Trust: The Unwritten Contract in Corporate Governance

By David F. Larcker and Brian Tayan
July 31, 2013

INTRODUCTION

Corporate governance systems exist to discourage self-interested behavior. Although shareholders would like organizational participants—employees, managers, executives, and directors—to work toward a shared goal of increasing corporate value, in reality each has individual interests that influence how they make decisions on a day-to-day basis. To economists, this is fundamentally an incentive problem: the incentive to work for one's own benefit is stronger than the incentive to work for the firm's benefit. The solution is to create a system—through contracts, controls, and procedures—that corrects this imbalance by aligning the interests of insiders with those of shareholders and encouraging insiders to take actions that benefit the organization as a whole and not just themselves.

An overlooked question is how extensive this system should be. The degree to which a company requires rigorous controls depends on the degree to which self-interest exists in the organization. A look at governance systems today suggests that self-interest is high because the list of governance requirements is extensive. Companies spend tens of millions of dollars annually on incentive compensation, director salaries, audit fees, internal auditors, and compliance efforts to satisfy a long list of rules, regulations, and procedures imposed by legislators and the market. Would corporate governance improve if companies instead had *fewer* controls? Would shareholders be better off if organizations instead demonstrated more *trust* in employees and executives?

THE ROLE OF TRUST

Although economists, psychologists, and sociologists use different definitions, fundamentally "trust" is having certainty about how another person will act.[1] In a corporate setting, a trusting manager "knows" that his or her employees will work diligently and in good faith to meet their commitments, and a trusting employee knows that a manager will adhere to agreed upon standards of oversight. Trust replaces the need for a written contract because these two parties commit in advance (implicitly or explicitly) to abide by a set of actions, behaviors, or norms that are mutually beneficial. Trust substitutes for rigorous controls because these controls become redundant.

An important presumption in the research literature is that relationships based on trust are more productive than relationships based on contracts. Kramer and Cook (2004) outline the many reasons why this is so. First, it is impossible to write a contract that specifies all behaviors. A contract to prevent self-interested behavior must necessarily be incomplete because it cannot anticipate all manifestations of self-interested behavior. By contrast, both parties in a trusting relationship generally understand the limits of acceptable behavior even when these are not fully specified. Second, an emphasis on contracts can cause employees to "work to rule." Strict enforcement of the terms of a contract has the unintended consequence of emphasizing the minimum amount of work required for an employee to satisfy his or her obligations and avoid punishment. A contract can therefore reduce, rather than increase, productive effort. Third, trust creates a more predictable environment, and predictable environments are less costly. From an economic perspective, a "risk premium" is required to deal with uncertain behavior. Supervisors must

put additional effort into monitoring employee actions, and employees must exert additional effort to demonstrate that they are compliant with the firm's standards. When trust is introduced into the environment, the motivations of each party are known ("certain"), their behaviors are predictable, and the "risk premium" is eliminated.[2]

For these reasons, a corporate governance system based on trust might be more cost-effective than one built on elaborate controls and procedures. However, in order for this to be true, self-interest within the organization must be low. It must be understood and accepted by both parties that each will elevate organizational interests above self-interests. Employees have to know that they will receive market-competitive rewards for meeting their obligations to the firm, and governance monitors have to know that they can trust the actions and motivations of employees. To build trust, a combination of structural and cultural changes are required (see Exhibit 1).

Once established, a high-trust governance system allows for the reduction or elimination of many of the costs, controls, and procedures that characterize today's governance systems. In the extreme case (utopia), the following could occur:

