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Corporate Governance Initiative

A compilation of INSEAD Research

"From our Faculty: The CEO"

"It is important for boards to understand that simply replacing the CEO is not going to accomplish very much. But unfortunately, too often, under the pressure of poor performance, boards do gravitate to CEO replacement as a handy solution." Guoli Chen, Assistant Professor of Strategy

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Editorial

In April 2013, the board of J.C. Penney Co Inc. faced scathing criticism from investors and corporate governance experts after ousting CEO Ron Johnson and replacing him with his own embattled predecessor, Myron Ullman. Last month the sudden exit of Procter & Gamble's Bob McDonald as chief executive and the return of former CEO A.G. Lafley raised questions about the vigilance of one of America's highest-profile corporate boards. Earlier this month we witnessed the voting of JP Morgan shareholders on splitting the CEO and Chairman roles held by Jamie Dimon. A few major pension funds voted for the split, but in total only slightly over 30% of the shareholders voting expressed support. And in Switzerland, long-time Chair and CEO Daniel Vasella left the country, partly as a result of the 'bottom-up' referendum of Herr Thomas Minder on 'say on pay'.

These latest dynamics in shareholder democracy raise the issue of trust and competence of CEOs, Chairs and the boards that elected them. Trust grows - as every sports coach or military officer knows - between people who have successfully gone through rough times together. This dynamic is part of the CEO-board issue. The CEO looks at how the board reacted when he was down, did the board make the CEO the 'black sheep' or 'scape goat' or did it instead take some of the blame for poor performance, since presumably the board and CEO are co-responsible. This is where loyalties are formed, or disappointment if not outright hatred creeps in.

The issue of Board-CEO dynamics devotes a full day of discussion in our International Directors Programme, raising good interest amongst our participants. We are herewith sharing research of our professors on this important aspect of governance - why and how do the CEO and top leadership achieve the right balance between challenge and support? How do they jointly define and achieve the objectives of the company?

The research topics aim at understanding what factors and pressures cause the CEO-Board relation to turn sour (or south?), and why concerns of power and private interest might raise issues of corporate and personal integrity. We would like to highlight the substantial and increasing governance literature that INSEAD generates, which also allows our teaching to be informed of the latest knowledge – as retailers say 'always fresh'. Furthermore, it allows me to underline that some of these results are sobering. One of the survey results, for example, concludes that on average, compensation committees do not appear to successfully correlate CEO lifetime remuneration and corporate performance over its lifetime (which is not to say that there is no evidence, but more to say that for one committee that is successful, another appears to do the opposite).

One unintended value of the financial crisis, at least as I can see, is that these issues have now been given more attention – by regulators, business people, directors and faculty. This is small consolation in view of the devastation of entire economies, but it may have major long-term benefits in terms of turning business into a full force for a better world.

Professor Ludo Van der Heyden
The Mubadala Chair in Corporate Governance and Strategy
Director of the Corporate Governance Initiative
June 2013

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From Our Faculty: The CEO

ICGI is launching a series of summaries of research carried out by INSEAD faculty. You will find below the list of summaries included in this issue. Links to the full texts are mentioned at the end of each summary.

Corporate governance can help shape the CEO's long term horizon and identifies ways that shareholders and board members could mitigate the short-termism often associated with earnings pressure is the research finding by **Professors Ju Zhang and Javier Gimeno**

> "Balancing Short-term Earnings and Long-term Competitiveness: How Does Corporate Governance Affect Competitive Behaviour under Earnings Pressure", Winner, 2012 Blackrock/National Association of Corporate Directors Award, Corporate Governance & Responsible Investment

Yet, it's no accident that chief executives so often focus on short-term financial results at the expense of longer-term performance. Developing a simple yet rigorous way to gauge long-term performance is crucial; after all, in business, leaders default to managing what's measured. **Professors Morten Hansen, Herminia Ibarra and Urs Peyer** researched on who and what qualifies as the **Best Performing CEOs.**

> "The Best-Performing CEOs in the World", Harvard Business Review, Jan 2013

However, the inner workings of the top executive team, and their importance for firm performance, are hard to observe or quantify. **Professors Lucian A. Bebchuk, Martijn Cremers, and Urs Peyer** uses a measure called CEO Pay Slice (CPS), which is defined as the fraction of the aggregate compensation of the firm's top-five executive team captured by the CEO.

> "The CEO Pay Slice", Journal of Financial Economics, 2011

A seemingly contrasting research by **Professors Gilles Hilary, Yuk Ying Chang and Sudipto Dasgupta**, suggests a positive correlation between the level of compensation and either firm performance, managerial career outside the firm and financial market perception. However, these positive relations only exist when the governance is good.

> "CEO Ability, Pay, and Firm Performance", Management Science, 2010, Winner of 2012 Syntec Prize in Research & Management

Interestingly, what is often difficult to measure is how improvements in the firm's internal corporate governance create value for shareholders. **Professor Maria Guadalupe,** together **with Vicente Cuñat and Mireja Gine,** presents novel evidence of the effect of corporate governance on the market value and long-term performance of firms.

> "The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value", Winner of 2012 Brattle Distinguished Paper Prize, Corporate Finance. Journal of Finance, 2012

Finally, when firm performance is in trouble, then it seems like one of the most common universal prescriptions is to replace the CEO. But, is CEO really replacement beneficial for companies in turnaround situations? And what kind of replacement is most beneficial and does it depend on the attributes and qualities of the person you choose to be CEO? **Professors Guoli Chen and Don Hambrick** explain.

