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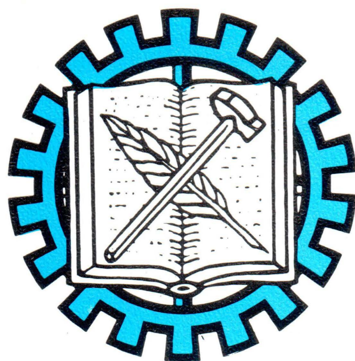

The Belden Center for Private Enterprise Education
Harding University School of Business
Searcy, Arkansas

The entrepreneur

Ownership Makes a Difference

NEW BOOKLET PUBLISHED

Marking the Fifteenth Anniversary of the **Entrepreneur** is a new booklet, **"HIGH OCTANE? A Primer on the Economics of the Energy Crisis."** Authored by Belden Center Director Dr. Don Diffine, a complimentary copy of **"HIGH OCTANE?"** is available to our readers upon request. Here are a few select paragraphs from the introduction:

> *In the late 1970's, the service station attendant said, "Fill it up?" Reluctantly, I replied, "Fill it up." He opened the cash drawer and said, "Fill it up." I filled it up. Then he filled my gas tank, doubling the value of my old, gas guzzling car.*
>
> *Today, those high gas prices again make us feel as if we are "paying through the hose." Aside from trying to face the current energy crisis with a sense of humor, fact is, gas is $1 more per gallon in Canada — $2 more in parts of Europe.*
>
> *Have we been "fuelish"? Not really. We have grown 54% in real GNP since 1973; and we did it with only 9% more energy. We're not "energy pigs" any more than our children whom we push to go on in school are "education pigs."*

Other sections in **"HIGH OCTANE?"** are titled, "The Sun Will Still Rise...Oil In The Family...How Many Crises?...Creative Juices Will Flow...Energy Facts Of Life In A Nutshell...Pay Your Money — Take Your Choice."

by David M. Johnson, Ph.D.
Assistant Professor of Accounting
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The undeniable shift from nationalized economies to privatized economies throughout Europe is a dream becoming reality. Over the past few years, industrialized nations of the Free World have been pursuing policies to unshackle industry from counterproductive government involvement. The theorists and philosophers will continue to argue, but for most of us, the evidence is in: private ownership is a survivor.

Addressing this issue, R. Joseph Monsen and Kenneth D. Walters have written a book, "Nationalized Companies: A Threat to American Business," which outlines the tremendous failure of government ownership at the test of profits and losses. By their account, "the history of nationalized companies is written in red ink." A few of their interesting findings are summarized below.

In the period 1972-1981, the majority of the 25 largest state-owned industrial firms in Western Europe reported losses in most years. The problem was growing by the end of that period, with twice as many losers as winners. Furthermore, losses increased in size as the decade wore on. These losses cannot be discounted by arguing that these were depressed industries, for they included basic manufacturing industries such as chemicals, plastics, paper, aluminum, machine tools, and fertilizers. In contrast, the 25 largest private companies in Europe reported few losses, and only one had losses over an extended period.

As Monsen and Walters explain, the blame for this record lies in the confused incentive structure of state-owned companies. These firms appear to be run for political rather than economic reasons, in accordance with a goal of maximizing votes rather than shareholder wealth. The symptoms are now classic, but the cause and the cure are no mystery. The separation of the

ownership of an asset and control (management) of that asset will result in significant problems of resource allocation.

Even as Americans congratulate themselves on the ideological triumph of freedom over totalitarianism, a trend has occurred on a microeconomic level resulting in the separation of ownership and management in large U.S. corporations. This separation can produce problems for the individual firm not unlike those that typify nationalized companies.

A LITTLE HISTORY

Until the Industrial Revolution, most manufacturing and merchandising were conducted via home businesses or small shops under the Handicraft System; the predominant business forms were the sole proprietorship and the partnership. Under this system, an individual develops a particular skill to provide goods or services that can be sold or exchanged for goods or services desired by the producer. The scale of production is very small by present standards, although this system still dominates in non-industrialized countries.

With improved transportation and production technology, economies occur that encourage the expansion of operations. As these businesses grow, employees are hired. At first, these few employees labor under the watchful supervision of the owner, who is ever-present and in close touch with the day-to-day business operation.

The entrepreneur's presence gives personality to the business, encourages efficiency, and ensures that the business is managed for the benefit of the manager/owner. But as the business continues to expand, the entrepreneur is unable to maintain control over operations as she once did. With growth comes specialization of labor and management. Supervisors are hired. At first, they supplement the owner as managers, but eventually supplant the manager/owner.

