Why Good Managers May Stick to Bad Decisions
- Internal Accounting Information, Managerial Turnover and Strategic Change

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Abstract

The connection between strategic change and managerial turnover is studied within a model where managers decide on a firm’s strategy. Managers as well as firm owners care for the long-term success of a company. But managers are also interested in their own reputation. Due to reputational concerns managers may be reluctant to alter strategic decisions they themselves made in the past even when internal accounting information indicates that they should do so. It is shown that it may well be optimal in some cases to dismiss managers of higher ability and keep managers of lower ability as the latter may be more willing to act on internal accounting information and change past decisions.

Key Words: Leading Indicators, Strategic change, Correction, CEO turnover, Reputation

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1 Introduction

Many aspects determine the decision whether the manager of a firm should be replaced in a certain situation. The key question addressed in this paper is in which way managerial turnover is related to strategic change. Are there reasons to exchange a manager when accounting information indicates that a major strategic change seems to be important for a company and how is this affected by the incumbent manager’s ability?

There are many examples from corporate practice indicating that managerial turnover is sometimes closely linked to firm’s decisions to change the strategic direction. One important reason discussed is that incumbent managers often seem to be reluctant to correct strategic decisions they themselves have made in the past. The latter argument is analyzed in this paper.

The following case study illustrates this argument. Bernd Pitschesrieder became CEO of BMW in 1993. At his initiative, BMW took over the British motor company Rover in 1994 for about 800 million pounds. The strategic objective of this decision was to enter the mass market for middle and lower class cars in addition to BMW’s own upper and upper middle class orientation. But right from the start Rover developed badly and made persistent losses. However, during nearly all of Pischetsrieder’s time in office the BMW brand itself was prospering.

In February 1999 Pischetsrieders was finally dismissed by the board and was replaced by Joachim Milberg. The German business daily Handelsblatt announced that this could introduce strategic change and the press agreed that the main reason for the dismissal was not his qualification but his lacking willingness to turn around or sell loss-making Rover. BMW’s stock price increased significantly at the announcement of his dismissal.

His successor Milberg immediately gave Rover an ultimatum of 121 days to solve its problems. In May 2000 BMW finally sold off Rover and returned to its strategy of being a premium brand automobile manufacturer. In total BMW lost an estimated 5 billion euros due to the Rover takeover. After the decision to sell Rover, BMW quickly regained its position among the world’s most profitable car manufacturers. But shortly afterwards Bernd Pischet-
srieder also returned to the industry, first, by becoming CEO of Spanish SEAT owned by Volkswagen AG. Finally, in April 2002 he was appointed as CEO of the whole Volkswagen group. When this became public, analysts applauded the board’s decision to choose Pischetsrieder as CEO.

It therefore seems interesting to investigate economic reasons for the reluctance of an apparently highly qualified manager to correct important strategic decisions he himself has made, which in turn may lead to his dismissal. We therefore construct a simple model in which a manager initially chooses a strategy. After some time has elapsed, the manager and the owner of the organization (or the board) receive some information from the accounting system containing a leading indicator on the success of the strategy. The owner can act on this information and may replace the manager. If retained the manager can decide on whether to correct his initial decision.

The key idea of our approach is that a manager’s utility is affected by two factors: his long-term interest in the firm’s success as well as his own reputation. The correction of a strategic decision which is publicly observable may be good for the firm’s long-term prospects but it may harm the manager’s reputation as it is revealed that he had previously chosen a bad strategy. We show that this may indeed prevent the manager from correcting a strategic decision although this would be in the owners’ best interest according to the internally observable accounting information.

Still, the owners can enforce necessary strategic change by dismissing the manager. It is therefore important to know under what circumstances the owners should take such a decision. As we will show, a manager of high ability will be more reluctant to alter a strategic decision than one of lower ability. This leads to the surprising effect that it is sometimes optimal to fire managers of high ability but keep those of lower ability when leading performance indicators show that strategic change should be enforced.

This result is due to the following effects: On the one hand a manager faces a utility loss when he corrects a decision: as outsiders do not know the manager’s ability and can only observe whether a correction has been made, this reputational loss is the same whatever the manager’s actual ability. But on the other hand, a manager of high ability (rightfully) has more confidence
in his initial choice even when intermediate information indicates that the strategy seems to be failing. Hence, a more able manager will be more ‘stubborn’ about sticking to his own decisions.