"CEO Replacement in Turnaround Situations: Executive (Mis)fit and Its Performance Implications", Organization Science, 2012

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Executive Summary

Balancing Short-term Earnings and Long-term Competitiveness: How Does Corporate Governance Affect Competitive Behaviour under Earnings Pressure

by Yu Zhang and Javier Gimeno

Winner, 2012 Blackrock/National Association of Corporate Directors Award, Corporate Governance & Responsible Investment

Earnings pressure leads managers to take actions that improve short-term profitability but damage long-term competitiveness and performance of their firms. This research shows how corporate governance can help shape managers' long term horizon and identifies ways that shareholders and board members could mitigate the short-termism often associated with earnings pressure. We define earnings pressure as the tension felt by management about meeting or beating analysts' earnings forecasts.

The Authors

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What action can be taken to help managers handle this pressure better? How can shareholders and board members design structures and systems that can help managers to be less affected by securities analysts?

A survey, by Graham, Harvey, and Rajgopal (2005), indicated that 80 percent of respondents (chief financial officers and financial executives) would decrease discretionary spending on R&D, advertising, or maintenance to meet an earnings target, and 60 percent would avoid initiating a positive net present value (NPV) project if it meant falling short of analysts" consensual earnings forecasts. This survey suggested that CFOs viewed earnings as the most important performance measure reported to outsiders. Seventy-three percent of respondents considered analyst consensus forecasts as an important benchmark, and over 80 percent believed that meeting earnings benchmarks helped to build credibility in the capital market and to maintain or increase their firm"s stock price.

From a strategic point of view, this is a big problem. It is seen that earnings pressure leads companies to become less competitively aggressive, in order to exploit market power, to raise prices that can help in short-term profitability but hurts long term competitiveness. For example in the winter of 2012, analysts expected negative results from Ryanair, and the big fear publicised was that they were going to have bad quarterly results. In response to this, Ryanair cancelled some flights, eliminated some discounts, etc., and they ended up doing better than they would have otherwise. However, the consequence of these decisions is that its reputation amongst competitors and customers now is that it is an airline who is more interested in making money than in gaining market share.

This is the tension - are you more focussed on maintaining or gaining market share, on being aggressive in the market, or are you more focussed on making money now even if it would hurt you more in the future?

Concerns about impact on competitiveness

In 2003, it was found that whenever Coca Cola was doing well, it spent money on advertising and when it wasn"t, it cut it. So, they were using investments to buffer earnings pressures. Is this the right long-term strategy?

"By looking at the context of corporate governance, we are able to tell whether earnings pressure might actually be bad for the company in

Managers are aware of the high stakes associated with missing earnings forecasts and try different ways to meet or beat earnings forecasts. Responses from managers could range from ignoring the pressures, managing expectations or engaging in „creative accounting" by managing discretionary accruals. Yet another response could be to engage in „real earnings management". This means changing real business decisions, such as the amounts spent on research and development, advertising, timing of new investment projects, changes in the intensity of competitive behaviour with the goal of increasing short-term earnings.

Some significant insights by successful leaders

Larry Page said, regarding Google"s IPO prospectus, *"Many companies are under pressure to keep their earnings in line with analysts' forecast. Therefore, they often accept smaller, but predictable, earnings rather than larger and more unpredictable returns. Sergey and I feel this is harmful, and we intend to steer in the opposite direction."*

Jeff Bezos, Wired, said, *"If everything you do needs to work on a three-year time horizon, then you're competing against a lot of people. But if you're willing to invest on a seven-year time horizon, you're now competing against a fraction of those people, because very few companies are willing to do that."*

Ted Turner, founder of CNN, commented: "*When all companies are quarterly earnings–obsessed, the market starts punishing companies that aren't yielding an instant return. This not only creates a big incentive for bogus accounting, but also it inhibits the kind of investment that builds economic value*"

Can corporate governance factors mitigate the effect of earnings pressure?

If earnings pressure is really a problem of inappropriate short-term orientation, does it affect companies with long-term oriented owners and managers? Academic literature is not very clear on how companies react to earnings pressure and whether the decisions made are good or bad for the company. This is where our paper comes in. If earnings pressure was actually good for the company, you would expect that manager would make decisions around this regardless of whether shareholders are long-term or short-term oriented. But if we find that this behaviour tends to happen primarily when managers or shareholders have short-term orientation, but does not happen when they have long-term vision, then that provides evidence that this is not good in the long term for the company.

Larry Page, regarding Google's IPO prospectus: "Many companies are under pressure to keep their earnings in line with analysts' forecast. Therefore, they often accept smaller, but predictable, earnings rather than larger and more unpredictable returns. Sergey and I feel this is harmful, and we intend to steer in the opposite direction."

By looking at this dimension of corporate governance, which is related to whether the company"s actions are short-term or long-term oriented, we are able to tell whether earnings pressure might actually be bad for the company in the long term. The two dimensions we examine are the ownership structure of shareholders, i.e. institutional investors and the incentives for CEOs.

Impact of ownership structure

There are different kinds of institutional investors – transient investors are those that trade a lot, typically invest in around 500 firms and shares are sold quickly for gain. And then there are dedicated investors, like Warren Buffet, who invest in very few companies, understand them well and stay with them long-term. Obviously the latter are less likely to respond or react to earnings pressure.

Impact of CEO incentives

"From a corporate governance perspective, it is important to focus on vested or unvested stock options rather than just stock or not-stock based incentives"

This is a more complicated and difficult argument. There is a lot of governance literature pertaining to bonuses and stock-based incentives. The latter are viewed as high-powered incentives to help align CEO"s interests with the improvement of a company"s shareholder value and to the shareholders" wealth, with less incentive to deviate from long-term optimal competitive behaviour to meet analysts" earnings forecasts. On the other hand, researchers have also argued that CEOs could also be more sensitive to changes in stock prices, and they may make business decisions to boost or maintain current prices instead of increasing future shareholder value.

