Advances in Economics, Business and Management Research, volume 214
Proceedings of the 2022 International Conference on Creative Industry and Knowledge Economy (CIKE 2022)

A survey of research on the effect of CEO dominance and CEO characteristics on capital structure

Yaqi Zhang[1*], Yonglin Zhang[2]

[1]*School of Economics and Management, North China University of Technology, Beijing, 100114, China*
[2]*School of Social Sciences, The University of Manchester, Manchester, M13 9PL, United Kingdom*
[*] *Corresponding author. Email: heihei010906@126.com*

Abstract

In this study, we outline papers connecting firms' capital structure to CEO dominance and CEO power. Most papers examining how the choice of capital structure is influenced by one or several specific variables related to the CEO. Whether the impact on changes in leverage on firm performance depends on CEO dominance is the focus on this paper. Research generally shows that entrenched CEOs will have an impact on a company's capital structure and lead to low levels of leverage. Our study aims to summarize some existing research and propose some possible future research directions to help researchers come up with new ideas and possible advances.

Keywords: *CEO dominance, CEO characteristics, Capital structure, Leverage, Debt, Optimistic manager*

1. Introduction

The scope of our literature review involves the relationship of CEO dominance and characteristics with firms' debt ratios, leverage ratios and cash holdings, and CEO characteristics in different countries. This topic is significant considering the following points. On the one hand, capital structure is crucial to maximizing the firm value and survival. Capital structure refers the composition of the total capital value of an enterprise and its proportional relationship. It involves the firm's profits and financial risks, directly affecting its overall financial and operational performance. Excessive debt will bring greater risks, and the capital structure of a firm is also one of the important indicators for investors to analyze and predict the company's operating conditions. On the other hands, CEO dominance and CEO characteristics are factors that may affect a company's capital structure choice. That's why this topic is vital to real-world problems.

The most critical question in this topic is how CEO's dominance affects a firm's decision-making about its capital structure. Most capital structure studies only study how the choice of capital structure is affected by one or several specific variables. But it's not enough to help managers face real problems. The ultimate impact of various variables on firm performance should be examined. Whether the impact of changes in leverage on firm performance is a function of CEO dominance will be an important question. CEO dominance poses a negative consequence on agency costs by adopting sub-optimal leverage. Then, the leverage change affecting the company's performance has a negative impact on the company with greater CEO power, and the CEO power is greater than that of the smaller company.

The personal characteristics of the CEO will also affect the choice of the company's capital structure. Older CEOs are more conservative, and optimistic CEOs may adopt more aggressive strategies. The CEO's professional experience, even gender, height and other factors will also affect the company's capital structure.

2. Theory summary

Modigliani and Miller showed that under the assumption that capital markets are perfect, capital structure has no effect on firms. But obviously, the capital market cannot be perfect, so since then, researchers have developed various theories to guide the choice of capital structure [1]. The capital structure of a firm is now influenced by many factors, including bankruptcy cost, tax considerations, and conflicts of interest among interest holders.Even since the development of this literature, the applications of MM theory are supposed to be limited by practical factors.

Another theory that has received substantial empirical support and is widely accepted by the public is agency theory Smith and Watts indicated that the conflicts of interest holders can be used to explain the change of firm leverage [2]. That's to say, capital structure is determined by agency costs arising from the divergence of ownership and control [3].Due to agency conflict, managers often do not take the leverage choice to maximize shareholder value. Instead, manager may chose to improve their personal interests. Morellec developed another theory Contingent claims and held that the firm's investment policy is also the factor that matters since it is related to the capital structure decision [4].

3. Empirical literature summary

According to the slope, the following papers are collected. The papers could be divided into two strands, the impact of CEO dominance and the impact of CEO characteristics. The crucial papers simply investigated how the capital structure is influence by the variables of CEO dominance or features. Most reviewed papers focused on the hypothesis that CEO dominance and characteristics jeopardize the choice of the company's capital structure. Regression analysis is the most used empirical test. Empirical research shows that the characteristics or power of the CEO can have an impact on the firm's choice of capital structure.