- *Board of directors*. The responsibilities of the board of directors could be significantly narrowed. Rather than balance advisory and monitoring obligations, the board would focus entirely on advising management on matters involving strategy, organizational design, and risk management (see Exhibit 2). Board-related compensation, which averages $2 million per year among mid-sized companies, would be greatly reduced.[3]
- *External audit*. The external audit could become largely unnecessary. Rather than sample a large number of accounts for material misstatement and check internal controls for deficiencies, the external auditor would serve a much narrower role of clarifying the application of accounting standards when questions arise. Audit fees, which average $3.9 million among publicly traded companies, would therefore also be greatly reduced.[4]
- *Internal audit*. The internal audit function could also become unnecessary. Companies would not require an independent assessment of their accounts, controls, and procedures because employees would be trusted not to abuse the system. Instead, the finance department would employ a small staff of personnel to check accounts for inadvertent errors. Headcount in the internal audit department, which averages seven to fifteen auditors in a typical organization, would shrink.[5]
- *Executive compensation*. Compensation contracts could be simplified. Most companies today offer a complicated program of fixed and contingent payments that vest over short- and long-term time horizons to motivate specific employee behaviors. In a trust-based environment, an elaborate program becomes unnecessary. Companies would also no longer have to pay the risk premium associated with contingent (risk-based) pay. Instead, companies would offer large fixed salaries, potentially supplemented with cash bonuses for achieving critical performance metrics. Equity programs, which require a larger risk premium relative to cash programs, would be scaled down or discontinued.[6]
- *Compliance and legal*. Finally, companies could eliminate many of the bureaucratic checks and controls that are often implemented to prevent and detect legal or regulatory violations. Instead, employees would self monitor, with line-managers responsible for reporting inadvertent legal or regulatory missteps to higher level executives.

Several examples exist of companies that demonstrate trust in their employees and managers, and each benefits from the types of cost reductions outlined above. For example, Berkshire Hathaway is renowned for granting considerable autonomy to the operating managers of its various businesses. This allows the company to maintain an extremely modest headcount of only 24 staff at company headquarters, despite having 288,000 employees worldwide.[7] Real estate company Keller Williams maintains a strict "open books" policy. All agents within the company's market centers have access to detailed information about the office's revenues, commissions, and costs. This reduces opportunity

for theft, waste, or special dealings; and also the need for a robust internal audit department.[8] Finally, Netflix is known for maintaining a high-performance culture rooted in the concept of "freedom and responsibility." Employees are expected to work hard, take ownership, and put the company's interests ahead of their own. In return, the company offers top-of-market salaries equivalent to the combined value of the salary and bonus offered by other firms. Netflix does not offer incentive bonuses, and equity compensation is only granted to employee's that request it as a portion of their compensation mix.[9]

Still, a company that adopts a high-trust governance system cannot entirely eliminate the risk that its trust will be abused. The downside is potentially amplified because the company will not have effective controls in place to deal with the breakdowns when they occur. Such a situation might have occurred at Johnson & Johnson, which historically has maintained a highly decentralized management system. In 2009, this structure was challenged when the company issued the first of what eventually became three dozen product recalls due to faulty manufacturing in its consumer healthcare division. A *Fortune* magazine article blames the recalls in part on "a wrenching cultural change and a quality assurance department that crumbled as mistakes were overlooked."[10]

WHY THIS MATTERS

1. Research suggests that companies might benefit by raising the level of "trust" in their organizations. High-trust settings are characterized by lower bureaucracy, simpler procedures, and higher productivity. Would shareholders be better off if companies had fewer formal corporate governance requirements and instead devoted greater effort to fostering trust?
2. Prominent corporate failures in 2001 (Enron, WorldCom, etc.) and 2008 (Lehman Brothers, AIG, etc.) ushered in an increase in regulatory requirements for corporate governance. However, the standards they imposed on board structure, internal controls, and compensation were designed with the worst offenders in mind. Is it cost-effective to impose these same standards on all companies? Should average companies be presumed to be more "trustworthy?"
3. In order for a trust-based governance system to work, companies must first develop a culture that discourages self-interest. How should executives and directors go about achieving this? Is a reduction of self-interest possible in all industries, or are some industries inherently more likely to attract individuals who put their own interests first? Are CEOs of a certain personality type more capable of developing trust?

If you know a company with a "high trust" culture, email us the details at: corpgovernance@gsb.stanford.edu. ■

[1] For reviews of the research literature, see: Roderick M. Kramer, "Trust and Distrust in Organizations: Emerging Perspectives, Enduring Questions," *Annual Review Psychology* (1999); and Denise M. Rousseau, Sim B. Sitkin, Ronald S. Burt, and Colin Camerer, "Not So Different After All: A Cross-Discipline View of Trust," *Academy of Management Review* (1998).

