Dissertation Proposal

Ronghuo Zheng

“Essays on Corporate Governance, Managerial Incentives, and Management Forecast”

Monday, March 21, 2016
10:00 am
388 Posner Hall

Corporate governance attracted much attention after the corporate failures of Enron, WorldCom, and others, and was again at the center of debate after the financial crisis in 2008. In response, regulations such as Sarbanes-Oxley Act and Dodd-Frank Wall Street Reform and Consumer Protection Act were enacted to protect investors by mandating requirements for executive compensation, board composition, and financial reporting. My dissertation aims at studying the incentive issues in corporate governance, especially how regulations might affect the communication and strategic interaction between managers, directors, and shareholders.

In the first chapter, titled “Compensation Duration, Shareholder Governance, and Managerial Short-termism,” I investigate the interaction between the duration of executive compensation and shareholder governance via voice and exit. Contrary to the view that short-term incentives imposed by large incumbent shareholders result in a value destroying wealth transfer, I show that short-term compensation can elicit shareholder engagement and, thus, enhance the firm’s value. The central mechanism is that a short-term compensation plan enables informed incumbent shareholders (e.g., private equity firms) to commit to using their private information to intervene (voice) instead of selling their shares (exit). Without a commitment to voice, incumbent shareholders might find exit more appealing than voice, ex-post, if they privately observe that a firm's type is bad. Short-term incentives encourage a good firm to take actions that reveal its type early on. This, in turn, reduces the information advantage of the incumbent shareholders and their ability to profit from exit. Effectively, short-term compensation serves as a commitment device for value-enhancing intervention. From this perspective, regulation and other actions that aim to lengthen the compensation’s duration might distort the large shareholders' incentives to intervene and, thus, reduce the firm’s value. I propose to construct additional analysis by considering different ways a good firm can use to reveal its type early on.

In the second chapter, titled “Nominal versus Real Board Independence: The Impact of Director Tenure,” (joint work with Jonathan Glover and Carlos Corona), we investigate whether a regulation that mandates a greater proportion of outside directors on the board results in a more independent board. We find that the higher the nominal independence level of the board, that is, the higher fraction of outside directors, the more reluctant the CEO is to replace the existing directors. The resultant longer tenures of outside directors make the CEO even less willing to replace them, which causes lower real independence. Regulations that mandate higher nominal independence can have the unintended consequence that they lower both the real independence and the expertise of the board of directors in the long run. We propose to extend the analysis in which the incumbent directors can choose an effort to learn and gain expertise.

In the third chapter, titled "Management Forecasts: A Counter-signaling Story," (joint work with Carlos Corona), we study the pattern of management forecast. Management earnings forecast is one of the most important channels through which a firm communicates to the market. In practice, we observe that some highly profitable firms (e.g., Google) choose not to make earnings forecasts, which seems puzzling. To explain this puzzle, we consider a signaling game where both the forecast error and the mandatory earnings report can serve as signals for the manager's talent (type). We find that the manager with a high talent level might choose to use the earnings report as the only signal while withholding forecasts in equilibrium. The reasoning is that the manager with average talent prefers to use both signals to differentiate him or herself from less talented managers, and in response, the manager with high talent prefers to only use the earnings report to differentiate him or herself from the managers with average talent. As we currently model managerial forecast as a pre-committed decision, we plan to consider an alternative assumption in which the forecast decision is contingent on the forecasted earnings.