CORPORATE GOVERNANCE, EXCESS COMPENSATION, AND CEO TURNOVER IN FAMILY AND NON-FAMILY BUSINESSES

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Abstract

The replacement of a CEO is one of the control mechanisms that companies employ to reduce the agency problems. This paper divides companies into non-family businesses and family businesses and investigates the influence of outside directors, outside blockholders, and excess compensation in CEOs termination process. The samples used in the paper come from manufacturing companies in Taiwan listed between 1996-1997; the analytical method is logistic regression model. The conclusion is as follows: 1. the characteristics of family businesses, corporate governance, and excess compensation have no correlation on CEO turnover. 2. External board members play an important role in CEO termination in non-family businesses.

Keywords: Agency theory, CEO turnover, corporate governance, excess compensation

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Introduction

The work character of a CEO is essentially different from that of other management levels, prompting the rare occurrence of CEO turnover to be main issue for scholastic research. Among scholars, agency theory holders regard discharging or changing managing the management level as an internal control mechanism that reduces the problems of agency (Dewing, 1953). They believe a company should change its CEO when company does not work effectively. Therefore, many scholars research the effect of CEO turnover on a company, in order to prove whether the internal control mechanism is efficient. However, does a decision-maker act naturally as is mentioned in agency theory? If not, dose the mechanism work at making sure the agent's move corresponds to the owner's favor as agency theory proposes? This question is indeed worth discussing.

In Taiwan there were not many examples of changing a CEO in stock market-listed companies before 1995, but more than a hundred happened in 1996 and 1997. The problem of CEO turnover has become very clear. However, there are only a few related research studies and overseas research towards this issue still remain on the relations between company performance and CEO turnover (Benston, 1985, Coughlan, & Schmidt, 1985, Jauch, Martin & Osborn, 1980, James & Soref, 1981, Morck, Schleifer, & Vichny, 1988, Osborn, Jauch, Martin, & Blueck, 1981, Warner, Watts, & Wruck, 1988). Not until recently has there been research about board control and CEO turnover Boeker & Goodstein, 1993, Denis & Sharin, 1997, Fisel & Louie, 1990, Kang & Shivdasani, 1995, Kesner & Dalton, 1994, and Weisbach 1988 , but they do not come to the same conclusion. To offer employees an inducement with their payment policy in order to lower the turnover rate is very important in human resources management. The efficient wage model says that the most direct way to keep employees is to offer them a higher residual value than your competitors (Katz, 1986), but this affect falls short of empirical research (Harrison, Torres & Kukalis, 1988).

This paper divides companies into family enterprises and non-family enterprises. It investigates the inference of corporate governance and excess compensation on the effectiveness of CEO turnover. This paper reviews literature pertaining to the above issues and develops six hypotheses. The samples used in the paper for CEO turnover research come from listed manufacturing companies in Taiwan

between 1996-1997 and the analytical method is the logistic regression model.

The remainder of this paper is organized into four sections. Section 2 is a review of the relevant literature and hypotheses development. Section 3 presents the method and variable explanation. Section 4 includes the empirical results and Section 5 offers the conclusions of this study.

Literature Review and Hypotheses Development

A. The Characteristics of Family Businesses

Handler (1989) points out that scholars approach the definition of family businesses from different angles, including:
Ownership and management;
The level of interdependence among the family and the family's level of involvement in the business;
The transfer of power between generations within a family.

Various factors

Yen (1994) lists the dual-system and bipolar co-existence phenomena characteristics of family businesses. Family businesses are not composed largely of family members, only the higher-leveled ones are. Family members are defined basically by blood or marriage (the characteristics of dual-system, as in Yen (1994), and promotion among CEOs in family businesses maintains a stagnant equilibrium simply due to family protection (the characteristics of bipolar co-existence phenomena, as in Yen, 1994). This fact declaims that the promotion of CEOs in family businesses is quite different from that in ordinary businesses.

B. CEO Turnover in Non-family Businesses

1. Corporate Governance and CEO Turnover

a. Board of Directors

Directors' responsibilities are defined as three broad roles which are labeled control, service, and resource dependence (Johnson, Daily & Ellstrand 1996). The control role entails directors monitoring managers as fiduciaries of stockholders. In this role the directors'' responsibilities include hiring and firing the CEO and other top managers, determining executive pay, and otherwise monitoring managers to ensure that they do not expropriate stockholder interests (Monks & Minow, 1995). Corporate law also gives the board of directors the power to appoint and dismiss a CEO.