3.1 CEO dominance

CEO dominance affects the firm's capital structure choices [5] and Bebchuk concluded that CEO centrality deserves as an aspect of firm management and governance[6], during which defined CPS (the CEO's compensation cut) as the CEO's all out pay as a fraction of the combined all out remuneration of the top five chiefs (counting the CEO) in an organization. The paper published in Journal of Financial Services Research, and Liu suggested that stronger CEOs tend to use lower leverage, When the CEO plays a greater leading role, changes in leverage have a more noteworthy antagonistic impact on the company's performance [3]. At the same time, a strong CEO dominance fuels the seriousness of agency conflicts. The research published in The Journal of Finance Berger, Ofek a Yermack discussed that the CEO may lead to a company's low leverage since entrenched managers seek to avoid debt. When a CEO's tenure is long, stock and compensation incentive is weak, and [7] the CEO is not strictly supervised by the directorate or major investors, the firm’s leverage ratio is low. Another paper also published in The Journal of Finance. Friend and Lang argued that capital structure related decisions are essentially to some extent motivated by managerial self-interest and the result show a negative relationship between the debt ratio and the management's shareholding, reflecting the greater non-diversifiable risk of debt to management than to public investors for keeping a low debt ratio [8]. Also, based on the data of listed companies in Ghana, the paper published in Corporate Governance. Joshua Abor used a regression analysis model to study the connection between corporate administration and corporate capital decision-making [9]. The outcomes by and large show a negative connection between term of office of the CEO and capital structure, proposing that entrenched CEOs utilize lower debt to lessen pressures on firm performance related with high obligation capital.

3.2 CEO characteristics

At the same time, CEO characteristics also affect the company's capital structure. The paper published in. Bertrand and Schoar indicated that older executives appear to be more conservative on average [10]; on the other hand, supervisors who hold a MBA degree appear to follow on normal more aggressive methodologies. The paper published in Journal of Financial Economics. Graham, Harvey and Puri showed that if a CEO's past experience is mainly in the finance/accounting field, the total debt used by the company may increase significantly [11]. Men, optimists, and private company executives are more likely to utilize a higher extent of short-term debt. The paper published in Academy of Management Journal. Li and Tang reached a similar conclusion that companies with experienced CEOs prefer to take risks [12]. The paper published in European Management Journal. Orens and Reheul discussed the influence of managers on the firm's cash holdings, indicating that when the CEO is older, the company has higher cash holdings than those run by younger CEOs [13]. Because of their risk aversion and commitment to the status quo, older CEOs will focus more on the preventive effect of cash and less on current opportunity costs, resulting in higher cash levels [13]. CEOs with experience in other industries hold less cash than CEOs without experience in other industries. CEOs with more diversified experience are more proactive about changes and innovations, and at the same time pay more attention to the opportunity cost, resulting in lower cash levels.The paper published in Financial Management. Heaton focused on managerial optimism and its relation to the benefits and cost of free cash flow via a simple model, and the conclusion showed free cash flow is beneficial when the NPV of the project is positive, because it can prevent the optimistic manager from rejecting the project because they think the financing cost is too high [14]. Free cash flow is harmful while the NPV of the project is negative and optimistic managers believe that the NPV of the project is positive because it will make the manager accept the project. Plus, Graham, Harvey and Puri showed that CEOs in the U.S. are less risk averse, more optimistic and less averse to sure losses compared with other countries [11]. It is suggested that State ownership weakens the positive relationship between CEO hubris and firm risk taking in China while Firms owned or controlled by the government were less likely to take risks and the political appointment of a CEO weakens the positive relationship between CEO hubris and firm risk taking[12].

4. Discussion of individual papers

In the previous section, the collected literature and the various findings are reviewed to summarize the influence of CEO dominance and their personal characteristics on capital structure. In this section, the process and conclusions of the paper by Berger, Ofek, and Yermack entitled 'Managerial constraints and capital structure' will be discussed in depth [7].

This paper is considered the most crucial paper in our entire investigation for two reasons. It explores the relationship between entrenched CEOs and firm capital structure. It uses many corporate governance variables in its analysis of the relationship between entrenched CEOs and leverage level, which is widely used in this field of research. This gives a more explicit direction to our investigation by allowing us to identify the variables that impact capital structure from this paper and conduct further investigation into other papers that are relevant to the study of those variables. On the other hand, this paper speculated on the relationship between each variable and leverage through the past evidence and empirical experience and used regression equations to draw conclusions. By comparing these conclusions with the literature that are collected on the impact of CEOs on capital structure in recent years, it is possible to get a good grasp of whether the direction of research and findings on a specific variable has changed in recent years, whether they still support the previous conclusions, or if there are newer perspectives.