So, we go to the next level that more clearly shows the influence of stock-based incentive and decision-making, as we examine whether a CEO can exercise the right to sell shares. If the incentive is restricted/unvested stock options, i.e. one cannot exercise his or her option for a period of time (say 1-2 years), then typically the CEO"s decision for the company is not motivated by the current stock prices. However, with vested stock options that can be exercised at any time, the risk is that the CEO would make decisions that damage his or her own wealth generation. From a corporate governance perspective, it is important to focus on vested or unvested stock options rather than just stock or not-stock based incentives.

Conclusion and research findings

Using data on competitive decisions by U.S. airlines under quarterly earnings pressure, we find that companies with long-term oriented investors and long-term unvested CEO incentives (restricted shares and un-exercisable stock options) are less sensitive to earnings pressure. In contrast, companies with more „transient" investors and CEOs with vested, immediately exercisable stock-based incentives are more responsive to earnings pressure.

This research has multi-fold impact. For instance, an important finding related to governance, is that, besides board members and shareholders, there is a significant influence that securities analysts have on a managerial behaviour (and a firm"s stock prices). Managers can benefit by understanding the influence of earnings pressure on firms" competitive behaviour and in particular, by understanding the contingent effects of different corporate governance structures. A better understanding of these effects can help managers to react more effectively to pressures from the stock market and to take advantage of competitors. For boards and investors, the kind of ownership structure and managerial incentives are relevant to keep the sound course of business actions. For regulators, the awareness of effect of earnings pressure on real business actions can help them see the possible spill-over effect of financial reporting.

Ted Turner, founder of CNN: "*When all companies are quarterly earnings–obsessed, the market starts punishing companies that aren't yielding an instant return. This not only creates a big incentive for bogus accounting, but also it inhibits the kind of investment that builds economic value*"

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Executive Summary

The Best-Performing CEOs in the World

by Professors Morten T. Hansen, Herminia Ibarra, Urs Peyer

Harvard Business Review, January 2013

The Authors

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It's no accident that chief executives so often focus on short-term financial results at the expense of longer-term performance. They have every incentive to do so. If they don't make their quarterly or annual numbers, their compensation drops and their jobs are in jeopardy. Stock analysts, shareholders and often their own boards judge them harshly if they miss near-term goals. And without equally strong pressure to manage for a future that stretches beyond 90 or 180 days, CEOs' behaviour is unlikely to change. Developing a simple yet rigorous way to gauge long-term performance is crucial; after all, in business, leaders default to managing what's measured.

Five years ago we launched a global project to address that challenge. But we wanted to do more than just devise the right metrics. Our goal was to implement a scorecard that would not only get people talking about long-term performance but also alter the way that boards, executives, consultants and management scholars thought about and assessed CEOs. We wanted this innovation to shine a spotlight on the CEOs worldwide who had created long-term value for their companies and we wanted to give executives around the world critical benchmarks they could aim for (Amazon's CEO Jeff Bezos is known for long-term leadership skills). Compared to the ranking published in the January-February 2010 issue of the Harvard Business Review (HBR), we have expanded it along two important new dimensions - making the group of CEOs we studied truly global and examining which CEOs and companies were able to do well not only financially but also in terms of corporate social performance.

What Accounts for Success?

Our 2010 HBR article looked at several factors that might be relevant to good performance (whether CEOs were hired from inside the company, had an MBA, and so on). We tracked those factors again, and our global comparison revealed some insights into differences across the world.

The Insider-CEO story

Management thinkers have long debated whether it is better to appoint an insider as CEO or get someone from the outside to run the company. But most studies have focused on U.S. corporations.

"Boards need to keep regional success factors firmly in mind when selecting CEOs"

OVERALL RANK

1

Steve Jobs

It comes as no surprise that the best-performing CEO over the past 17 years was Steve Jobs

In our full sample of 3,143 CEOs, 74% were insiders. India had the lowest proportion (63%) and Japan the highest (90%). Overall, insiders did better than outsiders - the former's average rank was 154 places higher than the outsiders' rank. Though this is similar to what we found in the 2010 global ranking, it didn't hold true in major parts of the world. Insiders got better results in the United States, the United Kingdom and Latin America, but there was no difference between insiders and outsiders in continental Europe, China and India.

What about the idea that outsiders are preferable when a company is in trouble? We find that boards - especially in the United States and Europe - do have a slightly greater tendency than normal to hire outsiders when the company is underperforming (measured as having an industry - adjusted total shareholder return of -24% or worse for the two years before the CEO started). But the results those outsiders produced varied by region. In the United States, they didn't get any better performance from struggling companies than insiders did. In Europe, outsiders did better - the average rank of those who took over subpar performers was 370 places higher than the average rank of their insider counterparts.

In Latin America, however, the picture was different: the average rank of insiders who had taken the helm of poor performers was 750 places higher than that of outsiders. Regional factors help explain this disparity. A large number of Central and South American firms are family controlled; another large segment is government controlled. Business families - and, in some cases, governments - exercise a strong influence on long-term strategies and investment decisions, which makes it more difficult for a CEO who is new to a company to operate.

The upshot: In the United States, outsider CEOs usually do not deliver the goods, whether the company is underperforming or not. But this finding can't be generalised to other parts of the world. Boards need to keep regional success factors firmly in mind when selecting CEOs.