The Industrial Revolution accelerated this process on a grand scale. Until the mid-1800's, the corporate organizational form was primarily reserved for public works projects such as bridges and canals. Investors were composed of those who had a vested interest in the project's completion. For example, a barge freight line might be compelled to share in the ownership of a canal project. But profit-oriented businesses were still conducted as sole proprietorships or partnerships.

With the Revolution, the corporation became the preferred form for for-profit businesses. Mechanization and mass production methods allowed large-scale manufacturing. The necessary large investments in plant and equipment required tremendous amounts of capital financing. The corporation proved the most efficient organizational form through which to obtain that financing.

With expansion of the assets under management, personal management by the manager/owner was impossible. At first, entrepreneurial managers were supplemented by professional managers; but it was only a matter of time until professional managers were in control. The result is the modern corporation, characterized by a widely dispersed stockholder group.

The stockholders, with rare exception, are uninvolved in day-to-day operations, and management of the firm falls to professionals who have very little ownership interest. Management decision-making, formerly the task of the entrepreneur, is now the domain of the professional manager, who likely has no stake in the firm whose future he or she is charting. The problems that result are collectively referred to as "agency" problems because the managers act as decision-making agents on behalf of the firm's owners.

DESCRIBING THE PROBLEM

Separation of ownership and control of assets has the potential to distort the incentives governing the firm's decisions, leading to mis-allocation of resources similar to that resulting from state ownership. Adam Smith recognized the problems of separation of ownership and control, noting in 1776 in "The Wealth of Nations:"

> *The directors of such (joint stock) companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own.*

Smith revealed tremendous insight for one so far ahead of the day when large corporations would dominate the economy. There, in the age of the butcher and baker, he predicted the shift of incentives that would accompany the rise of the modern corporation. It would be over one hundred years before industrialization would result in the dilution of manager ownership that gave rise to the problem Smith suggested.

In the early 1930's, Adolf Berle and Gardiner Means noted an increasing diffusion of corporate ownership that left control in the hands of hired managers who had little stock ownership. They predicted from this separation ill consequences for the national economy.

Private ownership works because the owners, acting out of self-interest, provide valuable products and services to the consumer, jobs to employees, and tax revenues to support public works. Their efforts to maximize personal wealth encourage efficient allocation of resources to those activities that are desired most by consumers. Without it, the profit motive — central to the proper functioning of a free market — is absent.

Further, the owners know that higher risks are, in general, rewarded with higher returns. Without the critical connection between risk acceptance and return enjoyment, the incentive to accept higher risk is absent.

SEPARATION AND THE INVESTMENT DECISION

By far the most crucial financial management decisions made by the firm are its investment decisions. Investments will determine the nature and size of the firm, as well as its future profitability and long-term viability. This decision may be adversely affected by the separation of ownership and control, resulting in sub-optimal investments that fail to maximize firm value. The agency problems relating to sub-optimal investments may be categorized as (1) excess perquisite consumption by firm managers, (2) perversion of the incentive to accept risk, and (3) perversion of the tendency to devote time and effort to the business. The remainder of this article provides a discussion of these problems and a summary of the evidence regarding them.

EXCESS PERQUISITE CONSUMPTION

Perquisites — "perks" for short — are non-salary employee benefits. Some examples of common perks are: health benefits, free or subsidized cafeterias, use of a corporate jet or auto, secretarial staff, office, and retirement benefits. Some level of perquisites is necessary, or at least beneficial to the firm. Excess perquisite consumption becomes a problem because we all tend to order more when someone else is footing the bill.

Say you and I go out to lunch. If I'm paying, I'll order a salad; if you're paying, I'll have the buffet. A basic economic principle governs — as the price of an economic good falls, consumption of the good rises. Suppose that I own 100% of the stock of a company that I also manage. I will consume a certain amount of perquisites, but I limit those because I know that the money comes directly out of my pocket.

Now suppose that I sell half of my stock to you, but maintain managerial control. Those perks which formerly cost me $1.00 now effectively cost me only $ .50... you absorb the other half. In simple economic terms, the cost of these perks has just been cut in half, and being a sensible individual, I'll increase consumption. The increased consumption above the previous level represents an additional cost to the business. Note that this additional consumption occurred because I am receiving the full benefit of the perks but only paying half the cost. The net increase in perks results solely from separation of ownership and control.