The paper builds on the literature on the effect of reputational or career concerns on managerial decisions starting with Holmström (1999) and Holmström and Ricart i Costa (1986). Bushman et al. (1989) explain the casual observation that managers tend to continue investing in failing projects with career concerns. Boot (1992) also shows that reputational concerns may keep managers from making efficient divestiture decisions. However in contrast to our model, Boot finds that less able managers are more reluctant to correct their decisions rather than more able managers. The key difference is that in Boot’s model a manager is only interested in his own reputation whereas in our model he also cares to some extent for the firm’s success. From this a natural trade-off between reputational loss and the firm’s interest arises in our model leading to the result that more able managers can be more reluctant to alter their decisions.

The paper is also related to the literature on reputational herding behavior, where it has been analyzed that managers have an incentive to distort their decisions due to reputational concerns when their private information does not correspond to publicly available information.\footnote{This literature starts with Scharfstein and Stein (1990), who assume that agents themselves do not know their own ability. Recently, Avery and Chevalier (1999) or Levy (2004) have shown that agents may have an incentive to anti-herd if they know their own talent.}

The decision whether to retain or dismiss a manager has mainly been studied in connection with the analysis of the board’s incentives to identify and fire bad managers such as in Hermalin and Weisbach (1998), Hirshleifer and Thakor (1994, 98) or Graziano and Luporini (2003). Recently, Dezső (2004) analyzed ‘scapegoating’, the random dismissal of an employee to maintain a firm’s reputation. A different reason for the dismissal of a manager of a firm has been analyzed in Hoeffer and Sliwka (2003) where employee’s incentives are strengthened to compete for attractive positions when a new manager comes in who is less well informed about their respective skills.

There are now numerous empirical studies on the determinants and con-
sequences of managerial turnover.\textsuperscript{2} Most of the studies focus on the development of the stock price and accounting figures before and after managerial changes. To investigate empirically whether the enforcement of a strategic change is the key reason for a dismissal is of course more difficult. However, there is some evidence that managerial turnover is linked to strategic change. Weisbach (1995) for instance finds that management change indeed leads to a higher probability of divestitures of assets that had previously been acquired by the outgoing manager. Denis and Denis (1995) give evidence that especially after forced resignations firms proceed with downsizing activities significantly more often than other firms in the same industry.

2 The Model

A manager $M$ works for a firm owned by an owner $O$. The manager’s key task is to make strategic decisions affecting the future of the firm. The owner’s utility is therefore affected by the manager’s strategic choice. The manager’s utility will be affected by several factors: First of all, he benefits from the firm’s success in the short and the long term. But in addition his utility is affected by his reputation in the labor market for managers.

The manager is either of high or low ability $a \in \{a_L, a_H\}$, where $1 > a_H > a_L > \frac{1}{2}$. Ex-ante it is known that the manager’s ability is $a_H$ with probability $\tau$. The manager himself knows his ability, but the owner and the outside market are initially uninformed about it. The firm faces an important strategic decision which has to be made by the manager. He can choose among two strategies, strategy $A$ or strategy $B$. For instance, the firm can decide on building a new plant, entering a new market or launching a take-over bid for another company. One of the two strategies is the optimal strategy $S^*$ for the firm, but it is not perfectly known whether it is strategy $A$ or $B$. From an ex-ante perspective, either of the two strategies is optimal with probability $\frac{1}{2}$.

However, the manager gets some information about the optimal strategic choice: He learns a private signal $s_1 \in \{A, B\}$ indicating the optimal strategy

\textsuperscript{2}See for instance Brickley (2003) for a brief overview.
with a probability $a$ equal to the manager’s ability. Hence, a more able manager is more likely to pick the right strategy. At a date $t = 1$ the manager makes the strategic choice $d_1 \in \{A, B\}$ which is publicly observable. After he has made this decision and some time has elapsed, the firm owner $O$ (or the board) but not the outside market learns the manager’s ability $a$ at date $t = 2$.

At date $t = 3$ the manager $M$ and the owner $O$ learn internal accounting information indicating whether the strategy is tending to work out well or whether it seems to be a failure. Both receive a signal $s_2$ which is a leading indicator on the future success of the strategy: When the accounting information is favourable the firm is better off sticking to the initial strategy and when it is unfavourable a strategic change would be beneficial. For ease of the exposition we assume that this signal $s_2 \in \{A, B\}$ is equal to the best strategy $S^*$ with probability $\eta > a_H$. Hence, this leading indicator of performance contains more information on the success of the strategy than the manager’s initial signal. The manager benefits from an early success of the project for instance as his compensation is tied to this non-financial performance indicator.\(^3\) Hence, he receives some short-term payoff

$$w_S = \begin{cases} 
0, & \text{if } s_2 \neq d_1 \\
W_S, & \text{if } s_2 = d_1,
\end{cases}$$

where $W_S$ is a given constant. After the signal $s_2$ is revealed to manager and owner, the strategic decision can be corrected by the manager. He has to make a decision $d_2 \in \{A, B\}$. When he sticks to the first decision then he chooses $d_2 = d_1$ and otherwise he corrects the initial strategic choice by choosing $d_2 \neq d_1$. This second decision is also publicly observable. For instance, the manager can decide to leave a newly entered market, to cancel the building of a new plant or to sell off an acquired company if the short-term results indicate that the strategy is failing.