[2] Roderick M. Kramer and Karen S. Cook, editors, *Trust and Distrust in Organizations: Dilemmas and Approaches* (New York: Russell Sage Foundation, 2004). See in particular Chapter 5: "Monitoring, Rules, and the Control Paradox: Can the Good Soldier Svejk Be Trusted?" by Gary J. Miller; and Chapter 6: "Commitment, Trust, and Worker Effort Expenditure in Organizations," by John M. Darley.

[3] Estimated based on average board size of 11 directors and average annual compensation of $178,000. Sources: Spencer Stuart Board Index 2012; and Frederick W. Cook & Co., Inc. 2012 Director Compensation Report.

[4] FEI, Audit Fee Survey 2011.

[5] The Institute of Internal Auditors, "Knowledge Alert: Internal Auditing in 2010: Shifting Priorities for a Changing Environment" (March 2010).

[6] See: Richard A. Lambert, David F. Larcker, and Robert E. Verrecchia, "Portfolio Considerations in Valuing Executive Compensation," *Journal of Accounting Research* (1991).

[7] Berkshire Hathaway, 2012 Annual Report.

[8] See: James N. Baron and Brian Tayan, "Keller Williams Realty," Stanford GSB Case No. HR-29 (2007).

[9] See: David F. Larcker and Brian Tayan, *A Real Look at Real World Corporate Governance*, Chapter 12: "Netflix: Equity on Demand" (2013).

[10] Mina Kimes, "Why J&J's Headache Won't Go Away," *Fortune* (Aug. 19, 2010).

David Larcker is the Morgan Stanley Director of the Center for Leadership Development and Research at the Stanford Graduate School of Business and senior faculty member at the Rock Center for Corporate Governance at Stanford University. Brian Tayan is a researcher with Stanford's Center for Leadership Development and Research. They are coauthors of the books *A Real Look at Real World Corporate Governance* and *Corporate Governance Matters.*

The authors would like to thank Michelle E. Gutman for research assistance in the preparation of these materials.

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EXHIBIT 1 — MECHANISMS OF ORGANIZATIONAL CHANGE THAT MIGHT INFLUENCE "TRUST"

FORMAL MECHANISMS

- Reporting structures
- Decision rules and rights
- Business processes and policies
- Training, leadership, and organizational development programs
- Performance management
- Compensation and rewards
- Internal communications
- Councils and committees
- Company events

INFORMAL MECHANISMS

- Behavior modeling by senior leaders
- Meaningful manager-employee connections
- Internal, cross-organizational networks
- Ad hoc gatherings
- Peer-to-peer interactions and storytelling
- Communities of interest
- Engagement of exemplars and motivational leaders
- Changes to physical plant, resources, and aesthetics

Source: Jon R. Katzenbach, Ilona Steffen, and Caroline L, "Cultural Change That Sticks," *Harvard Business Review* (July/August 2010).

EXHIBIT 2 — POTENTIAL REDUCTION OF BOARD DUTIES IN A HIGH-TRUST SETTING

RESPONSIBILITIES THAT COULD BE ELIMINATED

- Review and monitor the implementation of the strategic plan
- Review and approve potential mergers, acquisitions, and asset sales
- Review and approve annual operating plans and budgets
- Evaluate corporate performance in relation to the strategic plan and budget
- Evaluate performance of the CEO
- Evaluate performance of individual directors
- Review and audit financial reporting and internal controls
- Review risk management policies and procedures
- Review policies and procedures to ensure compliance with relevant laws and regulations

RESPONSIBILITIES THAT WOULD BE RETAINED

- Advise management on strategic plans
- Advise management on mergers, acquisitions, and asset sales
- Advise management on risk
- Determine appropriate CEO compensation levels
- Develop a CEO succession plan
- Identify and recruit new directors to the board
- Maintain relationships with shareholders and external constituents

Source: The authors.