# Evaluate the effect of CEO fame (awards) and fortune (pay) on firm value.

ECO-2A10 The Economics of Corporate Finance

LIAM KILROE*

## 1. Introduction

The recent financial crisis, and the subsequent unravelling of the global economy, has highlighted the existence of several contentious issues regarding corporate governance. Corporate governance differs significantly between firms and a lack of agreement in economic literature regarding an optimal structure reinforces the contention. As the leader of the board of directors, the CEO acts as a figurehead for the firm and is therefore central to the debate about corporate governance thus their actions must be examined. Achieving this initially requires a brief exploration of the economic theory underlying the corporate governance problems with particular focus on the role of the CEO. Moving forward, analysis of papers by Wade et al (2006) and Malmendier et al (2009) provides focus on the effects of awards and pay on firm value. A brief understanding of their methodological approaches and then examination of their empirical findings will allow an evaluation of the positive and negative impacts of CEO fame and fortune.

---

* 2nd year, BSc Economics

**2. Underlying Theory**

The areas of contention in corporate governance come about because of microeconomic inefficiencies. The principal-agent problem arises when there is a separation of ownership and management within a firm. The assumption that individuals act rationally to maximise their own utility creates a conflict of interest between the owners and the managers whom they employ. While the CEO is appointed to maximise firm value they may undertake activities which conflict with this goal as they strive to maximise their own utility. Additionally, the presence of asymmetric information, with managers benefiting from insider knowledge, enhances their ability to pursue self-interested objectives. Moreover, as ownership becomes more dispersed a free-rider problem is created whereby the individual shareholders lack sufficient incentive to properly monitor management (Brown, 2011). Ang et al (2000) examine these issues and conclude, expectedly, that agency costs rise as separation between management and control increases.

The empirical evidence of Gompers et al (2003) supports the intuitive theory that provisions to protect management, such as severance packages, have an adverse effect on firm performance. With protection, the disincentives of failing to maximise firm value are reduced thus encouraging the manager to 'slack off' or pursue self-interested goals. However, the direction of causation remains unclear. Do successful firms implement shareholder rights or do shareholder rights create successful firms? (Gompers et al, 2003)

The papers produced by Core et al (1999) and Bertrand et al (2003) specifically investigate the role of the CEO with relation to firm performance. Core et al look at the effects of various aspects of board composition and conclude that "firms with weak governance pay their CEO more than firms with strong governance, even after controlling for the economic determinants of pay" (Core et al, 1999). Bertrand et al seek to progress from the previous literature and observe whether the agency costs result in 'slacking off' or empire building, both of which are assumed to have adverse effects on firm value. They find that CEOs tend to open and close fewer plants, using this as a proxy for slacking off, and on average pay

employees higher wages. They conclude that, when protected by Business Combination laws, managers tend to shirk rather than empire build allowing productivity to decline and increasing their own prestige.

In order to carry out a full evaluation of the effects of awards and pay, the papers by Wade et al and Malmendier et al must be examined more fully. Both papers look at the effect of media recognition and certification on firm performance and CEO compensation.

**3. Methodology**

Wade et al work with a subsample of the S & P 500 taken at the end of 1992. 278 companies are included in the analysis because those with discrepancies in financial years and others with missing data are excluded. Information regarding CEO compensation is taken from the Compustat database. The majority of the work is based upon the *Financial World's* CEO of the year competition. CEOs are ranked according to their ratings received from analysts and other CEOs, obtained via an annual survey. They use this information to conduct an event study which explores how the public knowledge of certification influences firm performance judged by markets returns and returns on equity. A general method of moments model is eventually used, after the introduction of a lagged variable, as a means of avoiding serial correlation and observing results independent of reversion towards the mean.

Malmendier et al use a hand collected sample of award winners across a wide range of publications from 1975 to 2002. Again, they use the Compustat database for CEO compensation information. They also formulate a propensity to slack variable based on books written, external board positions and golf handicaps. Using this data they construct a 'nearest neighbour' matching estimate which uses observable characteristics to predict which CEOs are most similar to the award winners. This is necessary as it is believed to provide the best alternative to the performance of the CEO had had they not won the award, which is obviously not attainable. A regression is then conducted which compares the performance of award-winning CEOs to those most similar to them as determined by the matching criteria.