After the signal $s_2$ is observed but before the manager’s correction decision $d_2$ is made, the owner may replace the manager as for instance she may fear that he will not take the appropriate decision. He will choose whether to either keep or fire the manager $r \in \{K,F\}$. When hiring a new manager the owner incurs some positive but small cost. A newly hired manager also learns $s_2$ and has to make the decision $d_2 \in \{A,B\}$. After this stage, i.e. after the strategy may or may not have been corrected, the manager receives some medium-term payoff influenced by his external reputation, which is assumed to be equal to

$$w_M = E[a | I_M] \cdot W_M,$$

where $I_M$ is the information the outside market has so far obtained on the managers ability and $W_M$ is a given constant measuring the importance of reputation for the manager’s utility. One possibility to explain this assumption is that the manager gets external wage offers on a competitive labor market. When we assume for instance similar to the career concerns literature\(^4\), that the manager’s value in a different firm is linear in his ability then this payoff function will take this form. Alternatively one can think of a situation where the manager simply cares for his reputation in public and therefore receives some utility depending on his expected ability when viewed by some outside observer as for instance by the business press.

Finally, the firm attains a profit $\pi$ which is equal to II if the manager indeed picked the optimal strategy such that $d_2 = S^*$ and zero otherwise. The manager receives a long-term payoff $w_L$ equal to

$$w_L = \begin{cases} 
0, & \text{if } d_2 \neq S^* \\
W_L, & \text{if } d_2 = S^*,
\end{cases}$$

where $W_L$ measures the importance of a long-term success for the manager’s utility. The manager may for instance benefit from the long term success of the project as a part of his compensation consists of stock options which he owns even after he has left the firm or he may simply receive an intrinsic

\(^4\)Compare for instance Holmström (1999) or Dewatripont et al. (1999).
benefit when his company prospers in the long term. The larger $W_L$, the more he will care for the firm’s future prospects. The manager’s overall utility is the sum of his short, medium, and long-term components $w_S + w_M + w_L$.

The time structure of the model is therefore as follows:

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<td>Manager can</td>
<td>Manager chooses $d_2$</td>
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<td>signal $s_1$ and chooses $d_1$</td>
<td>obtain internal report $s_2$</td>
<td>$r \in {K, F}$</td>
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To simplify the equilibrium analysis we will assume that $W_S$ is sufficiently large such that the manager will follow his first signal in any equilibrium. The key question we ask is whether the manager sticks to his initial decision when he receives a signal indicating that the project seems to be failing and whether there may be a reason for the owner to dismiss the manager.

### 3 The Correction of Strategic Decisions

Before starting the equilibrium analysis, it is instructive to consider the decision made by a newly hired manager at date 5. A new manager also receives the leading indicator accounting information $s_2$ before making decision $d_2$. Recall that this signal $s_2$ contained more information on the project’s final success than the initial signal that had been observed by the old manager. Furthermore, note that the new manager’s reputation is not affected by $d_2$ as his ability had no influence on the initial strategic choice. Hence, a newly hired manager will always follow $s_2$: he will correct the strategic choice whenever $s_2 \neq d_1$ and otherwise stick to the initial strategy.

Furthermore, note that the owner always wants the decision to be corrected if $s_2 \neq d_1$: The conditional expectation of $\pi$ is always higher when $d_2 = s_2$ as $\eta > a_H$. But this has important consequences for the final outcome: Suppose there is an equilibrium in which the decision is not corrected by an incumbent manager although it should be according to the owner’s
interests. Then the owner will always be better off by dismissing the manager in that case. Hence, a correction which is necessary from the owner's point of view is always enforced in equilibrium. We can summarize these considerations in the following Lemma:

**Lemma 1**

(i) A newly hired manager always corrects the decision when it is in the firm’s best interest to do so according to the leading indicator of performance (i.e. if $s_2 \neq d_1$).

(ii) In any equilibrium $d_2 = s_2$.

