual monitoring are present and nontrivial, so that one would be more likely to expect to observe a connection between my measures of mutual monitoring and firm performance, policy, and governance structure. Indeed, statistically the empirical results in the paper are robust to using a variety of relevant control variables and econometric methods. Furthermore, I show that the endogeneity problem actually works against finding the documented relations between mutual monitoring and firm performance.

The remainder of the paper is organized as follows. Section 2 describes the data and Section 3 provides statistical description of the No. 2 compared to the CEO. Section 4 examines the relation of mutual monitoring and executive, firm, and governance attributes. Section 5 identifies the relation between mutual monitoring and firm performance. Section 6 studies the interactions between mutual monitoring capacity and incentives. Section 7 discusses alternative explanations. Section 8 concludes.

2. Data sources

I construct my sample with firms that comprise the ExecuComp database for the years 1993–2006. The database contains details of

[1] Mutual monitoring is more effective in a well-balanced authority structure as well as in small-group settings. In large groups, agents tend to free ride (Isaac and Walker, 1988) and have natural limits to observing each other (Heckathorn, 1988; Kandel and Lazear, 1992). In this sense, the No. 2 executive is a natural focal point for examining mutual monitoring.

[2] An alternative categorization that ignores the "CEO" title and defines the No.1 and No. 2 by their total compensation produces similar results.

[3] Keeping board independence constant, I show the No. 2 executive is a more effective monitor than an arbitrary inside director.

[4] I adopt this notion from Coles et al. (2010), who develop the same argument for outside directors.

[5] See the optimal contracting literature, e.g., Demstez and Lehn (1985) and Coles et al., (2012), for equilibrium explanations.

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