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CEO Power and Corporate Outcomes: What Can We Learn from Accounting Research?

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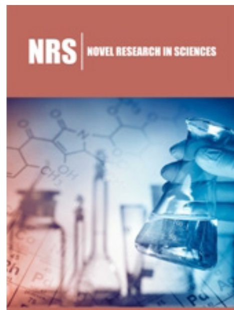

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The chief executive officer (CEO) is the highest-ranking executive in the company and can have a profound effect on the operations and performance of the organization [1]. Thus, stakeholders need to understand how CEOs make business decisions and what CEO characteristics materially influence corporate outcomes. The power and influence of the CEO vary across organizations [2]. In this review article, we discuss the lessons we can learn from the accounting literature about how the power and influence of the CEO matter for corporate outcomes. In preparing our review, we focus on academic studies published in the premier journals in accounting (e.g., The Accounting Review (TAR), Journal of Accounting and Economics (JAE), and Journal of Accounting Research (JAR)).

While the board of directors has the responsibility to protect shareholder interests, CEO's have an incentive to capture the board to maximize personal gain [3]. CEO's with more power within the organization are better able to do so. Cheng et al. [3] examine whether the level of monitoring by the Securities and Exchange Commission (SEC) Division of Corporation Finance is affected by CEO power in the company. The authors argue that regulators recognize that powerful CEO's have more opportunity to manipulate financial information due to their greater control over the board of directors. Stated differently, regulators would target firms where powerful CEO's dominate the financial reporting process and firm-level monitoring by auditors and boards may be relatively lenient (Cheng et al. 2014). The researchers find empirical evidence consistent with this notion.

Friedman [4] develops an agency model to examine the effects of a CEO's power to pressure a chief financial officer (CFO) to bias a corporate performance measure, such as accounting earnings. His theoretical model suggests that firms' responses to governance interventions like the Sarbanes-Oxley Act and Dodd–Frank will vary depending on the CEO's ability to pressure the CFO. Greater CEO power causes more negative responses to interventions that expose the CFO to greater liability for biasing.

Bishop, DeZoort, and Hermanson [5] empirically test the effects of inappropriate CEO social influence pressure and CFO accounting experience on the CFOs' reporting judgments and decisions. The results of their study indicate that compliance pressure (a request) and obedience pressure (an order) from the CEO both increase the CFO's willingness to revise their initial inventory adjustments. Furthermore, the researchers find that CFOs with accounting experience can empower resistance to CEO pressure. Baker, Lopez, Reitenga, and Ruch [6] propose that the power of the CEO relative to the CFO is an important factor in both the type and magnitude of earnings management. They study two types of earnings management, which are accruals and real earnings management. They also consider whether the passage of the Sarbanes-Oxley Act changes the dynamics. They find evidence suggesting that powerful CFO's inhibit the accruals earnings management preferences of powerful CEO's in both the pre- and post-SOX periods.

A stream of academic studies examines how CEO's use their power to attain economic benefits and personal gain. Abernethy, Kuang and Qin [7] investigate whether CEO power influences a company's decision to change its compensation system in response to regulatory and public pressure. The authors examine a component of CEO pay, which is the use of performance-vested stock option (PVSO) plans. Regulators intended the implementation of PVSOs to be beneficial to shareholders by improving the link between CEO pay and firm performance. This study finds that firms with powerful CEO's attach less challenging targets in the initial PVSOs granted to their CEO's. Further, their results suggest that powerful CEO's attempt to calm public outrage by quickly adopting PVSOs, but that adopting PVSOs quickly does not appear to be an optimal strategy for maximizing shareholder value. In sum, the work by Abernethy et al. [7] indicates that powerful CEO's can nullify some of the intended beneficial effects of PVSOs.

Chen, Cheng, Lo, and Wang [8] examine the effect of CEO contractual protection, in the form of employment agreements and severance pay agreements, on managerial short-termism. The authors argue that CEO's with contractual protection are less likely to engage in myopic behavior than other CEO's. They find that firms with CEO contractual protection are less likely to cut R&D expenditures to avoid earnings decreases and are less likely to engage in real earnings management. They further show that this effect increases with the duration and monetary strength of CEO contractual protection. In sum, this research shows that CEO contractual protection can yield beneficial corporate outcomes.

