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Insider versus outsider CEOs, executive compensation, and accounting manipulation ☆

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ABSTRACT

This paper examines the role of the financial reporting environment in selecting a new CEO from within versus outside the organization. Weak reporting controls allow the CEO to misreport performance information, which reduces the board's ability to detect and replace poorly-performing CEOs as well as aggravates incentive contracting. We show that these adverse effects are stronger when the CEO is an outsider rather than an insider. Our model predicts that boards are more likely to recruit a CEO from the outside when the performance measures with which the new hire is assessed are harder to manipulate.
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1. Introduction

When searching for a new CEO, corporate boards face an important question: Should they recruit a CEO from outside the organization or promote someone from within? Outsiders are typically considered to be more risky than insiders because corporate boards have less information about outsiders' strengths, experiences, and leadership style than they have about internal candidates. In addition, outsiders are less familiar with the organization's unique culture and inner workings. Outsider CEOs can nevertheless be valuable to the firm because they bring new ideas and fresh perspectives and are generally more open to transformational changes than insider CEOs.[1] One implication of this argument is that boards tend to promote internal candidates when the continuation of the current strategy and culture is desirable, but prefer external candidates when major changes are required (e.g., Zajac, 1990; Parrino, 1997; Farrell and Whidbee, 2003).[2]

The notion that bringing in an outsider is more risky than promoting an insider gives rise to another factor relevant for the selection decision – the firm's financial reporting environment. Financial reporting plays an important role because boards use earnings information not only for incentive contracting, but also for assessing how well the new CEO matches the needs of the organization and deciding whether to retain or replace him. We show that incentive problems and the board's ability to assess and replace poorly-performing CEOs influence the board's initial decision over what type of CEO to

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[1] See, for example, the discussions in Zajac (1990) and Zhang (2008). See also recent articles on insider versus outsider succession in the popular press, such as Battley (2012) and Miles (2009).

[2] Additional factors that influence CEO selection are the size of the firm (Dalton and Kesner, 1983; Guthrie and Datta, 1997) and the homogeneity of the industry (Parrino, 1997; Zhang and Rajagopalan, 2003). See also Zhang and Rajagopalan (2003) for an overview.

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hire. Our model generates new empirical predictions regarding the determinants of CEO selection and the effects of this decision on: optimal contracting, expected CEO compensation, the extent of earnings manipulation, and the frequency of forced CEO turnover.[3]

The heightened risks associated with bringing in an outsider do not necessarily put outside candidates at a disadvantage. As Lazear (1998) and Hermalin (2005) point out, boards have an option to replace the new hire if he turns out to be the wrong person for the job. Indeed, it is not uncommon that a CEO is fired within the first two years of his tenure.[4] Boards, and the shareholders they represent, benefit from the outsiders' upside potential and can limit downside risk by making appropriate subsequent replacement decisions. However, this argument relies critically on the board's ability to identify and dismiss CEOs who perform poorly.

Empirical evidence by Weisbach (1988) and Murphy and Zimmerman (1993) suggests that the firm's financial reporting system is an important source of information for assessing and replacing executives.[5] If, however, CEOs can manipulate accounting reports, the board may be unable to identify and correct a poor hiring decision. Consequently, when CEOs can more easily manipulate performance information (for example, due to weaker reporting controls), the probability of CEO turnover declines and the board's option to replace the incumbent becomes less valuable. Importantly, we show that the effects of weaker reporting controls on CEO turnover and the replacement option value are greater for CEOs hired from the outside than for those promoted from within. There are two reasons behind this result and both are driven by the assumption that outsiders pose a greater downside risk. First, the reduced ability to identify and replace unsuccessful CEOs due to distorted performance information is a bigger problem when the CEO is from the outside, because outsiders are more likely to fail. Second, as we discuss further below, outsiders have stronger incentives to manipulate the accounting report than insiders, and the difference in manipulation incentives between the two types of candidates further increases as reporting controls become weaker. In fact, for sufficiently weak reporting controls, the outsider's manipulation incentive exceeds that of the insider by a wide margin such that the probability of early dismissal and the value of the replacement option are both smaller for the outsider than for the insider despite the outsider's greater downside risk.

The reporting system affects the desirability of outsiders versus insiders also through its impact on incentive contracting. To encourage the CEO to take productive but personally costly actions, the board awards the CEO a bonus for high reported performance.[6] Because outsiders have a greater downside risk, they are less likely to succeed despite high effort. Outsiders must therefore receive a higher bonus to have sufficient incentives to work hard. The higher bonus, in turn, creates stronger incentives to manipulate the report, which increases the cost of the incentive system. As reporting controls become weaker, manipulation and the cost of the incentive contract increase for both types of candidates, but more quickly for outsiders than for insiders.

These arguments show that outsider CEOs have advantages and disadvantages relative to insider CEOs. On the one hand, outsiders have a higher option value as long as reporting controls are sufficiently strong. On the other hand, the incentive problem is more severe for outsiders, which implies higher expected compensation (and CEO rents). As reporting controls improve, option value increases and the expected compensation decreases for both types of candidates, but these effects are stronger for outsiders than for insiders. Thus, tighter reporting controls increase the advantages and decrease the disadvantages of outside candidates relative to inside candidates.

The analysis generates a number of new empirical predictions. First, boards are more likely to hire outsider CEOs in firms or countries with stronger reporting controls. Second, outsider CEOs engage in more earnings manipulation, face steeper incentive pay, and obtain higher expected compensation than insider CEOs, and these differences are greater when reporting controls are weaker. Third, outsiders have a shorter expected tenure relative to insiders if reporting controls are strong, and the reverse holds if reporting controls are weak.

Other models of CEO selection include Hermalin (2005), Murphy and Zábojník (2004, 2007), and Palomino and Peyrache (2013). Murphy and Zábojník (2004, 2007) argue that changes in the economic environment raise the value of general managerial skills relative to firm-specific skills, which in turn increases the desirability of outsider CEOs. When competition in the managerial labor market is high, the increased demand for outsiders translates into higher executive compensation. Building on Murphy and Zábojník (2004, 2007), Palomino and Peyrache (2013) consider a setting in which outsiders have pre-contract private information about their firm-specific skills, whereas the skills of insiders are commonly known. The additional information asymmetry leads to greater expected compensation for CEOs hired externally, relative to those promoted internally. In contrast, in our setting, the difference in expected compensation between insiders and outsiders is driven by the effort incentive problem and the scope to manipulate performance measures. Hermalin (2005) studies the value of outsiders versus insiders in a setting in which the board engages in costly information acquisition to uncover the

[3] Although we frame our analysis in terms of CEO selection, our results carry over to the more general question of whether to fill a senior management job opening with an inside or outside candidate.

[4] For example, J.C. Penney replaced CEO Ron Johnson after only 17 months on the job. Using U.S. sample data from 2000 to 2007, Kaplan and Minton (2012) find an annual CEO turnover rate of 16.8%, showing that the average CEO stays in control less than 6 years.

[5] See also Armstrong et al. (2010) and Brickley and Zimmerman (2010) for recent overviews of research on the role of financial reporting for corporate governance.

[6] See also Dye (1988), Feltham and Xie (1994), Dutta and Gigler (2002), Goldman and Slezak (2006), and Crocker and Slemrod (2007) for models in which the CEO's pay is linked to an interim performance measure such as earnings. Assuming that the CEO also enjoys private benefits of control when he is retained does not change our qualitative results.

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