Finance Research Letters 16 (2016) 268–274

Contents lists available at ScienceDirect

Finance Research Letters

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

How do independent directors view powerful CEOs? Evidence from a quasi-natural experiment

Pornsit Jiraporn[a,*], Seksak Jumreornvong[b], Napatsorn Jiraporn[c], Simran Singh[a]

[a] Pennsylvania State University, School of Graduate Professional Studies, Malvern, PA 19355, United States
[b] Thammasat University, Department of Finance, Bangkok, Thailand
[c] State University of New York (SUNY) at Oswego, Oswego, NY 13126, United States

ARTICLE INFO

Article history:
Received 10 September 2015
Accepted 20 December 2015
Available online 29 December 2015

JEL classification:
G30
G34
G38
G39

Keywords:
Independent directors
Independent boards
Board independence
CEO power
Powerful CEOs
Sarbanes–Oxley Act

ABSTRACT

Prior research shows that powerful CEOs can exacerbate the agency conflict, resulting in adverse corporate outcomes. Exploiting an exogenous shock introduced by the passage of the Sarbanes–Oxley Act, we explore whether board independence mitigates CEO power. Based on difference-in-difference estimation, our evidence shows that independent directors view powerful CEOs unfavorably. Board independence diminishes CEO power by more than a quarter. Based on a quasi-natural experiment, our research design is less vulnerable to the omitted-variable bias and reverse causality and therefore suggests that the effect of board independence on CEO power is likely causal.

© 2015 Elsevier Inc. All rights reserved.

1. Introduction

A number of recent studies have investigated the value of independent directors. For instance, Duchin et al. (2010) report that independent directors increase firm value when the cost of acquiring information about the firm is low. Nguyen and Nielsen (2010) and Nguyen and Nielsen (2014)

* Corresponding author: Tel.: +1 4847533655.
E-mail address: pjiraporn@gmail.com, pjiraporn@psu.edu (P. Jiraporn).

http://dx.doi.org/10.1016/j.frl.2015.12.008
1544-6123/© 2015 Elsevier Inc. All rights reserved.

examine the stock market reactions to sudden deaths of executive and find that outside directors positively contribute to firm value and that their compensation is proportional to their contributions to shareholder value. Armstrong et al. (2014) show that board independence increases firm transparency significantly. Knyazeva et al. (2013), using the local director pool as an instrument, show that board independence improves firm performance. Exploiting the governance reforms in South Korea after a financial crisis as a regulatory shock, Choi et al. (2007) as well as Black and Kim (2012) provide evidence that independent directors have a favorable impact on firm performance.

We contribute to the literature on the board of directors by exploring whether independent directors play a role in curbing excessive CEO power. In so doing, we exploit as a quasi-natural experiment changes in board composition mandated by new NYSE and NASDAQ listing rules following the Sarbanes–Oxley Act (SOX). The main provisions of these rules require the board of each public company to have a majority of independent directors. A principal advantage of this quasi-natural experiment is that the effects on individual firms are variable depending on whether a firm's prior board composition was compliant with the new requirements. This quasi-natural experiment is more likely to show a causal effect rather than merely an association (Chhaochharia and Grinstein, 2009; Guthrie et al., 2012; Guo and Masulis, 2014; Guo et al., 2015).

We advance two hypotheses that potentially explain the effect of board independence on CEO power. First, strong board independence represents more effective governance because independent directors are more objective than inside directors, who are employees of the firm and work under the influence of the CEO. Because excessive CEO power can be harmful as shown by prior research (Bebchuk et al., 2011; More et al., 2011; Liu and Jiraporn, 2010; Jiraporn et al., 2011), more independent boards lead to less powerful CEOs, who are less likely and able to exploit shareholders.[1] This notion predicts a negative relation between board independence and CEO power. We refer to this notion as the outcome hypothesis as weaker CEO power is an outcome of having a more independent board. On the contrary, the substitution hypothesis posits that more independent boards can monitor CEOs more effectively. Powerful CEOs can do less harm to the firm when they are subject to effective oversight. Thus, CEOs can be allowed to command strong power. In other words, board independence substitutes for any necessity for weaker CEO power. This hypothesis predicts a positive relation between board independence and CEO power.

We measure CEO power using the CEO pay slice (CPS). Invented by Bebchuk et al. (2011), CPS is calculated as the CEO's total compensation as a fraction of the combined total compensation of the top five executives in a given company. Our results show that firms forced to raise board independence experience a significant reduction in CEO power, relative to those firms not required to increase board independence. Our results hold even after controlling for a large number of firm characteristics. Therefore, the evidence is in favor of the outcome hypothesis. Independent boards are effective in restraining excessive CEO power, which, according to prior research, is detrimental to shareholders (Bebchuk et al., 2011, Morse et al., 2011; Liu and Jiraporn, 2010; Jiraporn et al., 2011). In terms of economic significance, board independence diminishes CEO power by 26%. We also execute an analysis using propensity score matching to ensure that our treatment and control firms are similar. The results based on propensity score matching also confirm that board independence significantly diminishes CEO power. Our approach based on a quasi-natural experiment likely shows that board independence is not merely associated with, but rather brings out weaker CEO power. The effect is likely causal, a finding that has not been documented before in the literature.

Our study extends the literature in several ways. First, we contribute to the literature in corporate governance by showing that board independence is effective in controlling CEO power. Second, we

[1] The recent literature has documented a number of detrimental effects of powerful CEOs on corporate outcomes. For instance, Bebchuk et al. (2011) find that strong CEO power leads to poor accounting profitability, lower stock returns accompanying acquisition announcements, higher likelihood of opportunistic timing of option grants, and lower performance sensitivity of CEO turnover. Bebchuk et al. (2011) argue that powerful CEOs exacerbate the agency conflict and lead to negative outcomes. Similarly, Morse et al. (2011) show that powerful CEOs induce boards to shift the weight on performance measures toward the better performing measures, thereby rigging incentive pay. Liu and Jiraporn (2010) find that bondholders view powerful CEOs unfavorably. Firms with more powerful CEOs experience lower credit ratings and higher bond yields. Jiraporn et al. (2011) report that powerful CEOs avoid using debt because interest payments serve as a governance mechanism that reduces the free cash flow under the CEO's control.

Download English Version:

https://daneshyari.com/en/article/5069470

Download Persian Version:

https://daneshyari.com/article/5069470

Daneshyari.com