The focus on the first part of this paper, which is a collection of data on 434 Fortune 500 companies over an eight-year period and uses cross-sectional regression to analyse the relationship between corporate governance variables and leverage. This part of the paper mainly focuses on six variables related to CEOs, which can be divided into two groups. One group of variables is directly related to the CEO, these are "CEO stock ownership", "CEO option holdings" and "CEO tenure". ", while the other group of variables represents the strength of the regulation of the CEO that many have influence on capital structure, which are "presence of at least one 5% block-holder", "board size" and "board composition".

In the first set of variables, paper's results suggest that the relationship between "CEO stock ownership" and leverage is positively and significantly related. Berger, Ofek and Yermack then states that the association with stock value greater, meaning that CEOs with a larger share of stock ownership exhibit high leverage and that incentives are equally positive influences on them [7]. However, the study also shows that although "CEO stock ownership" is generally recognized as an important factor that affect the capital structure of a firm, it has less influence on change in leverage. Another variable "CEO option holdings", the paper's regression indicated that it showed greater economic significance in the data than ownership, but they did not investigate this part in detail. Meanwhile, it is positively correlated with leverage, as well as ownership, implying that having more options encourages CEOs to create high leverage situations [7]. This also explains that CEOs whose self-compensation is directly linked to the firm value tend to use higher levels of leverage. The last variable in this group, 'CEO tenure', is further investigated and included in our previous discussion. The findings are in consistent with Joshua Abor, that is, longer CEO tenure leads to a lower leverage in the firm. There is a negative correlation between CEO tenure and leverage, and it shows some economic significance in the data [2]. Berger, Ofek and Yermack implies that the feature of low leverage may be an indication of the CEO's desire to reduce performance pressure due to high debt [7]. This point of view is also consistent with Joshua Abor [9]. At the same time, the paper speculates that high quality CEOs, that is, those with skills or highly educated, are more likely to have longer tenure, resulting in lower leverage. However, this does not appear to be the same as Bertrand and Schoar [8], which argue that highly educated managers are more likely to choose an aggressive strategy.

The second set of variables attempts to examine the relationship between variables related to the level of regulation on the CEOs and the leverage ratio. It shows the presence of significant shareholders in the firm by using the "presence of at least one 5% block-holder". And the results show that when there is a significant shareholder in the firm, the regulation of the CEO is increased, leading them to choose more debt decisions. Berger, Ofek and Yermack also states that in the role of supervisor of the CEO, the board of directors and the firm's debt holders are complementary to it, not a substitute [7]. The next two variables are associated with the board of directors and there are "board size" and "board composition". The regression shows that board size is negatively related to leverage; whilst leverage increases when there are more external directors on the board, in other words non-executive directors, which means that it is positive relation between “Board composition” and leverage. This finding seems to be consistent with Friend and Lang's observation that leverage levels are higher when there are many non-managed investors in the firm [8]. Following this result, Berger, Ofek and Yermack suggests that in smaller boards, there may appear to be greater regulation of the CEOs, leading to high levels of leverage [7]. As the paper does not define "small boards", we have investigated this section more closely. However, the results show that there seems to be no consensus on this conclusion. In Joshua Abor's study, they indicated that companies with larger boards, which have a greater level of regulation of the CEO, will pursue higher debt ratios. Then, in terms of board composition [9], Berger, Ofek and Yermack speculates that the large number of outside directors adds to the regulatory pressure and keeps the leverage ratio at a high level [7].

The six variables discussed above in relation to leverage all support the idea that an entrenched CEO will have an impact on a company's capital structure and result in a low leverage level. At the same time, this finding remains consistent with most of the papers we have surveyed. To be specific, that is, when CEOs face less regulation, have longer tenure or weaker compensation incentives, firms will exhibit low levels of leverage.