Devos, Elliott and Warr [9] show that CEO's take advantage of the timing of various corporate events. In their case, they examine the setting of stock split announcements, which are announcements that generate positive abnormal stock returns. In their sample, the authors show that 80% of CEO stock option grants are timed to occur on or before the split announcement date. Timing the stock option grants in this manner is lucrative for the CEO. Devos et al. [9] demonstrate that awarding the grant before the split announcement results in an average gain per CEO-grant approaching half a million dollars.

Henderson, Masli, Richardson, and Sanchez [10] examine CEO power in the context of how employee layoff events affect CEO compensation. The researchers propose that because of the public scrutiny and political pressures associated with both CEO compensation and layoffs, firms will alter CEO compensation by reducing bonus pay and increasing equity-based compensation as the magnitude of the layoff increases. Indeed, they find that as layoffs intensify, CEO's bonus compensation decreases and their equity-based compensation increases. However, CEO power matters in this case. During employee layoffs, more powerful CEO's experience smaller reductions in bonus pay, a higher likelihood of receiving a bonus, and comparable increases in equity compensation. Interestingly, they report evidence that post-layoff market performance of firms led by more powerful CEO's is not superior to that of firms led by less powerful CEO's.

In a newly published research work, Göx and Hemmer [11] study how friendly boards design the structure of optimal compensation contracts in favor of powerful CEO's. They show that powerful managers receive higher pay and a contract with a higher pay-performance sensitivity (PPS) if firm performance is low. Also, the authors show that friendly boards provide managers with higher salaries and more shares.

Some studies examine the personal relationships and social connections between the CEO and the board of directors. The board of directors is supposed to be independent of management and provide oversight over the CEO's suboptimal actions and decisions [12]. Personal friendships between the CEO and board members can threaten the effectiveness of monitoring by the board. For example, Bruynseels and Cardinaels [13] examine the social connections between the CEO and the audit committee, which is a sub-committee of the board in charge of monitoring the financial reporting process. The authors argue that although many audit committees appear to be "fully" independent, anecdotal evidence suggests that CEO's often appoint directors from their social networks. Bruynseels and Cardinaels [13] warn that friendship ties can lead the audit committee to be less critical of the CEO's financial reporting policies. The results of their study illustrate that companies whose audit committees have "friendship" ties to the CEO purchase fewer audit services and engage more in earnings management (i.e., have worse financial reporting quality). In sum, their work shows that when friendship ties are present between the CEO and the board, CEO's may engage in suboptimal behavior.

Lisic, Neal, Zhang and Zhang [1] posit that CEO power reduces or even eliminates the improvements in audit committee effectiveness resulting from independent and financially expert committee members. In other words, they caution that CEO power may result in an audit committee that appears effective in form but is not in substance. They find that, when CEO power reaches a sufficiently high level, an effective audit committee is no longer associated with higher financial reporting quality. The authors conclude that the substantive monitoring effectiveness of audit committees is contingent on CEO power.

Evans III, Nagarajan and Schloetzer [14] study the effect on the company when the incumbent CEO is removed from his or her position but still remains on the company's board of directors for an extended period. They call this condition "Retention Light." The authors suggest that companies may benefit from Retention Light because former CEO's possess unique monitoring and advising abilities. At the same time, the former CEO could also exploit certain situations for personal benefit. The study finds the following. Retention Light firms are more likely than CEO-exit firms to select a

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successor CEO with relatively weaker bargaining power. Moreover, Retention Light involving a non-founder CEO is negatively associated with the firm's post-turnover financial performance.

In this article, we review academic studies that investigate how the power and influence of the CEO can significantly shape corporate policies and affect business outcomes. Corporate stakeholders and market participants need to understand the implications of CEO power within the organization. Excessive CEO power can have material adverse consequences. Stakeholders ought to be cognizant about the effectiveness of governance mechanisms designed to combat the negative effects of a CEO having too much power.

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