To describe Perfect Bayesian Equilibria of the game considered we still need to characterize:

- The owner’s decision $r$ whether to replace the manager depending on the initial strategic choice $d_1$ and the signal $s_2$.
- The incumbent manager’s decision $d_2$ conditional on his information at this point described by $s_1$ and $s_2$.
- The market’s beliefs on the manager’s ability after observing $d_1$ and $d_2$ given that the incumbent manager has not been dismissed.

The key question that remains to be answered is whether and when the incumbent manager corrects a strategic choice if he is in a position to do so. Note that the manager has to take two effects into account: first, the strategic choice affects the long term success of the firm in which he has some interest. But second, a correction may influence his external reputation as the market updates its beliefs on the manager’s ability after observing $d_2$.

### 3.1 The Impact on Long-Term Success

Recall that the manager and owner receive both a report on the success of the initially adopted strategy at date $t = 2$ and that this report is more informative than the signal the manager initially received. As we have noted above, it is therefore always in the owner’s best interest to follow this second signal. When only the long term success of the company is considered, the
manager’s interests are completely aligned with those of the owner. Hence, the expected value of his long term payoff \( W_L \) is always larger when he follows \( s_2 \) and corrects his decision whenever \( s_2 \neq s_1 \). It is however important to note that the size of the expected long-term gain from a correction depends on the manager’s ability as the following result shows:

**Lemma 2** If the leading indicator of performance indicates that strategic change would be beneficial (i.e. \( s_2 \neq s_1 \)) a correction of the strategy always increases the manager’s expected long-term payoff \( E[w_L] \). The manager’s expected long-term utility gain from a correction \( \Delta w_L \) is larger, the lower the manager’s ability \( a \):

\[
\Delta w_L (a_H) = \frac{\eta - a_H}{a_H - 2\eta a_H + \eta} W_L < \Delta w_L (a_L) = \frac{\eta - a_L}{a_L - 2\eta a_L + \eta} W_L.
\]

**Proof:**

If \( s_2 \neq s_1 \) and a manager corrects the decision, then the newly adopted strategy will be successful, whenever the second signal \( s_2 \) is equal to the optimal strategy. Hence, for a manager of ability \( a \) the probability of achieving a long-term success after a correction is

\[
\Pr\{s_2 = S^*|s_2 \neq s_1\} = \frac{\Pr\{s_2 = S^*, s_2 \neq s_1\}}{\Pr\{s_2 \neq s_1\}} = \frac{(1-a)\eta}{a(1-\eta) + (1-a)\eta}.
\]

If \( s_2 <> s_1 \) but the decision is not corrected, the probability of achieving long-term success is

\[
\Pr\{s_1 = S^*|s_2 \neq s_1\} = \frac{\Pr\{s_1 = S^*, s_2 \neq s_1\}}{\Pr\{s_2 \neq s_1\}} = \frac{a(1-\eta)}{a(1-\eta) + (1-a)\eta}.
\]

Hence, a correction raises the probability of success by

\[
\frac{(1-a)\eta}{a(1-\eta) + (1-a)\eta} - \frac{a(1-\eta)}{a(1-\eta) + (1-a)\eta} = \frac{\eta - a}{a - 2\eta a + \eta}.
\]

Note that

\[
\frac{\partial}{\partial a} \left( \frac{\eta - a}{a - 2\eta a + \eta} \right) = 2\eta \frac{-1 + \eta}{(a - 2\eta a + \eta)^2} < 0
\]
and hence, the gain from correction is larger for the less able manager.

The intuition for this result is the following: a more able manager has a higher probability of adopting the optimal strategy right away. Hence, a more able manager can be more confident that his initial choice is the right one and will be confirmed by the early accounting information. A less able manager can and will put less trust in his first decision. Both types of managers get more information from the leading indicators on the success of the project. But this gain in information is smaller for a more able manager.

Note that when \( s_1 = s_2 \) a correction will of course always result in an expected loss in long-term payoffs

### 3.2 The Impact on the Manager’s Reputation

But in addition the external market may learn something from the manager’s decisions. When the decision is corrected, this indicates that the manager’s initial decision has not been confirmed by the short-term outcome. Hence, the outside market will update its beliefs on his ability as the latter determined the probability of choosing a successful strategy.

It is important to note that the market cannot observe the internal accounting information. But the market can observe whether or not the manager corrected the strategic decision and, hence, the market’s expectation will only depend on the correction. Hence, the utility loss for the manager due to a loss of reputation will be the same whatever the manager’s ability. This has an important implication:

**Lemma 3** There is no equilibrium in which only managers of high ability correct the decision when it is in the firm’s best interest according to the leading performance indicator.