The statistical analysis in both papers is robust and detailed therefore the results should be powerful and reliable. Control variables are used at every stage to control for economic determinants of variation in both compensation and performance, such as company size and industry. Thus the results aim to isolate the real effects attributable to changes in behaviour due solely to certification or compensation. The models are formulated especially to observe the real effects occurring beyond mean reversion which could otherwise be used as an explanation of underperformance after an award.

**4. Fame (awards)**

It is plausible that certification of a CEO may have either positive or negative effects on firm value. An award provides recognition of the CEO's ability which in turn is likely to increase the status of both the individual and the firm. The firm may benefit from increased sales, due to greater media exposure, and/or improved access to capital, since lenders are now more confident about the leadership and future of the firm. In contrast, an award could lead to overconfidence and complacency from the CEO as the newfound celebrity status draws their attention away from maximising firm value. Empirical evidence is required to determine which of these outcomes occurs.

Wade et al find evidence for small, positive abnormal market returns over the short term; indicating a favourable response from the market to the certification of the CEO; signalling a belief that firm performance is going to improve in the future. However, this effect is found to lose significance within three days, and moreover, the effects are found to be reversed in the long term. A highly significant return of -8.23 percent over the longest time horizon of 240 days indicates that investors lose confidence in firm performance after the CEO is awarded, supporting the argument for overconfidence and complacency (Wade et al). However, neither the market adjusted measure nor the return on equity measure provide statistically significant results. Consequently, our conclusion is limited to the market perceptions of the firm changing over time because of CEO certification; profitability does not appear to be affected.

Malmendier et al find “no evidence of an immediate market reaction to CEO awards” but they do find strong evidence of underperformance in the long run over one, two and three years. Firm performance is found to be between 15% and 26% below that of the predicted winners over the long term. These results are confirmed by an investment portfolio robustness test. An efficient market assumption would expect investors to immediately account for changes in information and this to be reflected in the price. As this does not happen there is evidence that investors opinions of the CEO change over time and this may be due to failure to meet expectations. This paper also proceeds to examine accounting returns as another indicator of firm performance. As with Wade et al, the results do not provide any significant evidence of a change in operating performance following CEO certification. Winners and non-winners are found to be statistically similar. (Malmendier et al)

Overall, while the papers adopt different approaches to measure the effects of CEO awards on firm value they produce similar conclusions. There is some evidence for an immediate positive effect on market returns but the results overwhelmingly imply the CEO certification leads to a fall in the firm’s market value in the long term. However, as this is not supported by evidence for a fall in the firm’s profitability we are unable to make definitive interpretations. At most the results imply that firm performance fails to meet market expectations following a CEO award. This may signal that celebrity status encourages the CEO to make over optimistic predictions which are not realised, perhaps due to complacency.

**5. Fortune (pay)**

The effect of CEO compensation on firm value is difficult to ascertain. Economic theory will clearly suggest that it is optimal for the firm to compensate a CEO up to the point where the marginal cost of pay is equal to the marginal benefits the CEO brings. The complexity of firm performance and unclear impact of CEO compensation make this impossible to accurately establish empirically. In theory, the CEO can be incentivised to maximise firm value by linking compensation to firm performance through payment in equities. However, the CEO will often be able to extract additional compensation if the level

of monitoring is insufficient. This makes both positive and negative compensation effects feasible. Both papers address the issue by considering whether or not compensation is affected by certification. Then, if compensation changes the subsequent change in performance will indicate the relationship they share.

Wade et al find that an award will increase compensation by approximately ten percent in the following year. Furthermore, each award in the previous five years is found to add almost five percent to total compensation, on average. Thus it is clear that winning an award is expected to lead to a substantial increase in compensation. Interestingly, the further finding that CEO compensation is dependent on maintaining a certain level of performance gives rise to the idea of the 'burden of celebrity'. The results indicate that while CEO pay does rise if expectations are met, if they are not achieved award winners are more likely to experience a fall in compensation. Consequently, awards and higher pay can be seen to raise the shareholders' expectations of CEO performance making the position more precarious. The results suggest that causality may be stronger in the opposite direction; at the CEO level performance may have a greater impact on compensation than compensation has on performance to an extent. Further analysis is required to determine the effect this burden has on firm value.