5. Conclusion

The scope of our literature review involves the relationship of CEO dominance and characteristics with firms' debt ratios, leverage ratios and cash holdings, and CEO characteristics in different countries.In discussions on CEO dominance, the research generally shows that more vital CEOs tend to use lower leverage.When a CEO plays a more dominant role, changes in leverage have a more significant adverse effect on the firm's performance. At the same time, CEO characteristics such as the CEO's age, work experience, and country of residence also impact a firm's capital structure. Older CEOs may be more conservative, and CEOs with financial or accounting experience tend to use more debt. The reviewed papers came to the same conclusion that an entrenched CEO affects the firm's capital structure which leads to lower levels of leverage. Although the surveyed papers have drawn different conclusions on the impact of CEO shareholdings and the size of the board of directors on the firm's capital structure, due to the different data cited in the papers, those results need further discussion.

In future research, several new directions and suggestions might be proposed. In terms of CEO characteristics, beyond the characteristics discussed in the papers. Other factors like the CEO are promoted internally or hired externally, the CEO has religious believe or not can also be included in the research. At the same time, due to the emergence of more and more multinational companies, CEOs may need to consider more, whether the policies and national conditions of different countries will affect the CEO, and then affect the company's choice of capital structure, which is also a direction worthy of discussion. For the data cited in the reviewed papers, their data source is totally different as the data is from various regions or countries. So when there are mutually refuting conclusions, it is impossible to make an intuitive comparison. In the future, whether such difficult-to-comparison conclusions can be avoided by using cross-country data or new research methods is also worthy of attention.

Reference

[1] Franco,M., Merton H. Miller. (1958) The Cost of Capital, Corporation Finance and the Theory of Investment. The American Economic Review, Vol. 48, No. 3 (Jun. 1958), pp. 261-297 (37 pages).

[2] Clifford W. Smith, Jr.Ross L. Watts. (1992) The investment opportunity set and corporate financing, dividend, and compensation policies. Journal of Financial Economics, Volume 32, Issue 3, December 1992, Pages 263-292.

[3] Pornsit,J., Pandej,C., Yixin,L. (2012) Capital Structure, CEO Dominance, and Corporate Performance. Journal of Financial Services Research volume 42, pages139–158 .

[4] Morellec,E. (2004) Can managerial discretion explain observed leverage ratios? Rev Financ Stud 17:257–294

[5] Lucian, A., Bebchuk, Martijn, C., Urs,P. (2007) CEO Centrality. NATIONAL BUREAU OF ECONOMIC RESEARCH, 1050 Massachusetts Avenue Cambridge, MA 02138.

[6] Lucian, A., Bebchuk, Martijn, C., Urs,P. (2011) The CEO Pay Slice. Journal of Financial Economics, Discussion Paper No. 679.

[7] Philip G. Berger, Eli Ofek, David L. Yermack. (1997) Managerial Entrenchment and Capital Structure Decisions. The Journal of Finance , Sep., 1997, Vol. 52, No. 4 (Sep., 1997), pp. 1411-1438.

[8] Friend, I., Lang, L. H. P. (1988) An Empirical Test of the Impact of Managerial Self-interest on Corporate Capital Structure. The Journal of Finance (New York), 43(2), 271–281.

[9] Abor, J. (2007), Corporate governance and financing decisions of Ghanaian listed firms. Corporate Governance (Bradford), 7(1), 83–92.

[10] Bertrand,M., Schoar,A. (2003) Managing with style: the effect of managers on firm policies. Q J Econ, 118(4):1169–1208.

[11] Graham, J. R., Harvey, C. R.,Puri, M. (2013) Managerial attitudes and corporate actions. Journal of Financial Economics, 109(1), 103–121.

[12] Li, J., Tang, Y. (2010) CEO HUBRIS AND FIRM RISK TAKING IN CHINA: THE MODERATING

ROLE OF MANAGERIAL DISCRETION. Academy of Management Journal, 53(1), 45–68.

[13] Orens, R., & Reheul, A.-M. (2013) Do CEO demographics explain cash holdings in SMEs? European Management Journal, 31(6), 549–563.

[14] Heaton, J. B. (2002) Managerial Optimism and Corporate Finance. Financial Management, 31(2), 33–45.