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ABSTRACT

When a firm has minimal agency and informational asymmetry problems it should make efficient capital budgeting decisions. Many firms over-invest prior to CEO turnover, halt investments in the period surrounding the turnover, and then greatly increase their level of expenditures. Empirical analysis of the cross-sectional and inter-temporal variation in the quality of firms' corporate capital budgeting decision reveals that the impact of CEO turnover is asymmetric between under- and over-investing firms, and this complements the larger literature using average firm-wide performance measures. Firms are more likely to have forced turnovers when there is more over-investment prior to the turnover, and these firms make more efficient investment decisions subsequently. Board influence is largely insignificant prior to a CEO turnover but is consistently associated with higher levels of investment subsequently.

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1. Introduction

Managers, and CEOs in particular, can significantly influence corporate behavior and performance. In pioneering research, [Bertrand and Schoar \(2003\)](#) provide evidence of managerial “style,” whereby managers that transition across firms have a direct, measurable impact on firm performance and a wide range of corporate policies. Many studies have found strong complementary evidence that the quality of a firm's performance varies markedly before and after a CEO turnover (e.g., [Huson et al., 2001, 2004](#); [Jenter and Kanaan, forthcoming](#), etc.). [Huson et al. \(2004\)](#) find that firms experience higher operating returns on assets in the 3 years following CEO turnovers, with these returns increasing more for firms with higher levels of institutional ownership and more independent boards of directors. Studies such as these generally use as dependent variables average firm-wide performance measures such as average Tobin's Q or operating returns on assets. These measures are useful top-down perspectives on the overall aggregated quality of a firm's investments, but do not shed light on the marginal investment decisions undertaken by the firm.

When a firm has good managers who are properly incentivized and monitored, agency problems should be minimized and a firm should use resources as effectively as possible. Corporate capital budgeting decisions should be most efficient when agency and informational asymmetry problems are minimized ([Greene et al., 2009](#); [Jensen, 1986](#); [Shleifer and Vishny, 1989](#)), which is often when a firm has particularly strong internal communication channels ([Hornstein and Zhao, 2011](#)). CEO turnover may reflect the presence of agency or informational asymmetry problems, and thus be associated with discrete changes in the functioning of internal

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communication channels. Intensified agency and informational asymmetry problems may cause a CEO to anticipate their departure is imminent, and thus induce a myopic bias that leads to the CEO attaching a higher weight to short-term firm performance. This might cause the quality of corporate capital budgeting decisions to be less effective as the CEO's departure approaches.

We examine patterns in the efficiency of corporate capital budgeting in the years surrounding CEO turnover. This complements and extends earlier research (e.g., Huson et al., 2004) by exploring how the capital allocation process changes at firms given the firm's prior tendencies to under- or over-invest. Moreover, this empirical framework permits exploration of whether under- and over-investing firms should be examined jointly, as is commonly done, or separately.

If a firm makes efficient capital budgeting decisions, it should invest in all positive-NPV opportunities and bypass all negative-NPV opportunities. Assuming firms always invest in the highest value-added projects first, then there should be a marginal investment project which has an incremental value-added exactly offset by the incremental cost and this would be the optimal final project for a firm to undertake.¹ In this scenario, a firm would have an estimated marginal q that deviates little, if at all, from the appropriate tax-adjusted benchmark value. This approach to evaluating capital budgeting was developed by Durnev et al. (2004), refined in Greene et al. (2009), and adopted by Ferreira and Laux (2007) and Siegel et al. (2011), among others.

CEO actions could influence the level and quality of corporate investments and capital budgeting decisions due to idiosyncratic concerns of the individual. For example, the CEO may invest in a wider range of opportunities to maximize shareholder wealth or due to agency problems such as empire building (Jensen, 1986), hubris (Roll, 1986) or overconfidence (Malmendier and Tate, 2005). Alternatively, the CEO may decline investment opportunities again out of a belief that it is best for shareholder wealth maximization or due to other agency problems such as reputational concerns (e.g., Hirshleifer and Thakor, 1992) or shirking (e.g., Hirshleifer and Suh, 1992; Holmstrom and Weiss, 1985). There are competing explanations for why the quality of a firm's capital budgeting decisions may vary around the time of CEO turnover. These theories are tested empirically in this paper.

The univariate data indicate that on average firms appear to invest more heavily in the CEO's earlier years and slow down investments in the years leading up to the CEO turnover before beginning a slow, steady increase in investments. This yields inter-temporal variation in estimated marginal q . The empirical analysis of the quality of a firm's capital budgeting decisions reveals that firms have sharply improved asset allocation when agency problems are minimized. For example, agency problems are lower after a forced departure and when an entrenched manager is replaced.

The results reveal that under- and over-investing firms should be analyzed separately as the impact of firm characteristics and board governance is not constant across the groups. The inter-temporal analysis reveals that boards take time to effect change, and that CEO turnover often trails the periods of less efficient capital budgeting decisions by several years, consistent with Jenter and Lewellen (2010).

Section 2 presents the model and empirical methodology. The data and variables are discussed in Section 3. Empirical results are analyzed in Section 4. Finally, Section 5 concludes.

2. Model and empirical methodology

The value of a firm's marginal investment can be assessed using marginal q , which is the ratio of the unanticipated incremental change in firm market value divided by the contemporaneous marginal investment. Thus, an optimal capital budgeting process would be one where a firm invests until the last investment generates a marginal q of 1.0. A positive (negative) deviation of estimated marginal q from 1.0 would thus reflect under- (over-) investment. Exogenous factors such as taxes, however, may affect the capital budgeting process and cause the optimal benchmark marginal q to differ systematically from the theoretical benchmark of 1.0.²

2.1. Marginal q estimation

The empirical approach for estimating marginal q was developed by Durnev et al. (2004) and extended by Greene et al. (2009) to use random coefficients.³ If the marginal investor in a firm faces capital gains and dividend taxes of T_{CG} and T_D then firm i 's marginal q is defined as the tax-adjusted ratio of unanticipated change in firm value to the contemporaneous unanticipated change in firm assets, or:

$$\hat{q}_i = \frac{(1-T_{CG})(V_{i,t}-E_{t-1}V_{i,t})}{(1-T_D)(A_{i,t}-E_{t-1}A_{i,t})} = \frac{(1-T_{CG})[V_{i,t}-V_{i,t-1}(1+\hat{r}_{i,t}-\hat{d}_{i,t})]}{(1-T_D)[A_{i,t}-A_{i,t-1}(1+\hat{g}_{i,t}-\hat{\delta}_{i,t})]} \quad (1)$$

¹ Firms routinely make investment decisions that directly impact the value of total firm assets and that should have a related impact on their market valuation. In practice it is not always easy for a firm to identify the true NPV of an investment, and firms often make multiple investment decisions in short time periods. When the capital markets are efficient and well-informed, the changes in firm assets and valuation should occur contemporaneously as soon as the change in firm assets is disclosed.

² Marginal q is distinct from average Tobin's Q , which reflects market perceptions of firm value. Average Q is the ratio of firm market value to the replacement value of firm assets. If firms have no agency problems then marginal and average Q may yield different interpretations of the impact of corporate leadership. For example, a manager may over-invest as part of empire building, leading to a marginal q that is less than the appropriate benchmark. However, if the market does not yet recognize that this was a duplicative or superfluous investment, then the market may reward the firm with a higher stock price and thus an increased average Q .

³ The efficiency gains of the Greene et al. (2009) approach are outlined in Hornstein and Greene (2012).

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