The Curse of Great Prior Performance

If you want to create a lot of shareholder value, it pays to take over a company that hasn't been doing well - at least if you're in the United States, China, India or the United Kingdom. In those countries a poorly performing predecessor is often followed by a high-performing one. But there is no such effect in continental Europe, Japan and Latin America.

The greater continuity in company performance in Latin America is probably a reflection of the long-term control exercised by business families, investor syndicates and governments, whose visions don't change even as CEOs come and go. In Latin America those parties generally make the important bet- the-company decisions and policies, while CEOs are mainly responsible for execution.

An MBA degree

In the wake of the financial crisis, MBAs were accused of being value destroyers. We supplied the debate with some contrary data in 2010, showing that the average MBA ranked 40 places higher in the study sample than the average non-MBA. We saw similar results in this year's list. In this case, we did not discover that CEOs of certain nationalities benefited more from an MBA than others.

Doing Well and Doing Good

Many management thinkers argue that it is no longer enough to do well financially; companies also need to improve the well-being of (or at least not harm) the communities in which they operate, the environment and their employees. (See, for example, *Cre-ating Shared Value*, by Michael E. Porter and Mark R. Kramer, HBR January–February 2011.) That's the good news. The bad news is that stellar performance on both dimensions is no common or easy feat.

This year we examined the correlation between the financial performance of leaders on our list and their social and environmental performance as measured by MSCI, a highly reputable firm that rates major companies. Despite all the rhetoric, we discovered that the correlation between the two sets of data is, well, zero. Though many articles suggest that responsible corporate behavior - say, in sustainability - will automatically improve your bottom line, clearly it's not as simple as that. Some companies probably aren't managing with such issues in mind. Some may not have attractive social or environmental strategies; some may have misalignment between those strategies and the overall corporate strategy; and some may have incomplete measures of social or environmental practices.

But our analysis did reveal outliers: Five percent of the CEOs for which we had sufficient data delivered great financial performance year over year and performed strongly on social and environmental dimensions. It is a rare achievement, indeed, but it is possible.

These trendsetting CEOs are the new role models for leaders pursuing the paradigm of creating shared value. One example: Franck Riboud of Danone, a French multinational with $27 billion in annual sales. Danone's excellent financial performance earned him a spot in the top 10% of this year's sample (a truly amazing achievement for a consumer goods company); at the same time, the company received extremely high ratings from MSCI. Another outlier is Natura's Alessandro Carlucci (who made the top 6% for financial performance), a leader among CEOs who believe that alleviating poverty and inequality and protecting the environment are intimately tied to their business agendas. Carlucci and Riboud have both confronted the key social or environmental issue in their industry (in Danone's case, obesity and unhealthful food consumption; in Natura's, deforestation and poverty) and redirected their company's strategy to tackle it.

We also looked at CEOs whose companies had high social and environmental performance in 2010 but whose financial performance kept them out of the top 15% of the group studied that year. Since doing both well and good can be a long-term strategy, we wanted to see whether any of those CEOs had then moved into the top 15% of the current financial ranking. We found four: the leaders of Adidas, Inditex, Hermès International and Eaton.

At Adidas, CEO Herbert Hainer oversaw the im-plementation of a triple-bottom-line philosophy, a massive push to slash the company's carbon foot-print and the increased use of recycled polyester as well as sustainably farmed cotton in products. One of Adidas's latest sustainable innovations is DryDye technology, which removes the need for water in the dyeing process. At Eaton, Alexander Cutler has embedded sustainability into the company's culture and practices. The diversified power management company develops innovative products and pro-cesses, such as hybrid electric and hydraulic power trains and electric power control systems, that help customers and consumers conserve resources and reduce their carbon footprint.

This new breed of leaders not only rejects the idea that financial market demands are more important than stakeholders' needs but also demonstrates that companies can excel at meeting both.

"This new breed of leaders not only rejects the idea that financial market demands are more important than stakeholders' needs but also demonstrates that companies can excel at meeting both"

Jeff Bezos, Amazon.com; overall rank 2nd: *"You have to be willing to be misunderstood"*

We don't foresee a time in the near future when measures of social performance will be as objective as the measure of long-term financial performance we've developed. That said, we will continue to track how CEOs are doing in the two areas, with the aim of encouraging leaders to shine in both.

Everyone in the business world seems to agree that executives should be less obsessed with quarterly earnings and more focused on the long term - everyone, that is, except the decision makers who hire and fire executives and the people who buy and sell company stock. The short-term emphasis won't change until a new paradigm for evaluating performance emerges. Talk alone won't bring about that change; we also need a whole new method of evaluating CEOs. Here, we're proposing two key improvements: a robust, objective measure of leaders' performance over their full terms in office, benchmarking all chief executives of major global companies; and an assessment of the correlation between a firm's financial results and its environmental and social practices. We hope that boards of directors, pension funds, hedge funds and other shareholder activists will use these measures to better evaluate CEOs and to guide the selection of tomorrow's leaders.

"Everyone in the business world seems to agree that executives should be less obsessed with quarterly earnings and more focused on the long term"

The highest-ranked woman on the list is Meg Whitman, currently the CEO of beleaguered HP, Overall, only 1.9% of all the CEOs we studied were women.