**Proof:**

Let \( \Pr \{ a = a_H | r = K, d_1 \neq d_2 \} \) be the probability that the market attaches to the event that the manager is of high ability when he is kept and corrects his decision and \( \Pr \{ a = a_H | r = K, d_1 = d_2 \} \) when he is kept and does not
correct the decision. Then
\[
\Delta w_M = (a_L + (\Pr \{a = a_H | r = K, d_1 \neq d_2\}) - \Pr \{a = a_H | r = K, d_1 = d_2\}\} (a_H - a_L)) W_M
\]
is the expected change in the manager’s mid-term payoff when he corrects
the decision which of course depends on the equilibrium strategies. Note
that in any equilibrium this expression is the same for managers of both
types. A manager will correct his decision if
\[
\Delta w_M + \Delta w_L (a) \geq 0.
\]
From Lemma 2 we know that \(\Delta w_L (a)\) is decreasing in \(a\). Hence, when this
condition is met for a manager of high ability, it will also always be met for
one of low ability.

Both types of managers incur a loss in reputation of the same size if the
decision is corrected. But the gain in long-term prospects is larger for the
manager of low ability. If in equilibrium the gain in long term prospects
from a correction outweighs the loss in reputation for a manager of high
ability then this will always also be the case for a manager of low ability.
Hence, a manager of lower ability always has a stronger incentive to correct
the decision.

In addition, however, for a low-ability manager the probability that a
correction becomes necessary will be larger as he has a lower probability
of picking the optimal strategy right from the start. As we will see, both
effects together imply that in equilibrium a manager’s reputation will suffer
when he corrects a decision: the observation of a correction will decrease
the subjective probability the market attaches to the manager being of high
ability.

When the short-term results of the strategy do not confirm the initial
choice, an incumbent manager faces a trade-off. By correcting his initial
decision he raises the expected long-term payoff of the project but his repu-
tation suffers. Of course, the loss in reputation depends upon the equilibrium strategies of manager and owner.

3.3 Equilibrium Analysis

First, we check whether an equilibrium exists in which managers of either ability will always correct their decisions, when the accounting information indicates that a correction becomes necessary. In that case a manager would never be dismissed in equilibrium. If the market then observes a correction without dismissal it can conclude that the signals were different but the manager’s type cannot be perfectly inferred. A correction leads to a loss in reputation as for managers of low ability the probability of observing dissenting signals is larger. However, this loss in reputation is relatively weak as it may also happen to a manager of high ability. As the following result shows, such an equilibrium may indeed exist:

**Proposition 1** If managers do not care much for their reputation i.e. \( W_M \) is sufficiently low or if the uncertainty about the manager’s ability is small (i.e. \( \tau \) sufficiently large or sufficiently small) an equilibrium exists in which a manager always corrects his strategic decisions if it is necessary from the owner’s point of view.

**Proof:** See appendix.

This result is illustrated in Figure 1. A manager corrects his decision when \( s_1 \neq s_2 \) if and only if the loss in reputation is smaller than the long-term gain. The inversely U-shaped curve starting from the origin depicts the loss in reputation \( \Delta w_M \) when both types correct the decision if \( s_1 \neq s_2 \) as a function of the fraction of high ability managers \( \tau \). Both types of managers correct their decisions whenever this curve is below the long-term gain from a correction for a manager of high ability \( \Delta w_2 (a_H) \) which implies that it is also below \( \Delta w_2 (a_H) \).

Recall that the only reason for not correcting the strategic choice was that a manager’s reputation suffers from a correction. If the manager’s
reputation has only a weak influence on his utility he will therefore act in the owner’s best interest as he also benefits from the long-term success of the firm. Of course, this will be the case when $W_M$ is sufficiently small. However, note that it is also the case when $\tau$ is either very large or very small. To understand this, note that in those cases there is not much uncertainty about the manager’s type. In the characterized equilibrium both types act in the same way and the loss in reputation therefore originates only from the fact that less able managers have to correct more often. When a correction is observed, the probability will be larger that the manager is of low ability than without a correction. But even with this information, when $\tau$ is very large the market will still believe that the manager is of high ability with a very high probability since high ability managers also correct their decisions. Hence, the loss in reputation is small. On the other hand, when $\tau$ is very small the market will believe even without a correction that the probability is very large that the agent is of low ability and again and by not correcting the decision the manager cannot gain too much. Hence, the effect on the company’s long-term success will outweigh the effect on reputation in those cases.