A number of studies suggest that the degree of alignment between boards and shareholders incentives varies with the composition of the board. Fama and Jensen (1983) argue that outside directors, who tend to be major decision-makers at other organizations, have incentives to signal to the labor market that they are experts in decision control by acting in shareholder interests. As Weisbach (1988) notes, inside directors are less likely than outside directors to challenge the CEO to whom their careers are tied. Hypothesis 1 states that:
Hypothesis 1: When the ratio of outside directors is high, CEO turnover will be high in non- family businesses.

b. Outside Blockholders

Berle and Means (1932) original managerial theory of corporate control maintains that the ownership of large corporations is dispersed, and therefore the influence of owners on the actions of managers is limited. The monitoring of the actions of top managers by numerous dispersed owners thus becomes a free-rider problem: no individual owner is willing to invest in the costs of monitoring necessary to keep management acting in the owner's ' interests. The concentration of ownership therefore becomes an important determinant of the extent to which free-rider problems are likely to occur (Davis, 1991). If ownership is concentrated in the hands of a few individuals, who can better monitor the actions of management, then the free-rider problem is reduced (Demsetz & Lehn, 1985). Conversely, if ownership is dispersed among several stockholders, none of whom have a significantly large ownership share, then managers may retain uncontested control over the organization (Davis, 1991).

Active investors are individuals or institutions that simultaneously hold large equity positions in a company and actively participate in its strategic direction. Active investors are important to a well-functioning governance system, because they have the financial interest and independence to view firm management and policies in an unbiased way (Jensen, 1993). This leads to the paper's second hypothesis:
Hypothesis2: CEO turnover is high when there are outside blockholders in non- family businesses.

2. Excess compensation and CEO turnover

The costs from executive turnover results in costs specific to the firm that is losing that employee, such as the company's loss of value from previous investments in recruiting and training that individual. Although the employee's firm-specific human capital is not valuable outside the firm or to its competitors, the firm loses rents and quasi-rents with the departure of said employee (Milgrom & Roberts,

1992). High turnover may also affect the morale and productivity of workers who remain with the company or provide a negative signal about the firm and its prospects. Further disruption to the organization could occur, because talented managers have ongoing incentives to shop for outside offers or engage in disingenuous bargaining in order to extract greater wages from their current employers (Milgrom & Roberts, 1992).

Firms can reduce costly managerial turnover through a better design of compensation contracts. A straightforward method for firms to retain their managers would be to offer premium or "excess" pay with a higher value than the contract offered by any competitor (Katz, 1986). In theory, firms should be willing to match any offer received by an executive up to the point where the compensation cost just equals the executive's marginal product, a process that should lead to a value-maximizing solution in the economy (Milgrom & Roberts, 1992). Therefore, we expect that the higher the premium or excess pay is, the less likely CEOs are to leave their jobs. Hypothesis 3 examines this correlation:

Hypothesis 3: CEO turnover will be low when there is excess compensation of CEO in non- family businesses.

C. CEO Turnover in Family Businesses

1. Corporate Governance and CEO Turnover

Board of Directors

The main duties of the board are to approve the CEO's policy and to supervise his/her effectiveness, and the board is legally empowered to employ and discharge a CEO (Fama & Jensen, 1983).

An outside director holding an independent position is able to work effectively (Fama, 1980), and as a result, the composition of the board, especially its ratio of outside directors, shows great influence on CEO turnover (Fredrickson, Hambrick & Baumrin, 1988; Fizel & Louie, 1990). Nevertheless, outside directors may still remain ineffective in family businesses for the following reasons:

I. The internal control mechanism of the company stands out even more in its importance when there is a conflict of profit caused by agency problems. However, when a family is not confronting conflict of profit and serious agency problem, then this mechanism will not work actively in terms of any serious loss of expenses (Davis, Schoorman & Donaldson, 1997).

II. A family business reveals the characteristics of family relations as a major path of promotion (Dommelley, 1964) and a stagnant equilibrium of upper level management (Yen, 1994).