Full publication available at:

http://hbr.org/2013/01/the-best-performing-ceos-in-the-world

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Executive Summary

The CEO Pay Slice

by Lucian A. Bebchuk, Martijn Cremers, and Urs Peyer

Journal of Financial Economics 2011, vol. 102, issue 1, pages 199-221

The inner workings of the top executive team, and their importance for firm performance, are hard to observe or quantify. In this paper, we aim to contribute to the subject by introducing a new measure pertaining to the relationship between the Chief Executive Officer (CEO) and the other members of the top executive team, as well as studying the relation between this measure and the performance and behaviour of firms. Our new measure is CEO Pay Slice (CPS), which is defined as the fraction of the aggregate compensation of the firm's top-five executive team captured by the CEO. By basing CPS on compensation information from executives that are all at the same firm, we control for any firm-specific characteristics that affect the average level of compensation in the firm's top executive team.

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The study looked at more than 2,000 publicly traded companies in the U.S. Such firms must disclose publicly the compensation packages of their five highest-paid executives. Our analysis focussed on the CEO "pay slice" – that is, the CEO's share of the aggregate compensation such firms award to their top five executives. We found that the pay slice of CEOs has been increasing over time. Not only has compensation of the top five executives been increasing, but CEOs have been capturing an increasing proportion of it. The average CEO's pay slice is about 35%, so that the CEO typically earns more than twice the average pay received by the other top four executives. Moreover, we found that the CEO's pay slice is related to many aspects of firms' performance and behavior.' It turns out that the bigger the CEO's slice of the pie, the lower the company's future profitability and market valuation.

The paper reveals a number of important correlations between what is known as "CEO pay slice" and various key measures of corporate financial performance. The study found that firms with a higher-than-average CEO pay slice were more likely to:

- Generate subpar returns for their shareholders.
- Produce lower profitability based on total assets and available capital.
- Make worse-than-average acquisition decisions.
- Reward their CEOs for fortuitous events (e.g., a rise in profits for an oil company due to an increase in worldwide oil prices) rather than for the outcome of their actual business decisions.
- Overlook poor performance, such that the probability of CEO replacement in the face of adverse earnings was lower than in comparable organizations where the CEO's pay slice was smaller.
- Provide CEOs with favourably timed options grants, an indication of either deliberate backdating or the use of inside information.

Governance Correlation

"A high CEO pay slice may signal governance problems that might not otherwise be readily visible."

What explains this emerging pattern? Some CEOs take an especially large slice of the top five executives' compensation because of their special abilities and opportunities relative to the other four. But the ability of some CEOs to capture an especially high slice might reflect undue power and influence over the company's decision-making. As long as the latter factor plays a significant role, the CEO pay slice partly reflects governance problems.

We should stress that a positive correlation between a CEO's pay slice and governance problems does not imply that *every* firm with a high CEO pay slice has governance problems, much less that such firms would necessarily be made better off by lowering it. In some such firms, the large pay slice captured by the CEO may be optimal, given the CEO's talents and the firm's environment, and reducing the CEO pay slice might thus make the firm and its shareholders worse off.

Still, our evidence indicates that, on average, a high CEO pay slice may signal governance problems that might not otherwise be readily visible. Investors and corporate boards would thus do well to pay close attention not only to the compensation captured by the firms' top executives, but also to how this compensation is divided among them.

Beyond our particular findings and their interpretation, our general conclusion is that CPS is an aspect of firm governance and management that deserve the attention of researchers. Future research on the effects of governance arrangements and management processes - as well as research on a wide range of aspects of firm behaviour and decision-making - could consider using CPS as a useful control or a subject of investigation. We hope that our work can provide a framework and a starting point for this line of work.

It turns out that the bigger the CEO's slice of the pie, the lower the company's future profitability and market valuation

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Executive Summary

CEO Ability, Pay, and Firm Performance

by Yuk Ying Chang, Sudipto Dasgupta and Gilles Hilary

Winner of 2012 Syntec Prize in Research and Management

Management Science, Vol. 56, No. 10, October 2010

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The debate over whether CEOs add value to firms has come under renewed scrutiny in the wake of the global financial crisis. Recent indignation over seemingly exorbitant CEO compensation in the face of poor company performance have given rise to the question: Does CEO pay accurately reflect CEO ability? If so, does the CEO make a difference to company performance? Practitioners intuitively know the importance of top CEOs, however does academic research concur? Despite its extreme importance, there is surprisingly little direct evidence whether CEOs contribute positively to firm value.

It is plausible to assume that the firm's performance is largely determined by the nature of its core competence, the quality of its products, other employees and stakeholders, its life cycle, and even possibly by 'luck'. According to this view, CEO ability is relatively unimportant for firm value, and in fact there are reports that say that in any well-run company that's conscientious about grooming its managers - candidates for the top job are so similar in their education, skills, and psychology as to be virtually interchangeable. All that matters is that someone be in charge. An even more cynical view is that, CEOs are in fact in a unique position to deeply establish themselves in such a manner that they obtain uncompensated value without making any real contribution to productivity (called rent extraction). Some argue that CEOs can easily capture their boards and essentially set their own pay, which is then determined more by managerial power than by ability.

In this paper, we test the proposition that CEO ability matters. In addition, if ability difference exists across CEOs, we examine whether these differences are reflected in CEO pay. We look at entire cross-section of firms, and find that compensation is actually a positive predictor of performance. The main takeaway is this: remuneration is reasonably well aligned with performance - i.e. better compensated CEOs deliver higher performance and are better valued by both financial markets and other employers. However, these positive relations disappear when the corporate governance of the firm is bad.

The Study

The main stumbling block has been how to measure CEO impacts on a firm. We fill that gap with a study of CEO departures so that we can take a 'before and after' snapshot. And we find that yes, CEOs do matter.

The study assesses 298 voluntary and forced CEO departures in the US from 1992-2002 on three factors: the stock market reaction to the departure news, the subsequent success of the CEO in the managerial labor market, and the performance of the firm after the CEO leaves. We examine how these factors relate to the past performance of the firm while under the CEO's management, and the CEO's pay relative to the other highest paid executives of the firm.