Whenever popular business magazines feature the astronomical salaries and benefits of top management groups, they raise questions about agency problems. Are these salaries in the shareholders' interests, or are they symptomatic of agency problems? Many of us have read with disbelief the accounts of how the officers and directors of U.S. Steel in the 1970's enjoyed gourmet luncheons among silver settings and extravagant furnishings while the company — and the stockholders — were losing money hand over fist. Similar conditions occurred at Chrysler, but your own experience likely can yield more meaningful examples. These serve to remind us that agency problems indeed exist in the form of excess perk consumption.

REDUCING THE TENDENCY TO ACCEPT RISK

The second element of the agency problem associated with the firm's investments is the tendency for managers to avoid risk-taking as their ownership of the firm's equity declines. The risk/return tradeoff that stockholders face is very different from that of creditors. The claims of bondholders on corporate earnings is fixed while that of stockholders is residual. The creditor does not enjoy the fruits of exceptional performance, but may lose his fixed return if performance is sufficiently poor to jeopardize his claims.

Facing this tradeoff, the creditor will recommend to the corporation a relatively conservative course of action — slow growth occasioned by minimal risk, with few ventures into unfamiliar operations. This is one reason that too much debt in the corporate capital structure is costly to the firm — with debt comes debt covenants, some of which restrict the firm's managerial flexibility in pursuing new investment opportunities.

A corporate manager whose compensation is based primarily on salary is effectively a creditor of the company. His fixed salary is by nature a debt claim, and barring other counterincentives, we can expect him to chart a conservative course for the firm.

Compensation packages that include stock and stock options are adopted in attempts to realign interests of managers with those of common stockholders. By making managers' compensation (and wealth) dependent on the market value of the stock, stockholders hope to offset the distorted incentives wrought by ownership-

diffusion. But the only way to truly align manager interests with those of shareholders is to make compensation entirely dependent on the value of the common stock. I don't know of any firm that uses such a compensation arrangement.

A firm that shuns risk will necessarily shy away from innovation and new product or market development, thereby reducing its ability to compete in a world where being in the forefront is critical to survival. Reducing the tendency to accept risk may be a tremendous malefactor bearing on a nation's ability to compete in a high-tech era.

REDUCING ENTREPRENEURIAL EFFORT

The third agency problem is closely related to the other two. Diluting insider ownership simultaneously dilutes the incentives to commit time, effort, and energy to the business. The result is a reduction in entrepreneurial effort devoted to the business.

Students in Finance 101 learn on Day One that the goal of the firm is to maximize shareholder wealth. For the corporation, this translates into maximizing the stock's market price. Although some argue that this goal is incomplete, most would admit that the firm exists primarily for the benefit of its owners, the stockholders. Their interests are therefore paramount.

But modern corporate managers often have been labeled "satisficers" rather than "maximizers" of shareholder wealth. Maximizing requires choosing the best alternative from among those available. Satisficing requires only that managers attain some minimum acceptable result. And since shareholders of widely held corporations are not apprised of the alternatives facing management, there is no basis by which to judge whether managers are maximizing or simply satisficing.

There is reason to be skeptical that managers voluntarily choose to maximize shareholder wealth. Much like the "straight-A" student whose parents take their child's consistent top performance for granted, managers find that superior performance in one year results first in approbation, but later to increased expectations — or demands. Furthermore, if their efforts are not directly tied to rewards, then the connection is fuzzy, incomplete.

Return now to the sole owner who sold half-interest in his business, and now as a partial owner consumes more perks than before. The manager/owner is also inclined to consume more leisure time than before; that is, he is inclined to exert less effort in the conduct of his business. After all, why over-exert oneself when others reap much of the benefit?

"Shirking," the reduction in entrepreneurial effort applied to the business, applies not only to time devoted to the business, but also to creative energies that characterize the helmsmen of vigorous, competitive, innovative firms. The agency cost here is by nature an opportunity loss — the potential wealth foregone by virtue of undiscovered, unpursued investment opportunities — and may represent the greatest cost of agency problems.

DOCUMENTING THE PROBLEM

Proposing these problems is one thing — documenting them is another. For the last ten years or so, much research effort has been directed at determining how the separation of ownership and control manifests itself in corporate financial policies and performance.

The investment decision reflects the firm's strategy and determines its profitability and survivability. An interesting aspect of the investment decision concerns the firm's attitude toward corporate diversification via mergers and acquisitions.

Because salaried managers' interests are aligned with those of the firm's creditors, they will be interested in reducing the riskiness of the firm's investments. One way to do so is by diversification. Financial theory holds that corporate diversification is of little value to stockholders — it is relatively easy and inexpensive for individuals to diversify their stockholdings, especially with the proliferation of mutual funds.