The reasons above explain why the ratio of outside directors has no influence on CEO turnover in a family business. Hypothesis 1a therefore states:

Hypothesis 1a: In family businesses there is no correlation between CEO turnover and the ratio of outside directors.

b. Outside Blockholders

Because power held by a few members makes it much easier to supervise a CEO, the free-rider problem is reduced (Demsetz & Lehn, 1985). If aggressive shareholders own a huge amount of stock in a company, then from an indifferent position they are able to supervise management and the CEO, and also act importantly in the internal control mechanism (Jensen, 1993). In family businesses, outside blockholders have no effect on CEO turnover by similar reasons mentioned in the earlier paragraph. The hypothesis accordingly is made as the following:

Hypothesis 2a: In family businesses there is no correlation between CEO turnover and outside blockholders.

2. Excess Compensation and CEO Turnover

Offering higher salaries than competitors in the same industry, the effective model of compensation, is the most effective and direct way for owners to keep their employees (Katz, 1986). Surprisingly, the effective model of compensation does not impact CEO turnover in family businesses, simply because core members of the higher-leveled management are usually family members. They are well protected by blood, and thus turnover of family members seldom happens. Even if it occurs occasionally, they are always transferred here and there at the same level. Under this circumstance, the higher-level management remains at a stagnant equilibrium. Therefore, offering excess compensation to keep employees does not influence CEO turnover in family businesses. On the other hand, in family businesses, the CEO as a family member will not leave company, because of a low salary. This paper thus develops the following hypothesis:

Hypothesis 3a: In family businesses there is no correlation between CEO turnover and the excess compensation of CEO.

Sample Selection and Explanation of Variables

The definition of a family business in this paper is: a firm in which over half of the seats on the board of directors are held by the family, and the CEO is also a family member. The definition of a non-family business is: a firm in which less than half of the seats on the board of directors are held by the family.

The following is an explanation of the sampling methods, variable indicators, and analytical method in this paper.

Sample Selection

Samples are selected for this paper based on the following principles and standards:

There are records of compensation for a CEO who has held his/her position for a full year.

There is public access to the financial statements, structure of the board of directors, and stock holdings of the CEO and large shareholders of the company in question.

Samples are rejected if the age of the outgoing CEO is over 65, as this is viewed as retirement age.

In order to avoid any deviation in the study's conclusion due to changes in the power structure of companies, this research does not include companies that merged, declared bankruptcy, or reorganized. In order to avoid too large a discrepancy among industries, the financial, department store,construction, and shipping industries are not included.

Based on the criteria above, 184 companies represent non-family businesses, while106 companies are family businesses.

Explanation of Variables

Ratio of Outside Directors: The definition of outside directors in this paper refers to all members of the board of directors who are not employees, as well as their relatives once removed. The number of outside directors is then divided by the number of total directors.

Outside Blockholders: The definition of outside blockholders refers to all members of the board of directors who own at least 5% of the total shares of stock, are not employees, as well as their relatives are once removed. This paper uses a dummy variable to express whether large external shareholders exist in the company or not: "1" represents that there are, and "0" represents that there are none.

Excess Compensation

CEO compensation is the sum of all forms of remuneration in the previous year (cash compensation, dividends, and performance bonuses). This paper uses the calculation method put forth in Coughlan & Schmidt (1985), although recent research into CEO compensation shows that other than company performance and company size, there are other factors that influence CEO compensation. As a result, the model employed in this paper also includes other factors: control by the board of directors, the influence of large shareholders, the ratio of stock held by CEOs, and the company's investment opportunities.

These elements are factored in to calculate an anticipated market compensation level. Excess compensation thus refers to the value of the residual in the regression model shown below and represents the difference between the anticipated market compensation and the actual compensation of CEOs.

Log (Cash Compensation)it = b1 Log(Sales)it + b2 (ROA)it + b3(Log(1+Stock Return) it)+ b4 (Rinpert)it + b5 (CEO Duality)it+ b6(CEO Holdings)it + b7(Board Holdings)it + b8(Outside blockholders)it + b9 (MKTBKEQ)it + eit

Control Variables

This research includes a series of control variables based on previous research. These are firm performance (The two variables used to calculate company performance are: industry ROA and industry stock return rate), board shareholdings minus CEO's holdings, CEO's holdings, investment opportunity = (Outstanding share * Price)/ Total common equity, total assets, and the debt ratio.