Examination of the stock market's response to the departure of a CEO is very informative about a CEO's contribution to firm value. However is this perception or

actual ability? To find out, we also examine whether the firm's post-CEO-departure performance is related to the prior performance, relative pay and abnormal returns around the announcement date.

"We find a positive correlation between the level of compensation and either firm performance, managerial career outside the firm and financial market perception However, these positive relations only exist when the governance is good."

The Findings

Do CEOs really matter to firm profitability? Here are our key findings:

- Stock market reactions to CEO departures link CEO ability with firm performance. The market reacts more negatively when a more capable manager who generated higher stock returns leaves a company. Past firm performance and CEO pay also have an impact on a CEO's subsequent career. Those from stronger performing firms and with higher pay were more likely to progress to the expected top positions in public or private companies. Moreover, the firm who sees a capable CEO depart has a poorer stock and operating performance in the one to three years after he or she leaves.
- Collectively, our results *reject* the view that differences in firm performance stem entirely from non-CEO factors such as the firm's assets, other employees, or 'luck', and that CEO pay is unrelated to the CEO's contribution to firm value.
- Even when comparing differences within a particular industry or with other companies, our results are consistent with the view that firm value and performance are related to ability differences across CEOs.
- We also find evidence *against* the view that CEOs are paid well simply because they are in a position to extract better compensation from their boards.

All of this adds up to evidence that top managerial ability has been a factor in the firm's success. The insight for management is that the CEO's pay is often justifiable with respect to the market for CEOs and when the CEO's influence on company performance is considered.

The advantage of our multi-pronged approach is that it leaves little room for alternative explanations. For instance, it could be argued that CEOs 'jump ship' or are forced to quit when the firm's future prospects look dim, but this would not explain why the manager's subsequent job prospect is positively related to past pay.

It comes down to Governance

Previous important research revealed that in firms where manager are entrenched, the CEO's pay relative to the pay of the four other highest-paid executives in the company is negatively associated with firm performance – interpreting this evidence that high CEO relative pay represents rent extraction by CEOs. We found that CEO relative pay is no longer significant in firms with poor governance characteristics. However, our results are stronger, both economically and statistically, in the firms with good governance characteristics. These results suggest that governance plays a very important role in determining the pay-performance relationships.

Full Publication available at

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1608312

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Executive Summary

The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value

by Vicente Cuñat , Mireja Gine and Maria Guadalupe

Winner of 2012 Brattle Distinguished Paper Prize, Corporate Finance

This paper investigates whether improvements in the firm's internal corporate governance create value for shareholders. We analyse the market reaction to governance proposals that pass or fail by a small margin of votes in annual meetings. We present novel evidence of the effect of corporate governance on the market value and long-term performance of firms.

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Corporate Governance and Firm Value

Our research found that on the day of voting, firms that passed a governance related proposal had a 1.3% higher market return than firms that did not. We estimate that this reflects the fact that adopting one governance proposal increases shareholder value by 2.8%. Furthermore, the market responds positively to the governance change, and the effects are sustained in the long-term - for 3-4 years after the vote, as reflected by the market to book value.

We also found evidence that firms with better governance practices in place carried out fewer acquisitions. This suggests that managers are more conservative in their acquisition strategy under the improved corporate governance structure (with more shareholder rights). We argue this possibly indicates that better governance reins in the tendency towards potentially inefficient and unnecessary acquisitions.

Interestingly, our research showed that the biggest price reaction was in response to removing anti-takeover provisions, in particular poison pills and staggered boards. In contrast, other governance proposals, such as proposals to make auditors more independent or compensation issues did not lead to significant market responses.

How did we discover this?

There are two problems that one traditionally encounters in trying to assess the relationship between corporate governance provisions and firm performance using data. One is the „expectations problem" – that is the fact that provisions are normally talked about, discussed in various meetings and leaked to investors, and therefore in most cases the market already knows beforehand whether certain provisions will be adopted or not. So, in absence of a surprise, it becomes hard to measure the market"s accurate response. The second is the „endogeneity problem" - that is the difficulty of measuring the causal relationship between a firm"s positive or negative performance with strong or weak governance structure because governance structures are also related to many other firm characteristics, making it hard to identify a causal relationship.

These problems are pervasive in the existing literature. To overcome these limitations, we need a setting in which governance rules are exogenously or

„randomly" adopted and, at the same time, in which their adoption is not foreseen by the market and incorporated into returns.

We found a clever way to relate firm performance and market value to governance: by looking at close-call votes on shareholder sponsored governance proposals in annual shareholders" meetings. For example, when shareholders want to remove a poison pill, their proposal is voted on in the annual meeting. In many cases, these proposals obtain votes that are very close to the majority threshold of 50% (i.e. some obtain 49% some 51% of the vote). Focussing on proposals that had „close-call votes", solves both the expectations problem and the endogeneity problem. We call this technique a „regression discontinuity design" because it focuses on the differential response of firms - that barely a pass a proposal relative to firms that barely fail to pass a proposal. This allows us to obtain a causal estimate of governance on firm value and performance.

Close Call Proposals

The crux of the paper is this: For these „close-call" proposals, passing is akin to an independent random event (it is "locally" exogenous) and therefore uncorrelated with other firm characteristics. This solves the endogeneity problem. Intuitively, the characteristics of a company in which a proposal passes with 50.1% of the votes are similar to those of a firm in which the proposal gathers only 49.9% and fails to pass. However, this small difference in the vote share leads to the resolution of uncertainty and a discrete change in the probability of implementing the proposal. This resolution of uncertainty solves the expectations problem.