This, however, will no longer be true when reputational concerns become more important. Now we consider possible equilibria in which the manager never corrects a decision, whatever his ability. If this happened in equilibrium, the owner would of course dismiss any incumbent manager when a correction became necessary. Note, of course, that on the equilibrium path we would then never observe an incumbent manager who corrects his decision. To check whether such an equilibrium exists we have to consider the worst possible loss in reputation a correction could cause, which occurs when the market believes that the manager is of low ability once a correction by an incumbent manager is observed off the equilibrium path. In that case, a correction leads to a stronger loss in reputation than in the previous case. This again strengthens the manager’s incentives never to correct a strategic choice. The existence of such equilibria is characterized in the following result:
Equilibrium exists in which both types correct.

Figure 1: Incumbent managers correct their decisions.

**Proposition 2** If managers care much for their reputation i.e. $W_M$ is sufficiently large and if there is a high ex-ante probability that the manager is of high ability there is always an equilibrium in which the manager never corrects his strategic choice whatever his ability. Therefore any incumbent manager is dismissed when a correction becomes necessary.

**Proof:** See appendix.

Note that the market cannot infer the manager’s type when it is observed that an incumbent has not been dismissed and has stuck to the initial decision. However, the larger $\tau$, the higher is the probability that such a manager will be of high ability. Hence, the worst possible loss in reputation is upward sloping in $\tau$. This equilibrium is illustrated in Figure 2. The upward sloping curve starting from the origin depicts the worst possible loss in reputation caused by a correction. An equilibrium exists in which neither
type corrects his decision when this loss in reputation exceeds the long-term gain from a correction for a manager of low ability $\Delta w_2(a_L)$. This is the case when the manager’s reputational concerns $W_M$ are sufficiently strong, and if the prior probability that the manager is of high ability is sufficiently large.

In this equilibrium, managers do not correct their decisions although it would be in the owner’s interest for them to do so. A key implication is that dismissing a manager may well become beneficial when strategic change is necessary from the owner’s point of view. Managers fear to abandon their own past decisions as the outside market may infer that they are of low ability.

Figure 2: Managers never correct their decisions

We have seen in Lemma 3 that there will never be an equilibrium in which only the high ability managers correct their decisions. Hence, a possible pure strategy equilibrium that has been left out so far is one in which low ability
managers correct their decisions but high ability managers do not. Would such an equilibrium exist then high ability managers will be dismissed when a correction becomes necessary but low ability managers will be retained. If in this case a correction is observed by the market, a manager will be identified as being of low ability and the loss in reputation will again be large.

**Proposition 3** If the managers neither care too much nor too little for their reputation, i.e. for intermediate values of $W_M$, there will always be equilibria in which a manager of low ability will correct his decision when it is necessary but a manager of high ability will never do so and hence is dismissed when a correction becomes necessary.

**Proof:** See appendix.

![Graph](image)

**Figure 3:** Only low ability managers correct their decisions
Note that as in the previous case the loss in reputation will be relatively large as compared to the loss when both correct their decisions. A manager is identified as being of low ability when he corrects his decision. In contrast to the previous case this loss in reputation actually occurs on the equilibrium path as low ability managers indeed correct their decisions and high ability managers do not. The functional form of this reputational loss takes exactly the same form as the worst reputational loss when neither corrects: In both cases the market learns from observing a manager who has not been dismissed and has stuck to his decision that his initial choice has been confirmed by the short term results and in both cases a manager who corrects his decision will be regarded as one of low ability.

Recall that a high ability manager can be more confident than a low ability manager that the strategy will finally turn out to be a success although the short term signals indicate the opposite. Hence, for intermediate values of $W_M$ the loss in reputation from a correction will outweigh the long-term gain for a high ability manager but not for a low ability manager. This is illustrated in Figure 3.

In turn, the owner will dismiss the ‘more stubborn’ high ability manager in that case but keep the low ability manager as the latter is ‘more modest’ and therefore ready to overrule his own decision. Hence, if an important change in a firm’s strategy seems appropriate it may well be optimal to dismiss a manager of high ability, not although, but precisely because he is of high ability.

Figure 4 illustrates all pure strategy equilibria. For certain parameter constellations there exist multiple equilibria. Consider for instance the area where an equilibrium in which both types correct coexists with one where only the low ability managers correct their decisions. The multiplicity can be interpreted as the feasibility and stability of different conventions in different managerial labor markets. If the market believes that only managers of low ability correct their decisions then the reputational loss from a correction is large. In this area such perceptions keep high ability manager from correcting decisions but not managers of low ability. If however the market thinks that managers always correct their decisions when it is necessary,
then the reputational loss is smaller. In turn, it is less harmful to correct a strategic choice and managers will do so regardless of their ability.

