Integrity of Management

Integrity can now be measured and why that’s good for investors and issuers alike

Gerhard Foerster

(Working Paper WP16-13E)

Public corporation One of the predominant type of corporations of the western capitalism, the public corporation, has a light and a dark side. The self-assertiveness and the ability to survive of this type of corporation is explained by economic theory according to the separation of ownership and control. Separation of ownership and control creates economies of scope by specializing typical management functions in the context of creating and leading a company, which is not existent with ownership-entrepreneurs. We talk about separation of decision management and risk bearing.

This specialization allows an owner to hire a manager for the decision management who can’t be owner of the company because he lacks the necessary financial resources but who has the resource of ability to find and take the right decisions. This specialization allows an investor to found and own a company without having the ability to find and take the right decisions but who has the ability and the financial resources to bear risks as an investor. The results of this innovative type of corporation are its strong growth, its power to innovate and its ability to adapt to a changing world, in the sense of Schumpeter’s creative destruction worldwide.

Agency Costs The scientific argument for the success story of the public corporation is based basically on economic studies and articles of Michael Jensen and other co-authors. Within his scientific work on the theory of firm he shows that from the point of view of capital as the principal and the optimal allocation of capital for the whole economy the separation of ownership and control offers high benefits but that there are costs which have to be considered. These costs are called by Jensen as agency costs which he and his fellows interpret as a highly relevant economic category.

The benefit of specialization is the light side, agency costs are the dark side of the public corporation. Agency costs are the result of information asymmetry between manager and owner. The manager as agent sub-optimally carries out the by definition incomplete contract with the owner as principal and seeks to achieve own personal objectives by doing his job as manager of the company. Power, vanity, status, money, hubris etc. are widespread motives behind the effort promises of managers towards owners.

Gatekeeper

According to Jensen the market system has evolved solutions to limit the agency costs of the public corporations. The market for corporate control complements the manager market by additional components of competition, external manager teams which compete with incumbent managers to control a firm, which they believe badly controlled, and which join with financiers to run the battle for control. This threat forces the incumbent management to increase their efforts to improve the performance of the firm in order to decrease the agency costs for the owner. In addition the internal governance structures, board and respective committees, have the task to represent the interests of the principals but are limited as another principal-agent conflict is implied.

Agency cost exist not only for actual principals, the actual owners of the company, but also for future principals, future owner of the company. The latter are not as good informed about the company compared to the former so that specific market solution for the specific agency cost problem have evolved. We talk about gatekeeper. Gatekeeper guard the “heaven door” to “paradise”, to unlimited “pastures” and “feeding grounds” of the worldwide capital market and its unlimited financial resources and unconsummated income and savings. Gatekeepers are: Rating-Agencies, Auditors, Financial Analysts, Investment banks as underwriter.

The deep practical experiences in last decade inclusive the last 3 years as well as the scientific reappraising of several financial crises, manager frauds and Wall Street scandals have shaken the image of the gatekeeper as a superior solution for the agency costs of the public corporation. The crises of the gatekeeper leave a unpleasant taste thinking that with the existence of gatekeeper the principal-agent-relation is in best order.

Overvaluation

Jensen and his seine science fellows theoretically and empirically described and explained the crises of the gatekeeper. But they could not offer a satisfactory solution to improve the principal-agent-relationship accept a reference to respective market regulations which is not a satisfactory solution.

Completely unsatisfactory becomes the situation for fans of capital market autopoisesis in an article from Jensen of the year 2005 where he analyses the agency costs of overvalued companies. If firms are strongly overvalued it will lead to huge damages for investors, the economy and the society as a whole. Jensen explains the thesis with the wrong incentives of manager, owner, board, gatekeeper, external manager teams which do not stop or limit overvaluation in time but in contrary do accelerate the problem. The vicious circle leads to huge damages which we all have experienced in the last decade.

Jensen resigned and stated that he did not find a solution for the problem of overvalued firms so that he appealed the economists worldwide for thinking about and finding a solution for overvaluation because the problem is huge and urgent.

