The British Accounting Review 45 (2013) 229–241

Contents lists available at SciVerse ScienceDirect

The British Accounting Review

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

Do powerful chief executives influence the financial performance of UK firms?

Elena Veprauskaitė, Mike Adams*

University of Bath, UK

Keywords:
CEO power
Board structure
Ownership
Financial performance
UK publically listed companies (plcs)

A B S T R A C T

Drawing on a framework from agency theory, we examine the relation between the decision-making power of Chief Executive Officers (CEOs) and the financial performance of 468 United Kingdom (UK) publicly listed companies (plcs) using a dynamic panel data estimation method for the six years 2003–2008. We measure CEO power using a 'power index' which captures the extent to which the autonomy of the CEO to make unilateral decisions could influence firms' financial performance. To test for robustness, our analysis is conducted using different measures of financial performance. Our results reveal that, consistent with previous UK research, CEO power, as defined by CEO-Chair duality, CEO-tenure and CEO share ownership, is negatively related to financial performance. We also find that concentrated ownership is inversely related to the performance of UK plcs. CEO's compensation and board structure, however, do not appear to be related to the financial performance of the UK plcs.

1. Introduction

Recent studies using firm-level data drawn mainly from the United States (US) have examined the impact of powerful Chief Executive Officers (CEOs) on corporate strategic decisions and financial performance (e.g. see Adams, Almeida, & Ferreira, 2005; Kang & Zardkoohi, 2005; Morse, Nanda, & Seru, 2011). The results of such studies, however, are inconclusive. For example, Adams et al. (2005) and Adams and Ferreira (2007) find that in US firms where CEOs have considerable discretion over strategy (i.e., high power) speculative decisions are often made leading to variable financial performance over time. Recent research in the US corporate sector by Morse et al. (2011) further argues that powerful CEOs can have a deleterious impact on the value of firms as they can surreptitiously 'skim economic rents' by rigging their incentive compensation contracts in line with more favourable measures of performance. On the other hand, Kang and Zardkoohi (2005) observe that board leadership structure and firm performance have a weak empirical relation. Kang and Zardkoohi (2005), however, observe that CEO-Chair duality can often be a potent mechanism that can positively influence a firm's financial performance.

The present study builds on the 'CEO power literature' by examining the link between CEO power and the financial performance of United Kingdom (UK)-based publicly listed companies (plcs) using a multifactor measure of power. Specifically, we analyse the financial results for 468 UK firms over the six years, 2003–2008, employing a principal components analysis (PCA) derived power index and controlling for both board and ownership structure. Our data estimation method (Generalised Method of Moments (GMM)) allows us to control for dynamic adjustments between corporate governance and firms' financial performance. In addition, by testing various measures of financial performance, we ensure the robustness of

* Corresponding author. School of Management, University of Bath, Claverton Down, Bath BA2 7AY, UK. Tel.: +44 (0) 1225385685; fax: +44 (0) 1225386473.

E-mail address: m.b.adams@bath.ac.uk (M. Adams).

0890-8389/$ – see front matter © 2013 Elsevier Ltd. All rights reserved.
http://dx.doi.org/10.1016/j.bar.2013.06.004

the results. In this regard, our study extends prior cross-sectional analyses of the CEO power–performance relation in the UK's corporate sector (e.g., Abdullah & Page, 2009).

Three main motives underpin our research. First, prior US studies (e.g., Adams et al., 2005) show that a CEO's decision-making autonomy can directly influence corporate financial performance. Research that examines the link between the power of CEOs and the level of financial performance of firms in the UK – arguably a less prescriptive regulatory and legislative environment than many other jurisdictions including the US[1] – can contribute new and potentially useful insights on the effectiveness on corporate governance and strategic leadership and so be of interest to investors, regulators, and others. Furthermore, our work is expected to help explain the current mixed empirical evidence on the influence of corporate governance on firm performance by controlling for board composition, ownership structure and other factors, such as firm size and leverage, which can also influence firm financial performance.

