The British Accounting Review 48 (2016) 359–378

Contents lists available at ScienceDirect

The British Accounting Review

journal homepage: www.elsevier.com/locate/bar

CEO succession in the UK: An analysis of the effect of censuring the CEO-to-chair move in the Combined Code on Corporate Governance 2003

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ARTICLE INFO

Article history:
Received 4 April 2013
Received in revised form 28 August 2014
Accepted 27 January 2015
Available online 12 March 2015

Keywords:
Corporate governance
CEO succession

ABSTRACT

In 2003, a new UK corporate governance Code recommended that the CEO should not become chairman of the same firm. The UK regulator, adopting an agency theory perspective, argued that this prevents powerful CEOs from clinging to power, to the detriment of firm performance. An alternative viewpoint, offered by stewardship theory, proposes that managers are inherently motivated to act in the best interests of the company and such controls are unnecessary, bringing no benefits to shareholders. This study therefore asks: (i) Does allowing the CEO to remain as chair damage firm performance? (ii) Did the changes to recommended best practice affect the number of CEOs remaining as chairman? (iii) Did the Combined Code (2003) affect the use of relay-style succession in the UK? Analysing a sample of 225 CEO routine departure events from 1996 to 2007 produces the answers: (i) this practice caused no apparent harm to accounting or stock market performance; (ii) there was a significant reduction in the practice in the period following the reform; and (iii) while UK firms were employing relay-style succession practices prior to the reforms, this has since abated. Overall, the evidence fails to support the agency view adopted by UK regulators.

1. Introduction

Agency theory, developed by Jensen and Meckling (1976) predicts that, as firms grow using external finance, the incentives of the owner–manager to maximise the value of the firm are reduced in favour of the manager maximising his own utility. The agency problems resulting from the separation of ownership and control, left unchecked, can result in firms being run less efficiently, reducing their value. In competitive capital markets, regulators and firms will take costly actions to ameliorate this agency problem, thereby assuring the external providers of capital that their investment is not at risk, and increasing the ability of the stock market and firms to attract capital at low cost (Shleifer & Vishny, 1997). An important assumption of agency theory is that managers are extrinsically motivated and, in the absence of incentives and controls, will expropriate wealth from the principal in order to maximise their personal utility.

An alternative perspective is advanced by stewardship theory (Davis, Schoorman, & Donaldson, 1997). Adopting a different psychological approach to that of agency theory, stewardship theory argues that managerial behaviour is shaped by an intrinsic desire for achievement and responsibility, which may be reinforced by a positive relationship with the organisation

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http://dx.doi.org/10.1016/j.bar.2015.01.003
0890-8389/

(Etzioni, 1975). Under stewardship theory, the manager is inherently motivated and derives utility from the competent performance of his job.

UK regulators have implicitly adopted an agency view of corporate governance (McKnight & Weir, 2009) and have taken steps to monitor, control and sanction companies and company directors in order to maintain the confidence of the capital market. One of these steps has involved the formation of various committees, each with the remit to improve corporate governance in UK listed companies. Since the initial (Cadbury) Code of 1992, the UK has periodically ordered reviews of the corporate governance of listed firms, each one resulting in additions to the previous set of recommendations in what has become known as the Combined Code on Corporate Governance.[1] In the UK, this Code is issued on a 'comply or explain' basis, meaning that firms, in their annual reports, must report that they comply with all aspects of the current Code recommendations, or explain and justify any deviations from 'best practice'. Salient to the background of this study is that, since the original Code of 1992, firms have been obligated to separate the roles of chief executive officer (CEO) and chairman or explain the reason(s) why the roles are not separated. Following the Higgs Report (2003), this aspect of the Code was amended to include a recommendation that the chairman be independent upon appointment, meaning that allowing a retiring CEO to remain as chairman would be in contravention of best practice. The definition of independence pertaining to company directors was also made more precise by Higgs and in the subsequent Combined Code (2003).

The agency view of the Combined Code (2003) provision (A.2.2), which says, '*A chief executive should not go on to be chairman of the same company*', is that it empowers boards against powerful CEOs who are reluctant to step aside for a successor. Further, a chairman who is independent upon appointment (which is the recommendation of the Code) is believed to provide better board oversight and monitoring of the incoming CEO. The alternative, stewardship perspective, would argue that strong identification with the company encourages better managerial decisions and steward-type managers do not require excessive monitoring, so an independent chairman is not necessary. In fact, a chairman who has been with the company for a long period of time and identifies strongly with the organisation, is desirable under stewardship theory.

The UK regulator's approach is not only subject to theoretical challenge – there has also been unfavourable practitioner response to a similar rule imposed upon German firms by remuneration legislation in 2009. A letter was sent to the chairmen of Germany's 80 largest companies by Hermes, the activist UK fund, arguing that it,

> '*will lead to valuable experience and relevant knowledge being lost*.'[2]

Commenting on the rule, which imposes a two-year cooling off period before members of the management board may join their company's supervisory board, the head of European corporate governance at Hermes, Hans-Christophe Hirt, went on to say,

> '*Some investors have over-emphasised the importance of independence. Expertise is also important* …'

Germany's largest investor, DWS, also opposed the move, arguing,

> '*It is senseless to have a two-year waiting period. Valuable expertise will be lost. If there were plenty of good, well-qualified candidates to be board members it would not be a problem, but unfortunately there is a shortage of good people*.'

Given the theoretical and practitioner objections to the reform in question, the first objective of the study is to examine whether the practice of retaining the CEO as the non-independent chairman of the same firm upon retirement from executive duties is associated with subsequent poor firm performance (Hypothesis 1, below). If this is the case, then support for the regulatory (agency) view will be provided. If, however, there is no evidence that the practice is harmful to firm performance, then this offers support to the view expressed by stewardship theory, some investors and to the economic argument that firms are generally able to arrange themselves efficiently without regulation (e.g. Hart, 1995). If firms are self-selecting into stewardship or agency types appropriately, then restricting firm choice in regard to the CEO-owner relationship may actually result in deadweight costs to firms and their owners (Linck, Netter, & Yang, 2008). The issue is therefore worthy of empirical investigation.

An examination of 225 routine CEO succession events from 1996 to 2007, and subsequent performance until up to 2010, yields no evidence of any detriment to either accounting or stock-market performance in firms where the CEO remained as chairman.[3] A positive association between market-adjusted share price returns and the CEO remaining as chairman in the years preceding the handover of power is observed. This may be due to the increased likelihood of retention of better performing CEOs, and/or the market attaching a positive value to this type of transition. Though the findings are tentative, they do not support the regulator's decision to discourage the practice of retaining the CEO as chairman.

The next objective of the study is to examine whether the change in recommended best practice has led to a change in actual practice (Hypothesis 2, below). Although firms are not *required* to comply with corporate governance Codes in the UK,

[1] The Cadbury Report of 1992 was followed by the Greenbury Report in 1995, which dealt with issues in executive compensation and which recommended a review after 3 years. This review led to the Hampel Report (1998) which recommended, inter alia, consolidating the two codes into one 'Combined Code'. Since then, the Code has been updated in 2003, 2006, 2008 and 2010.

[2] Milne and Wilson (2009) Hermes calls for an end to ban on 'moving upstairs'. *Financial Times* Online 26 August. Available from Nexis. Accessed 24/08/2014.

[3] Throughout the paper, the CEO is referred to as a man. This is not strictly true but of 225 events studied, only 2 female CEOs are identified.