Integrity

Jensen itself with co-authors developed a theoretic model of manager integrity. By this he moved the problem of agency costs in general and the high agency costs of overvaluation specifically to the point where it is created and where in his opinion it has to be resolved if other market solutions do not work, to the management of the company. Managers should exhibit a high integrity and by this reduce its agency costs.

Jensen defines integrity as „Honoring its own word“. This means: To keep your own word. If you can’t keep your own word because the situation does not allow it than you have to announce early in time that you can’t keep your own word and that you do everything to bear the consequences of not keeping your word. High integrity is meant not only for persons but also for organizations, institutions and systems etc.

Decisive in this picture is that integrity is not a normative quality of character of a person like moral and ethic but that integrity is a positive economic category which has an impact on a firm’s performance like technology, know-how and knowledge, specific abilities etc. The key word for the performance impact of integrity is according to Jensen the workability of economic relations and the accountability for the strategic value of the firm. The empirical knowledge shows, that the increase of performance of a company through high management integrity is not only 1-2% but reaches 100% and beyond.

Veil of invisibility

The problem with management integrity is, as Jensen sees it, that everyday reasoning advocates the thesis that integrity implies high costs in the short run and that the benefits of integrity for the manager only can evolve in the long run. This is the reason, as Jensen says, that it is so difficult to implement integrity as a production factor into the managers’ world view. Jensen argues against this thesis and explains the lack of integrity with the „Veil of Invisibility“. This veil of invisibility, following Rawl’s veil of ignorance in his theory of justice, prevents that the benefit of integrity can directly be recognized. This led some co-authors of Jensen to develop manager trainings to try to lift the veil of invisibility and to show explicitly the benefit of integrity for the manager.

Concept

At this point the present concept comes in place. The idea is to measure and evaluate integrity with methods that allow it from outside the company. In case of finding methods to do this the capital market and its gatekeepers are able to judge the company’s management whether it uses the production factor integrity beside all the valuable production factors which can be recognized so that the management feels responsible and accounts for the long-term strategic value of the firm what is the core of the positive economic category integrity.

Companies which show strong management integrity as well as all other valuable technical and organizational production factors will be highly valued on the stock market. And this increase in valuation will take place not in the long run when the strategic value of the firm is in the balance sheet of the firm but immediately when the high integrity of the firm’s management is recognized and evaluated by the capital market. This implies that management can immediately profit from high integrity i.e., by stock based compensation. In contrast companies with a high value on the stock market but low integrity will be devaluated.

Obviously the present concept offers a solution against high agency costs in general and specifically against the very high agency costs of overvaluation.

Measuring

The demands on the measurement of integrity are extremely high but they are worth according to the above comments. Basically indicators are needed which can be measured from outside the company on the one side and which can be influenced directly or indirectly by management through means and decisions on the other side. The first principle of measurement is obvious, the second principle of a manager’s influence is indispensable in order to gain integrity as a production factor.

Integrity in this concept is what can be measured and what the manager can measure and what he can influence. This sounds trivial but it is an illusion to believe that this is trivial.

Watching Therefore another principle of measuring and evaluating integrity is needed. Integrity cannot be observed directly according to the veil of invisibility but an attempt can be made to measure all cases where a lack of integrity is obvious. To limit this task in its complexity and its volume it is reasonable to concentrate on areas where there is no market solution, especially overvaluation which comes from a lack of integrity.

This means that overvaluation coming from market hype or noise trading behavior (Bubbles, Herding, etc.) cannot deliver indications for management integrity. In case of undervaluation the market for corporate control can offer a solution. Corruption and other criminal wealth offences are in the responsibility of justice and courts.

Manio What is called an indication area for integrity can be described with the terminus technicus “Manager-intended Over-Valuation“ (in the following called Manio). In theoretical empirical literature Manio is circumscribed by Fraud, Misreporting, Fraudulent Financial Statements, Over-Optimism, Over-Investments, Empire-Building, Restatements, Litigations, Class Actions etc. In the Manio-case management is able to overvalue its company’s stock through own decisions and means or to extent an overvaluation created through market hype (the Jensen-case of 2005) in order to get own benefits (Agency Costs).