In a related manner, we are also motivated by recent evidence of the influence CEO power played in several high-profile lapses in corporate governance in financial institutions, including the recently reported financial problems at the Royal Bank of Scotland (RBS). Indeed, the public media have alleged that the former RBS CEO, Frederick Goodwin, wielded too much power over major strategic decisions during his period of tenure (2000–2008), particularly in expanding the group through corporate acquisitions, such as the takeover of the Dutch bank ABN Amro. Goodwin's power is particularly noteworthy in comparison with the Chair's (Thomas McKillop) position as subordinate to, and obligated to Goodwin, a powerful CEO (Aldrick, 2008). The RBS experience suggests that in practice the separation of the Chair and CEO positions, as advocated by the UK's Cadbury Report (1992), may not be effective in protecting stakeholders from powerful CEOs. Our work on the relation between CEO characteristics and corporate performance can contribute to corporate governance policy decisions.

Beyond the literature on CEO and corporate governance influences, we are motivated further by the opportunity to consider variations in the relevance of institutional investors. Short and Keasey (1999) note that institutional shareholders in the UK are likely to be more active in monitoring board decisions and CEO pay compared with their US counterparts due to various legal and regulatory practices that differ between the two nations. For instance, Myners Report (2001) set the pathway to enhancing quality of engagement between institutional investors and companies to help to improve the efficiency and effectiveness of corporate governance in the UK. The current study could thus highlight institutional influences on the CEO power-firm performance relation that have not been given sufficient emphasis in prior research.

Our results reveal that, consistent with previous UK research (e.g., Florackis & Ozkan, 2009) CEO power, as proxied by CEO-Chair duality, CEO-tenure and CEO share ownership, is negatively related to financial performance. We also find that concentrated ownership is inversely related to the performance of UK firms. However, we do not find, that board structure and CEO's compensation are related to the financial performance of the UK firms.

2. Literature review and hypotheses development

The relationship between a firm's CEO and its shareholders is a classic agency theory scenario as depicted by Jensen and Meckling (1976). In general, CEOs are assumed to maximise their own interests, which may be at the detriment to the interests of the shareholders. The greater the degree of decision-making discretion retained by a CEO and the more severe are information asymmetries between the CEO and the owners, the greater the likelihood of weak governance and that non-value-adding decisions will be made (Brown & Sarma, 2007). In this context, owners are likely to establish a combination of contractual incentives for their agents and directly monitor their behaviour – for example, by means of annual audits (Watts & Zimmerman, 1986). Indeed, improving managerial incentive contracts, such as linking executive compensation to agreed performance targets and promoting outsider representation on corporate boards, are common mechanisms designed to increase the traded value of firms (Morse et al., 2011).

Those efforts, however, have been shown to have limitations. One primary weakness occurs when the CEO possesses 'structural power' over other board members. When this occurs, the effectiveness of outside and inside directors can be compromised and firm performance impaired (Combs, Ketchen, Perryman, & Donahue, 2007; Jiraporn, Chintrakarn, & Liu, 2012; Liu & Jiraporn, 2010). Adams and Ferreira (2007) argue that too much CEO power can also create a moral hazard problem when the CEO's preferred projects differ from those of shareholders. In other words, when an individual CEO has complete autonomy to make decisions, he/she can use such authority to make personal economic gains, such as through increased rates of perquisite consumption and/or 'rigged' payoffs under compensation plans, and thus reduce shareholders' wealth (Morse et al., 2011). In summary, agency theory predicts that powerful CEOs could be motivated to take advantage of information asymmetries and use their influence on the board to maximise their personal wealth at the expense of shareholders' utility (e.g., see Morse et al., 2011). Therefore, the following hypothesis is put forward:

H1a: CEO power is likely to be negatively related to firms' financial performance.

[1] Since the publication of the Cadbury Report (1992), the UK has had a comprehensive but voluntary system of corporate governance for plcs while in the US the currently stringent statutory corporate governance requirements of the federal government's Sarbanes–Oxley Act (2002) replaced a previously ad hoc and discretionary system of governance for plcs. Such institutional differences could have different impacts on the behaviour of CEOs between the UK and the US.