4 Conclusion

In reality many other aspects are of course important and have to be considered when a major shift in a firm’s strategy seems appropriate and the dismissal of a manager is considered. But this paper shows that it is not so much the managerial skills themselves that should guide the decision to replace a manager but rather the manager’s willingness to act in the firm’s best interest.

It is important to note that from an ex-ante point of view the owners are of course better off having a manager of high ability as he will choose the better strategy right from the beginning. Still – as our simple model has
shown – this changes ex-post when internal accounting information indicates that the strategy seems to be wrong. As we have shown, it may well be the case that exactly highly skilled managers may be less willing to act on this information and alter decisions they themselves have taken in the past.

5 Appendix

We already know that in equilibrium $d_1 = s_1$ and that a new manager will always choose $d_2 = s_2$. Due to the symmetry of the model with respect to the possible strategy choices $A$ and $B$, it suffices to specify the owner’s and the manager’s strategy after date 2 for either the case that the same or different signals have been observed. For ease of notation, let $c \in \{C, N\}$ be the decision on a correction such that $c = C$ when $d_1 \neq d_2$ and $c = N$ otherwise. A perfect bayesian equilibrium can therefore be described as follows:

- Probability for a dismissal $\omega (d_1, s_2, a) \in [0, 1]$
  - When $s_2 \neq d_1$ (signals Differ) & the manager is of high ability $\omega_{DH}$
  - When $s_2 \neq d_1$ & the manager is of low ability $\omega_{DL}$
  - When $s_2 = d_1$ (signals are the Same) & the manager is of high ability $\omega_{SH}$
  - When $s_2 = d_1$ & the manager is of low ability $\omega_{SL}$

- Probability of a correction $\kappa (s_1, s_2, a) \in [0, 1]$
  - When $s_1 \neq s_2$ & the manager is of high ability $\kappa_{DH}$
  - When $s_1 \neq s_2$ & the manager is of low ability $\kappa_{DL}$
  - When $s_1 = s_2$ & the manager is of high ability $\kappa_{SH}$
  - When $s_1 = s_2$ & the manager is of low ability $\kappa_{SL}$

- An incumbent manager’s strategy at date 5 for signal $d_2 (s_1, s_2, a)$
• Market’s beliefs on the manager’s abilities and market wage offer depending on whether the manager has been fired and whether he has corrected the decision \( w_M (r, c) \).

Proof of Proposition 1:
Suppose there is an equilibrium where the manager always corrects the decision when signals differ. In this case \( \kappa_{DH} = \kappa_{DL} = 1 \) and, hence, no one will be dismissed such that \( \omega_{DH} = \omega_{DL} = 0 \). A correction leads to an expected long-term gain for the manager of \( \Delta w_L (a) = \frac{\eta - a}{a - 2a + \eta} W_L \).

When no correction is observed, the market can conclude that the same signal has been observed twice. Hence,

\[
\Pr \{ a = a_H | r = K, d_1 = d_2 \} = \frac{\tau \gamma_H}{\tau \gamma_H + (1 - \tau) \gamma_L}.
\]

When a correction is observed, the market learns that the second signal differed from the first and

\[
\Pr \{ a = a_H | r = K, d_1 \neq d_2 \} = \frac{\tau (1 - \gamma_H)}{\tau (1 - \gamma_H) + (1 - \tau)(1 - \gamma_L)}.
\]

Hence,

\[
w_M (K, N) = \left( a_L + \frac{\tau \gamma_H}{\tau \gamma_H + (1 - \tau) \gamma_L} (a_H - a_L) \right) W_M \quad \text{and}
\]

\[
w_M (K, C) = \left( a_L + \frac{\tau (1 - \gamma_H)}{\tau (1 - \gamma_H) + (1 - \tau)(1 - \gamma_L)} (a_H - a_L) \right) W_M.
\]

A high ability manager corrects his decision if

\[
w_M (K, C) + \Delta w_L (a_H) \geq w_M (K, N)
\]

and a low ability manager if

\[
w_M (K, C) + \Delta w_L (a_L) \geq w_M (K, N).
\]
Hence, such an equilibrium exists if

\[
\Delta w_L(a_H) \geq \left[ \frac{\tau_H}{\tau_H + (1-\tau)\gamma_L} - \frac{\tau(1-\gamma_H)}{\tau(1-\gamma_H) + (1-\tau)(1-\gamma_L)} \right] (a_H - a_L) W_M. \tag{1}
\]