Generally, the problem with governance is that firms do not adopt governance structures randomly, but if we focus on these close-call proposals, it is as if we were randomizing which firms change their governance and which do not: We try to approximate what one would do in a „clinical trial", which allows us to say something about causality.

Who's Interest?

The challenging question then is this: If better governance provisions are so valuable, why don"t all firms adopt them systematically? We argue that one possible explanation is that the current governance structures in the U.S are such that the large institutional shareholders, (e.g. banks, mutual funds) vote in the interest of management – who typically oppose these corporate governance improvements and the increased shareholder oversight. This is because in addition to shareholder prices they may have other interests in the firm. At a minimum, our results point to the presence of a substantial agency problem. Our results suggest that there is something getting in the way of aligning these incentives better, but unfortunately we don"t have evidence to document what that is exactly. This is an important question given the implications we show it has for the market value of firms, and it is certainly an issue that needs to be investigated further.

"Our research found that on the day of the vote, firms that passed a governance related proposal had a 1.3% higher market return than firms that did not. We estimate that this reflects the fact that adopting one governance proposal increases shareholder value by 2.8%."

The challenging question then is this: If better governance provisions are so valuable, why don't all firms adopt them systematically?

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Executive Summary

CEO Replacement in Turnaround Situations: Executive (Mis)fit and Its Performance Implications

by Guoli Chen and Donald C. Hambrick

Organization Science, 2012

The Authors

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One of the most common universal prescriptions for a company in trouble is to replace the CEO, however, this isn't without significant pain and cost. So do the benefits outweigh the costs and liabilities? Our initial question was: 'Is CEO replacement beneficial for companies in turnaround situations? On average our data revealed that this did not accomplish anything – that is, it is neither good nor bad. So then the richer part of our paper explores the question: 'What kind of replacement is most beneficial and does it depend on the attributes and qualities of the person you choose to be CEO'?

A firm's performance implication with CEO succession or CEO change in general is a hotly debated subject, with theories and empirical evidence throwing up mixed findings. Some are positive stating that the new CEO brings in fresh ideas, new resources and different perspectives; while others point out that leadership change is destructive and that the new CEO may not understand the company, with the overall survivor rate being low and the company performance actually worsens. And yet another set of literature reveals that it doesn't matter either way, i.e. if the industry gets better, the company will perform better and it doesn't matter who the CEO is.

Once we confirmed, from prior research literature, that on average succession does not make a difference to firm performance, then we explored the more subtle idea - that success depends on how badly suited the incumbent is and how well suited the successor is. For example, if the company's problems are largely or partly due to the fact that the industry is in a chronically bad state, then it is better to replace the CEO who might be a long term industry insider, because he is probably too entrenched or contaminated by industry recipes. The other part of that equation is that the successor CEO then would ideally be someone who comes from outside the industry. And we find great support for this – the '*misfit*' of the incumbent and the '*fit*' of the successor. It is a more sophisticated idea than just the matter of replacing a CEO *p er se*.

In a turnaround situation, one of the immediate reactions typically is to get rid of the CEO, who takes the proverbial silver bullet. This traditional wisdom supported by descriptive data is considered common enough to be a rule of thumb for board of directors. The annual CEO succession rate, on average, is around 10%, whereas in turnaround situations it was more than doubled! One set of data showed that the immediate market reaction to CEO replacement on average was slightly positive, i.e. the market also thought it was a good idea to replace the CEO. However, the long term performance of the company (1-3 years) showed that on average, CEO replacement had no effect on firm performance.

Corporate Governance Insights

"The boards of troubled firms are often under pressure to make prompt leadership changes, thus lacking deliberate-ness or care in such actions"

It is important for boards to understand that simply replacing the CEO is not going to accomplish very much. But unfortunately, too often, under the pressure of poor performance, boards do gravitate to CEO replacement as a handy solution. Or sometimes it's under pressure from investors or shareholders, and is carried out for ritualistic purging and ceremonial purposes, which is very rampant in companies - getting rid of the incumbent and appointing a new successor quickly, with the chief attribute of the latter being just that he is new. The board needs to be very careful, because it is possible that the incumbent CEO might well pass the test of being better suited in executing the turnaround, and in which case the board should be doing all that it can to hold on to the CEO. However, this rarely happens.

The best advice we can give to a board is to not fall victim to any knee jerk pressures or impulses to replace the CEO. The board needs to carry out a thorough diagnosis of the source of the company's problems - is it a bad industry issue; are there wrong decisions that the incumbent's predecessor had made that are still in the process of being fixed; etc. It is important to fully understand if the incumbent CEO is the source of the problem, and then to step back and ask if this particular CEO also has the capabilities to fix it. Sometimes, even if the troubled situation is the incumbent's fault, he might still have the best tools, experience and qualities to find the solution. If analytics reveals that there were exogenous factors, then there is little reason to assume that the replacement CEO would do any better. The bottom line: *It is the board's responsibility to be objectively diagnostic about the CEO's capabilities, his degree of fit and source of the problems of a troubled company.*

Sometimes the pressure comes from investors or shareholders, but the most troubling aspect is if journalists lead the charge, with no direct stake in the company, but who wave the sensational news flag, that decision-makers succumb to. Furthermore, though CEO replacement or dismissal isn't as prevalent outside the US, when it does happen, the core logic still pertains in any cultural context.

In brief, the top learning's for directors are: 1) Simply changing the CEO doesn't help; 2) Evaluate organizational requirements and candidate. 3) CEOs have certain generic attributes and certain specific ones – so the board needs to look at both kinds of human capital better.