Malmendier et al find evidence of a significant immediate increase in total compensation for CEOs following an award but no significant increase in cash compensation. This increase fades, but is still significant, over the three year horizon. They provide two possible interpretations for these results. Firstly, shareholders mat increase equity-based compensation to offset agency problems. Alternatively, CEOs use increased power to extract extra compensation and view equities as the least likely to "violate the shareholders' outrage constraint" (Malmendier et al, 2009).

It is evident that certification is likely to increase the compensation of the CEO but this may come with increased expectations which, if not met, are seen to lead to a fall in overall compensation in the long term. The direct effect of compensation on firm value will depend on how the CEO is incentivised to maximise firm value. If the CEO is able to extract rent due to agency costs firm value will not be maximised.

## 6. Other relevant findings

Another important result from the Superstar CEO paper is that the strength of corporate governance, in terms of shareholder rights, determines the change in CEO compensation following an award. By using an established governance index the sample is grouped according to strong or weak corporate governance. It is found that increases in compensation and long run underperformance are concentrated in firms with weak corporate governance (Malmendier et al) This underlines the importance of strong corporate governance in ensuring continued strong firm performance.

## 7. Conclusion

Examination of the two relevant papers generally reveals a positive relationship between certification and compensation and, conversely, a negative relationship between certification and performance. It is difficult to quantify and isolate the effect that CEO pay has on performance but it is clear that linking compensation to performance aligns incentives and thus should minimise CEO rent extraction and complacency. Moreover, it appears that strong corporate governance reduces the adverse effects of both CEO certification and pay.

In conclusion, it is right that individual CEOs are recognised and rewarded for their achievements as they contribute significantly to the global economy. Achieving this in the presence of strong corporate governance will minimise the adverse effects of the celebrity culture on performance. This will ensure the optimal outcome for society but, as all firms are different, there will be no simple blueprint and it will be difficult to accomplish. Further research into the roles of other board members and deeper qualitative research into how firms establish what compensation they pay will help to further untangle the dynamics of corporate governance and firm performance (Wade et al).

**Bibliography**

Ang, J.S., Cole, R.A. & Wuh Lin, J., (2000) "Agency Costs and Ownership Structure" *Journal of Economic Finance*, v.55 p.81-106

[Accessed 12th March 2011 via http://tolstenko.net/blog/dados/unicamp/2010.2/ce738/03_SSRN-id94043.pdf]

Bertrand, M & Mullainathan, S (2003) "Enjoying the Quiet Life? Corporate Governance and Managerial Preferences" *Journal of Political Economy* v.111 p.1043-1075

[Accessed 13th March 2011 via http://faculty.london.edu/dgromb/papers/BertrandMullainathan(JPE2003).pdf]

Core, J.E, Holthausen, R.W & Larcker, D.F (1999) "Corporate Governance, Chief Executive Officer Compensation and Firm Performance" *Journal of Financial Economics* v.51 p.371-406

[Accessed 13th March 2011 via http://papers.ssrn.com/sol3/papers.cfm?abstract_id=10376]

Gompers, P., Ishti, J & Metrick, A (2003) "Corporate Governance and Equity Prices" *Quarterly Journal of Economics* p.107-155

[Accessed 12th March 2011 via http://papers.ssrn.com/sol3/papers.cfm?abstract_id=278920]

Hillier, D., Ross, S., Westerfield, R., Jaffe, J. & Jordan, B. (2010) *Corporate Finance*, McGraw-Hill

Malmendier, U & Tate, G (2009) "Superstar CEOs" *Quarterly Journal of Economics* v.124 p.1593-1638

[Accessed 15th March 2011 via http://www.nber.org/papers/w14140]

Wade, J.B., Porac, J.F., Pollock, T.G. & Griffin, S.D (2006) "The Burden of Celebrity: The Impact of CEO Certification Contests on CEO Pay and Performance" *Academy of Management Journal* v.49 p.634-660

[Accessed 17th March 2011 via http://www.terry.uga.edu/profiles/pub_docs/amj_burden%20of%20celebrity.pdf]