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Capital allocation and delegation of decision-making authority within firms ☆

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A B S T R A C T

We use a unique data set that contains information on more than 1,000 Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) around the world to investigate the degree to which executives delegate financial decisions and the circumstances that drive variation in delegation. Delegation does not appear to be monolithic; instead, our results show that it varies across corporate policies and also varies with the personal characteristics of the CEO. We find that CEOs delegate financial decisions for which they need the most input, when they are overloaded, and when they are distracted by recent acquisitions. CEOs delegate less when they are knowledgeable (long-tenured or with a finance background). Capital is allocated based on "gut feel" and the personal reputation of the manager running a given division. Finally, corporate politics and corporate socialism affect capital allocation in European and Asian firms.

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1. Overview

An exciting new area of research looks inside the black box of the firm, to understand how corporate decisions are made and by whom. One branch of the organizational economics literature focuses on the delegation of decision-making authority (see Section 2 for a review). A basic framework involves a principal (the Chief Executive Officer (CEO) in our analysis) who needs information or effort from an agent (upper level management in our analysis). In order to benefit

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from employees' information or proximity to certain activities, the CEO considers sharing control via delegating decision-making authority down the corporate ladder. The CEO could in principle gather the desired information but this self-gathering approach would become more costly to the CEO as the firm becomes very large or complex or as the CEO becomes overloaded (e.g., Aghion and Tirole, 1997). While the theoretical literature identifies many interesting trade-offs, the empirical evidence is scarce because [as noted by Prendergast (2002)] and others the econometrician can rarely observe the roles and responsibilities behind the corporate decision-making process, including how these vary across different decisions and settings.

We use a unique database of executive decision-making to study how CEOs and other high-level managers share the decision-making process related to five important corporate decisions: financing choices, returning capital to investors, mergers and acquisitions (M&A), corporate investment, and the allocation of capital across divisions. Our analysis relies on an anonymous survey-based sample of more than 1,000 CEOs and 500 CFOs who work in U.S.-based companies. In addition, we sample approximately 800 Asian and European executives. These business leaders provide information about their own backgrounds and training, demographic information about their firms, and the degree to which the five corporate finance policy decisions are delegated. In addition, we probe more deeply into decision rules associated with capital allocation.

Our data set has substantial variation across people, firms, divisions, industries, countries, and crucially, in the importance of informational inputs coming from different levels of the corporate hierarchy. This allows us to measure the degree of delegation in general, whether delegation varies across policies and settings, and to the extent that it varies, the factors that drive the variation. Our main findings can be grouped into the following themes.

First, we study whether delegation is company-wide; that is, invariant within the firm. We examine how the magnitude of delegation varies across the five key corporate policies, whether the sensitivity of delegation varies across policies and key drivers of those policies, and in particular, whether this variation is tied to the information requirements of the different policies. We also study interactions in delegation across policies.

We find evidence of the CEO's influence across all policies we study within a given firm. Even so, though it is often modeled as being company-wide, we also establish that delegation is *not* a monolithic decision across the entire firm but rather varies with the information characteristics of the policy. Aghion and Tirole (1997) and Harris and Raviv (2005) argue that CEOs likely possess the greatest informational advantage for M&A and we find that they are least likely to delegate M&A decision-making. In contrast to an external-facing policy like M&A, CEOs need the most internal informational input for investment decisions (capital allocation and corporate investment), policies that we find they delegate the most. The informational needs and delegation of capital structure and payout fall in between these extremes.

Not only does the magnitude of delegation vary across policies based on information needs, as just discussed, but the sensitivity of the delegation decision to key drivers also varies with the informational needs of a given policy. For example, the marginal effect of CEO job tenure is greatest for M&A, and to a lesser extent for capital structure and payout. Thus, our evidence is consistent with an interpretation rooted in the informational needs of the policy.

We also examine whether CEO involvement in (and potential distraction by) one policy or aspect of the firm could capture the CEO's focus and lead to more delegation in other policies. We find some evidence of this. In particular, we find that in firms that have recently completed multiple mergers and acquisitions, the CEO is more likely to delegate the capital structure and capital allocation decisions to others. To our knowledge, we are the first to so closely tie delegation to CEO distraction or preoccupation with other recent events, as predicted by theory related to complexity. In addition, we discuss whether there may be offsetting influences on the desire to delegate versus centrally coordinate certain policies.

Second, our results reveal that decisions are made by people within firms, not just by firms as generic entities (though firms matter too, as discussed below). This is evident in that the degree of delegation varies with the personal characteristics and experiences of the CEO. In particular, we find that less delegation occurs when the CEO is particularly knowledgeable about a decision and when executive pay is primarily incentive-based. As an example of the former, a CEO delegates less as job tenure increases and when the CEO has a finance-focused background. We also find that the amount of capital allocated internally increases with the reputation and past success of divisional managers, more evidence that specific people matter (e.g., perhaps via their individual characteristics or work relationships with the CEO), not just the numbers and job descriptions.[1]

Third, in addition to the people involved, delegation is affected by company characteristics and circumstances. For example, we find that CEOs are more likely to delegate decision-making authority down through the corporate hierarchy when their firms are large or complex (multi-segment), which according to theory can cause CEO overload and increase the need to delegate (Aghion and Tirole, 1997; Harris and Raviv, 2005).

Fourth, given the high degree of delegation in capital allocation noted above, and because allocating capital to divisions involves delegating both funds and decision-making authority, we explore this policy in more detail. We find that companies rely on several decision rules when allocating capital, including net present value (NPV) ranking, the timing of cash flows and financial constraints, as well as some rules tied closely to the people involved, such as the divisional manager's reputation and senior management's "gut feel." We also find some evidence of variation across countries in that corporate socialism (that is, even distribution of capital across divisions) and corporate politics are more important in Europe and in Asia than they are in the U.S.

[1] This result is consistent with the existence of relational contracts between the CEO and managers (Gibbons and Henderson, 2012).

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