Integrity vs Manio If Manio is the relevant indication area the reasoning consequences are clear: Integrity is high if indicators for Manio are low and vice versa. If there are indicators to explain and/or predict Manio and which are measurable from outside the company and which can be influenced by the management than there are indicators to explain and/or predict low/high manager integrity which is created by and only by Manager-intended Over-Valuation (Manio). In this case it is obvious that the indicators can be influenced by management because the indicators watch overvaluation which is intended and therefore managed by management.

Indication areas Following indication areas are observed within the present concept:

- Internal Governance
- External Governance
- Performance and risk of the company
- Complexity of the firm and the respective monitoring by principals resp. gatekeeper
- Earnings Management
- Over-Valuation of the firm’s stocks

- Trading-behavior of insider and informed investors
- Over-Investment of the firm
- Over-optimistic Management
- Executive Compensation
- Entry/Exit-transactions, like M&A, IPO etc.
- Refinancing
- Replacement threat for management

Theory/Empiricism The theoretical and empirical fraud- and earnings management-literature recognizes a strong impact of internal governance on fraud- and earnings management-behavior of management.

A high complexity of the firm, its products and technologies, its markets and strategies etc. protects the firm against critical questions about a possible low quality of the disclosed data and information.

Low performance and/or high risks of the company can motivate for fraud in the sense of Ultima Ratio, which is not the case if the performance of the firm is high or the risks are low.

Earnings Management in financial statements, overvaluation of the company's stocks and over-investments in the company's strategy are footprints which are left behind Non-Integrity behavior of management.

Observing the trading behavior of the management as well as of normally well informed investors, i.e., short seller, can give good indications that well informed market participants seem to believe that they have recognized overvaluation, so the empirical literature.

A decisive indication for integrity lies also in the structure of executive compensation. Extensive theoretical and empirical studies show a significant indication function for executive compensation.

In addition job loss fear of management due to bad performance of the company or a low valuation of the firm's stocks is a strong driver for non-integer behavior.

High refinancing needs at low capital costs and attractive terms of trades in entry/exit-transactions (i.e., Equity as currency for Acquisitions) imply strong incentives for Manio-behavior.

In all the above mentioned indication areas theoretical and empirical studies in the Anglo-Saxon oriented literature support the conception of measurement and evaluation of manager integrity. Therefore the theoretical empirical economic literature in the last decade has found and offers a host of strong evidences with which Manio-behavior can be reasonably well be detected and probably be predicted and which can be used as indicators for a lack of integrity or for high integrity of management.

Methods

The concept partly relies on linguistic methods of text mining due to unstructured text sources and in large parts statistical methods of econometric science for structured quantitative data of the company, its management and its industry. The results of indicators are epistemologically probabilities for individual indicators, for indicator areas and for manager-intended overvaluation and management integrity as a whole.

An important issue is to improve the quality of indicators and therefore the quality of statements on Manio and integrity using back-testing. First of all the issue is to optimize error types I (Manio wrongly detected) and II (Manio wrongly not detected). After that the issue is to make possible an integrity rating which is connected with empirically found thresholds on the company's performance and risk expectations.

Who could be interested in the concept?

A due diligence in the context of M&A-transactions can be complemented by an integrity-component with a high benefit for the bidder resp. buyer.

For investors on the stock market information on the integrity of management of the target company could be highly beneficial.

Hedge Funds can short trade Manio firms, Banks can enrich their internal rating systems of their commercial credit clients by an integrity component.

Rating-agencies and financial analysts can offer an integrity rating for the market as well as integrate integrity information in their evaluation of the company. A publicly offered integrity rating influences the pricing process on the stock market in the same manner as credit ratings and financial analyses do today. Using the concept Auditors can back their attestation with integrity information about the firm's management. In addition the agencies can use the integrity concept as a consultancy product without getting in conflict with their respective agency business clients, because integrity consulting for management and board of a company is a strongly value increasing consultancy product.

Resume

Following Jensen in evaluating the value of the positive economic category „Integrity“ and offering a concept of measuring and evaluating the integrity of the management of a company which can accomplish what it promises means that the integrity concept has a high Net Present Value and therefore a high strategic value.