The first derivative with respect to \(\tau\) of the expression in square brackets is

\[
\frac{\gamma_H(\tau_H(1-\gamma_L) - \tau(1-\gamma_H))}{(\tau_H + (1-\tau)\gamma_L)^2} - \frac{(1-\gamma_H)(1-\gamma_L)}{(\tau(1-\gamma_H) + (1-\tau)(1-\gamma_L))^2}
\]

and the second is

\[
-\frac{\gamma_L\gamma_H}{(\tau_H + (1-\tau)\gamma_L)^2} (\gamma_H - \gamma_L) - \frac{(1-\gamma_H)(1-\gamma_L)}{(\tau(1-\gamma_H) + (1-\tau)(1-\gamma_L))^2} (\gamma_H - \gamma_L)
\]

which is strictly negative. Hence, the function is strictly concave. Furthermore, note that the first derivative is strictly positive at \(\tau = 0\) and strictly negative at \(\tau = 1\). Hence, it has a unique maximum at some value between 0 and 1. As the value of \(\Delta w_L(a_H)\) is independent of \(\tau\), condition (1) holds if \(W_M\) is sufficiently small or \(\tau\) is sufficiently close to either 0 or 1.

\[\blacksquare\]

**Proof of Proposition 2:**
Suppose there is an equilibrium where the manager never corrects his decision whatever his type \((\kappa_{DH} = \kappa_{DL} = 0)\). Then he will always be dismissed when different signals are observed and a correction is necessary \((\omega_{DH} = \omega_{DL} = 1)\). Note that we would never observe a correction by an incumbent manager on the equilibrium path. If any such equilibrium can be sustained, then it will be possible when we specify that the market believes in a low ability manager when a correction by an incumbent is observed. When no correction by an incumbent manager is observed the market learns that the second signal has confirmed the first, and therefore again

\[
Pr\{a = a_H | r = K, d_1 = d_2\} = \frac{\tau_H}{\tau_H + (1-\tau)\gamma_L}.
\]
Hence,

\[ w_M(K, C) = a_L W_M \] and
\[ w_M(K, N) = \left( a_L + \frac{\tau \gamma_H}{\tau \gamma_H + (1-\tau) \gamma_L} (a_H - a_L) \right) W_M. \]

A correction thus leads to a loss of reputation of size

\[ \frac{\tau \gamma_H (a_H - a_L)}{\tau \gamma_H + (1-\tau) \gamma_L} W_M. \]

As \( \Delta w_L(a_L) > \Delta w_L(a_H) \) both types of managers will indeed have no incentive to correct their decisions when

\[ \frac{\tau \gamma_H (a_H - a_L)}{\tau \gamma_H + (1-\tau) \gamma_L} W_M \geq \Delta w_L(a_L). \] (2)

The left hand side is increasing in \( \tau \). Hence, such an equilibrium exists when \( W_M \) and \( \tau \) are sufficiently large. \( \square \)

**Proof of Proposition 3:**
In this case \( \kappa_{DL} = 1 \) and \( \kappa_{DH} = 0 \). Hence, only high ability managers will be dismissed and therefore \( \omega_{DL} = 0 \) and \( \omega_{DH} = 1 \). When the second signal differs from the first, a correction leads to a long-term utility gain for the manager of \( \Delta w_L(a) = \frac{\eta - \sigma}{\alpha - 2\eta a + \eta} W_L \). Furthermore, the market learns from a correction that the manager is of low ability and, hence,

\[ w_M(K, C) = a_L W_M \]
\[ w_M(K, N) = \left( a_L + \frac{\tau \gamma_H (a_H - a_L)}{\tau \gamma_H + (1-\tau) \gamma_L} \right) W_M \]

A high ability manager does not correct his decision if

\[ w_M(K, N) \geq w_M(K, C) + \Delta w_L(a_H) \]
and a low ability manager corrects his decision if
\[ w_M(K, C) + \Delta w_L(a_L) \geq w_M(K, N). \]

Such an equilibrium exists, when \( \Delta w_L(a_L) \geq w_M(K, N) - w_M(K, C) \geq \Delta w_L(a_H) \) or
\[
\Delta w_L(a_L) \geq \frac{\tau \gamma_H(a_H - a_L)}{\tau \gamma_H + (1 - \tau) \gamma_L} W_M \geq \Delta w_L(a_H). 
\] (3)

Note that the loss in reputation from a correction is strictly increasing in \( \tau \). Hence, such an equilibrium exists for intermediate values of \( W_M \).

References


