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Capital Allocation and Delegation of Decision-Making Authority within Firms

Posted by R. Christopher Small, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday December 18, 2014 at 9:11 am

Editor's Note: The following post comes to us from John Graham, Campbell Harvey, and Manju Puri, all of the Finance Area at Duke University.

In our paper, Capital Allocation and Delegation of Decision-Making Authority within Firms, forthcoming in the *Journal of Financial Economics*, 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. Our results can be grouped into four themes.

First, the degree of delegation is not monolithic for a given firm. Delegation varies across corporate policies and in particular, it varies by the informational requirements needed to make a given policy decision. For example, CEOs delegate more when they need more input from their direct reports (such as for capital allocation and investment) and less when the CEO's informational advantage is at its greatest (M&A). We also document interactive effects across policies: Delegation of capital allocation and investment is greater in firms that have recently completed multiple acquisitions, likely because the executives are overloaded by the integration phase of previous transactions.

Second, decisions are made by individuals, not simply by corporate entities. We find evidence that CEOs are less likely to delegate decisions when they are knowledgeable about a policy (as measured by CEO tenure as well as work experience and educational background), and somewhat when the outcome matters more to them (as measured by incentive compensation). Also, the sensitivity of delegation to person-specific characteristics varies with the informational requirements of a given policy are greater. For example, CEO knowledge matters less for highly delegated policies.

Third, delegation decisions are also affected by the characteristics of the firm. Delegation increases with the number of business segments and firm size, evidence that CEO workload may be high, and in public firms.

Finally, there is a strong "human element" to the delegation of investment funds (capital allocation). In addition to net present value, CEOs rely heavily on informal allocation rules, many of which reveal a human element, such as the divisional manager's reputation, the timing of when cash flows are produced by a project, and senior management's "gut feel." We also find that, relative to U.S. firms, in Asian and European companies capital is more likely to be evenly distributed across divisions, and corporate politics are more likely to play an important role.

The full paper is available for download here.

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