In contrast, diversification of real assets is expensive and the cost of a mistake is much greater (e.g., diversifying into areas outside management's sphere of expertise, then having to divest at bargain-basement prices for survival's sake — Beatrice a case in point). So diversification by the corporation is of questionable benefit, at least to stockholders. If the stockholder owns a well-diversified portfolio, the failure of one stock would have limited adverse impact on her wealth since the other stocks would be unaffected and might even benefit from the failure.

To the manager, however, salary represents the primary source of income, and the corporation's survival is a prime determinant of personal wealth. If the corporation founders or fails, the manager may find himself standing in the unemployment line, the possessor of a tainted resume. To reduce this risk, the manager may recommend corporate diversification so that the corporation's survival is better assured, not being dependent on the success of a single line of business.

Research aimed at investigating the relationship between corporate characteristics and the level of manager ownership provides interesting evidence on the problems outlined above. One study reveals that firms with low manager ownership have a tendency to carry relatively higher levels of liquid assets (primarily cash, marketable securities, and inventories) than firms with high insider ownership. A high level of liquid assets is usually associated with a conservative, or even defensive, operational policy. This study suggests that firms with low manager ownership pursue more conservative policies related to investment in working capital than otherwise similar firms with high manager ownership.

Another aspect of the firm's investment decision relates to corporate diversification. As explained above, diversification is of little benefit to the well-diversified stockholder, but may be of great value to the manager whose wealth is dependent primarily on the survival of the corporation.

Recent studies suggest that firms with low manager ownership pursue conglomerate mergers to a much greater degree than of high-manager-ownership firms. Conglomerate mergers, by definition, represent combinations of unrelated businesses. As a result, synergies — where the combined result is greater than the sum of the parts — cannot be used as justification for the mergers. Instead, they are pursued to obtain greater diversification of the firm's operations, and thereby to reduce risk. This suggests that the incentives to diversify the firm's operations is different for the firms with high manager ownership and those with low manager ownership.

Another recent study finds that managers with small amounts of stock ownership are more opposed to takeovers of their companies than are managers with high amounts of stock ownership. Stockholders of target companies usually realize substantial increases in wealth as a direct result of takeover attempts; managers of firms that are acquired usually are released once the acquisition is accomplished. Target company managers with small amounts of stock ownership stand to lose much in a successful takeover, and try to thwart the attempt.

In summary, evidence suggests that the most crucial decision facing financial managers — the investment decision — is significantly influenced by the level of manager stock ownership. Managers who are not owners pursue financial goals which may not be in the best interests of stockholders. In general, these policies suggest a more conservative attitude than is the case for manager-owners.

MANAGER OWNERSHIP AND RETURN ON INVESTMENT

It is fairly common to find investment advisors who recommend stocks of companies on the basis of high stock ownership by firm managers. The arguments are sensible and, in fact, follow from the suggestions made above — managers with high stock ownership have greater incentive to work harder, stick their necks out, and not waste assets on silly investments.

Unfortunately, the matter isn't at all clear. Writers who propose "evidence" that manager ownership produces superior returns usually rely only on a few select examples. They cite a few cases of successful companies where owners are active in management — Sam Walton and Wal-mart as an example — and conclude that high manager ownership will produce equally superior returns in other firms. That may be, but isolated examples do not a reliable investment rule make.

Simply stated, empirical evidence doesn't suggest any consistent relationship between the level of manager ownership and the returns on common stock. A number of problems exist in measuring such things, most of them concerned with adjusting for the relative riskiness of the stocks. Barring a breakthrough in developing better measurement tools, the investor should be aware that the evidence does not support the often-made claim that stocks of high-manager-ownership firms outperform others.

CONCLUSION

Agency theory proposes that the separation of ownership and control in the modern corporation produces conflicts of interest within the firm that lead to management decisions that are not in the stockholders' best interests. Research suggests that these conflicts produce problems which are manifested in the firm's investment policies.

Many firms have recognized these potential problems, and have responded by making stock ownership and stock option plans a part of the management compensation package. These attempt to realign manager and shareholder interests to encourage managers to act more like owners.

The ENTREPRENEUR is a quarterly journal and newsletter addressing contemporary economic issues from a moral perspective. One may not agree with every word printed in the ENTREPRENEUR series, nor should one feel he needs to do so. It is hoped that the reader will think about the points laid out in the publication, and then decide for himself.