

DISSERTATION DEFENSE

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The Mechanism of Control in Organizations: Essays on Imperfect Measures of Managerial Talent

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1. Purpose and Scope of this Study

Managerial talent is neither observable nor divisible. Thus, performance measures that evaluate a manager's human capital are significant not only for compensating a manager through accurate appraisal, but also for inferring managerial talent. In practice, however, talent measures are often imperfect, thereby hindering firms from control of a manager's behaviors. As such, exploring the nature of imperfect measures and addressing how firms deal with it are important considerations in managerial accounting research. In this study, I investigate these issues through the lenses of both the market for managers and internal control. In particular, I examine how the market for managerial talent is influenced by imperfect talent measures and how such influence leads to a different matching of firms and managers. Then, taking the matching of firms and managers as given, I explore how firms make use of alternative contracting instruments to control managers' behaviors resulting from imperfect measures. The results provide novel explanations that increase our understanding of 1) imperfect measures of managerial talent and 2) documented empirical evidence associated with managerial accounting research.

2. Outline of this Study

The unifying goal of this study is to better understand the impact of imperfect measures of managerial talent on a manager's behavior and how a firm attempts to control such behavior in both the market and firm levels. To distinguish different aspects of and issues developing from imperfect measures, Chapter 1 and Chapter 2 first discuss how an imperfect talent measure creates an agency problem and how firms respond to it when the measure is verifiable. Specifically, Chapter 1 aims to find a foundation of how imperfect talent measures influence the matching of firms and managers when managers have career concerns. Having found the tension from a manager's career concerns, Chapter 2 studies available, but less-understood contracting devices as internal control mechanisms that can serve as reputation insurance. Then, shifting the focus from a verifiable talent measure to an unverifiable measure, Chapter 3 examines, in the context of CEO hiring, how firms provide incentives to managers for developing firm-specific talent and the implications for subsequent firm performance and pay.

In Chapter 1, "The Market for Reputation: Repeated Matching and Career Concerns", I propose a multiperiod matching model of firms and managers to explain that the labor market efficiency in

sorting through imperfect measures may not guarantee the economic efficiency in matching. In the model, firms compete for managerial talent and managers are concerned with their reputation. Due to the trade-off between match efficiency from productive complementarity and agency costs from managers' reputational concerns, assortative matching of firms and managers may fail. I derive sufficient conditions for such failure with respect to the size distributions of firms. The model can be applied to various agency problems with consideration of the labor market for managers, which will be particularly useful for analyzing cross-sectional patterns of two-sided matching, aggregate firm performance, and agency costs depending on the size distributions of firms.

Motivated by the Chapter 1, in Chapter 2, "Project Selection and Career Concerns: The Role of Reputation Insurance", I explore, in the context of CEO turnover, the latent aspects of existing practices in managerial accounting and control. In particular, this chapter asks how well different governance practices provide incentives for project selection when managers have career concerns and how such practices influence a firm's decision of whether to replace their CEO. I show that a board of directors' monitoring, performance disclosure policy, and a severance package serve as reputation insurance and mitigate a manager's career concerns through different mechanisms. However, the incentive effects of reputation insurance are followed by a weakened turnover-performance relation. The board's monitoring makes the relation weaker since the board's information serves as a substitute for the project earnings. The non-disclosure of a CEO's performance at departure weakens the relation due to information suppression. The presence of severance pay, on the other hand, creates performance tolerance for firms in order not to pay out, thereby lessening the turnover-performance sensitivity. I also provide empirical predictions related to the existing CEO turnover and governance practices based on the perspective of reputation insurance.

In contrast to Chapter 1 and Chapter 2, in Chapter 3, "Generalists versus Specialists: When Do Firms Hire Externally", the discussion centers on the aspect of unverifiable talent measures. This chapter is inspired by puzzling observed associations among CEO appointments, pay, and firm performance. In recent decades, the trend of external CEO hiring has increased, a practice often involving high outsider pay premiums. Most academics and practitioners ascribe the practice of outsider premiums to two factors: managerial talent and a match between a firm and CEO. However, this perspective seems to overlook that, after an outsider CEO is hired, firm performance often becomes unsatisfactory. To understand the missing link between CEO hiring choices, I consider CEO hiring as an incentive device for non-CEO employees for firm-specific talent acquisition. Specifically, I develop a multitask-multiagent team production model where each task sequentially requires a firm-specific talent and a management decision. Both internal promotion (the specialist CEO) and external hiring (the generalist CEO) provide incentives of talent acquisition to non-CEO employees but through different mechanisms. I identify conditions under which either internal promotion remains optimal or external hiring becomes optimal. This optimal contracting framework for multiple agents also explains why outsider CEOs appear to be paid more than insider CEOs, and how the performance of external hiring firms tends to be worse than the performance of internal promoting firms in spite of the higher pay.