Method

In a turnaround situation, one of the immediate reactions typically is to get rid of the CEO, who takes the proverbial silver bullet.

Though some of our findings and conclusions might look intuitive and logical, the problem is that companies are not doing what seems like common sense, and previous research has not been able to test and show empirical evidence that the board can refer to in pushing back unwarranted pressure from big investors for hasty CEO replacement.

First we identified what is a 'turnaround situation' in over 220 companies in the United States of America. We tracked when the companies got into a troubled state and if they replaced the CEO. Who was the predecessor and who was the successor. From prior turnaround literature we drew on two issues – the severity of the situation and the source of the problems, i.e. industry related or firm specific. Based on these, we posed certain hypotheses which we tested, e.g. what kind of CEO was the predecessor, what expertise did he have, what was the CEO tenure and industry background, etc. We examined companies that were not only in a turnaround situation, but ones who experienced a very rapid and steep drop in performance – i.e. companies that went from good profits to actual losses. The reason we chose to examine such companies is so

that we could test the possibility that the CEO would be replaced in the first year of poor performance and explore the question of what happens from there.

Since we found that the CEO succession rate was higher in turnaround companies, we were able to collect more observation points, and it also gave us a context to measure the organisation's needs. Furthermore, in such a situation the CEO effects are felt higher and can be tested, compared to those in a healthy company where all processes and systems are running smoothly and the CEO effects are less felt.

We looked at the view taken by Finkelstein, Hambrick and Cannella (2009) in their portrayal of CEO succession, that it is an occasion for boards to realign company leadership with contextual conditions. According to Finkelstein, et al's 'fit-drift/shift-refit' model, when a board selects a new corporate leader, it has an opportunity to appoint a person whose competencies fit current and foreseeable contextual requirements. Over time, as conditions drift (or possibly radically shift), the CEO's capabilities and mindset tend to become less suitable. Succession provides the board a new opportunity to once again refit executive competencies to the altered context. The board needs to continuously evaluate the competencies of the CEO and the contextual needs of the company. However, this was not easy to test empirically prior to our research. In turnaround situations where we can compare the predecessors and successors of companies, it was possible to test for empirical evidence to support this argument.

Key Findings & Implications

Based on the sample of companies in turnaround situations, we found that when boards of troubled companies remove incumbents who are substantively mismatched for the contextual circumstances at hand, and when they appoint new CEOs who are well matched to these conditions, the companies have greatly increased chances of improvement.

People believe that the CEO expertise is an important resource for a company. But this is not always true. In fact, we find that this can be a burden for certain companies. For example, in companies with market share erosion, when no new products are launched and the product cycle has slowed down, a good operations experienced CEO might be a burden because what the company actually needs are exciting new products. However, the leadership of Hewlett Packard's CEO Mark Hurd, for example, with his prior experience as COO, was the right fit, in solving HP's integration problems (leading to huge operations costs) when it merged with Compaq. It is important to understand that a CEO's expertise and experience is not a universal resource. There is no all-purpose universal CEO. Some of the human capital traits are generic, like personality types, but other aspects are very specific such as industry knowledge, relationship with suppliers, understanding of the organization, etc. It depends on the context and localized needs.

Often companies wrongly assume that a 'star' CEO from one company will be a 'star' in any company. A case in point is Robert Nardelli, a talented former executive at GE who came within a hair's breadth of replacing Jack Welch as head of the giant conglomerate, brought the wrong toolbox to the job after he was recruited for Home Depot's top spot in December 2000. He did not know the retailing business and mistakenly thought that what had worked at GE could be readily transplanted to Home Depot's more freewheeling, entrepreneurial culture. After years of stumbling stock prices - and a now-legendary 2006 shareholders meeting where an imperious Nardelli refused to answer questions - Home Depot announced the CEO's resignation on January 3. He walked away with a package worth US $210 million.

"The board needs to continuously evaluate the competencies of the CEO and the contextual needs of the company"

Succession success depends on how badly suited the incumbent is and how well suited the replacement is

We found considerable support for the following propositions about CEO (mis)alignment in turnaround situations: 1) If performance problems are severe, the company will benefit from replacing a long-tenured CEO, and it will benefit from an outside successor. 2) If performance problems are severe, the company will benefit from replacing a CEO who lacks throughput experience (i.e. for managing major asset/cost rationalization), and it will benefit from appointing a successor who has such credentials. 3) If the industry performance problems are severe, the company will benefit from replacing a long-tenured industry veteran, and it will benefit from hiring an industry outsider. 4) When a company faces a severe situation, requiring major changes and especially retrenchment, the chances of these actions occurring, and of recovery, are greatest when long-tenured incumbent departs and an outsider arrives.

Further Research

Our study has implications for multiple research streams, most notably upper-echelons and corporate governance literature. We extend the centrally important idea that executives have finite, bounded repertoires, and that the value of a given executive's repertoire depends on the business context.

Even under normal, healthy company conditions, succession issues generally still generate puzzling results and not enough has been understood about the complexity of change leadership. For example, one research area is related to a board selecting an heir apparent or the next CEO a few years before the incumbent's retirement and therefore presuming the context of the company's need ahead of time - there is such a thing as betting on somebody earlier than you should.

Which boards get it right? This paper indicates the promise in considering predecessor and successor attributes in tandem, which may be an important new avenue for succession researchers.

"We extend the centrally important idea that executives have finite, bounded repertoires, and that the value of a given executive's repertoire depends on the business context"

The performance implication of CEO replacement depends on the actual characteristics of the incumbent and whether the new person really has the qualities now needed.

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