Data regarding CEOs, board of directors, and the rate of return on stock are taken from the Fiscal Databanks of the Taiwan Economic Press.

Data on CEO compensation, total assets, the rate of return on assets, and the rate of return on equity are found in the annual reports made by the companies, while data for the age of CEOs are drawn from the "List of Managers in Taiwan."

Analytical Methodology

The research herein uses logistic regression analysis to test the relationship among outside directors, outside blockholders, excess compensation, and CEO turnover.

The Empirical Results

1. Descriptive Statistics

Table 1 shows the minimum value, maximum value, mean, and standard deviation for the non-family businesses. The table shows that the average ratio of outside directors is 0.63. In addition, when the ratio of outside directors' reaches zero, it means all the board members are composed of either employees or relatives, while when it reaches one, it conveys that all the board members are neither employees nor family members. In the samples, there are 86 companies, 47% of all samples that have blockholders owning over 5% of all stock in a company, the numbers of companies with CEO compensation higher than the average is about 80.

For family businesses, Table 2 provides the minimum value, the maximum value, the mean, and

the standard deviation. The table shows that the average ratio of outside directors is 0.21. In the samples, the number of blockholders owning over 5% of stock is 21, 19.8% of all samples; the number of companies with a CEO compensation higher than the average is 50.47% of all samples.

The correlation among variables (Table 3 and Table 4) reveals that the problem of variable collineality is not great. The coefficient of all variables is less than 0.51.

2. Empirical Results of CEO Turnover in Non-family Businesses

The CEO turnover rate for non-family businesses and the results of the logistic regression analysis of the variables are listed in Table 5.

The first column of the table is the industry ROA, while the second column is the industry stock return and P values are in parentheses.

This table shows that no matter what indicator firm performance is, the higher the ratio is of outside directors, the higher the ratio of CEO turnover accordingly is.

This result supports Hypothesis 1: When the ratio of outside directors is high, CEO turnover will be high in non- family businesses.

From Table 5 one sees that outside blockholders of shares do not significantly influence CEO turnover. By means of a residual from the regression model or comparing with companies in the industry, the excess compensation of a CEO has no deep relationship with CEO turnover. These results do not support Hypothesis 2 & Hypothesis 3.

3. Empirical Results of CEO Turnover in Family Businesses

The CEO turnover rate for family businesses and the results of the logistic regression analysis of the variables are listed in Table 6. The first column of the table is industry ROA, the second column is industry stock return and P values are in parentheses. From this table, there is no variable that affects CEO turnover. This result supports Hypothesis 1a: In family businesses there is no correlation between CEO turnover and the ratio of outside directors, Hypothesis 2a: In family businesses there is no correlation between CEO turnover and outside blockholders, and Hypothesis 3a: In family businesses there is no correlation between CEO turnover and the excess compensation of CEO.

Conclusions

The major conclusions of this paper are:

The characteristics of family businesses, corporate governance such as the ratio of outside directors and outside blockholders, and excess compensation have no correlation on CEO turnover.

Outside directors are a crucial factor in the decision-making of CEO turnover in non-family businesses. Even though business law legally empowers the board to hire and fire CEOs, the empirical result of this research supports that outside directors show a better effectiveness on supervising CEOs than the board. In this research, the higher the number of outside directors there is, being neither employees nor relatives, the higher the ratio is of CEO turnover.

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Appendices

Table1. Descriptive Statistics (non-family businesses samples = 184)

	Minimum	Maximum	Mean	Std. Deviation
Outsiders	0	1	0.63	0.25
Blockholder (Dummy)	0	1	0.47	0.50
Excess compensation (log)	-0.73	0.70	2.0E-15	0.19
Industry ROA	-0.30	0.25	-0.02	0.06
Industry stock return	-0.47	2.73	-0.02	0.33
CEO holdings	0	0.35	0.03	0.06
CEO tenure	1	47	22.58	12.70
Debt ratio	0.06	0.70	0.38	0.14
Assets (log)	640,193,000	76,000,000,000	10,000,000,000	13,000,000,000
Investment opportunity	0.68	3.99	1.79	0.64

Table 2. Descriptive Statistics (family businesses samples = 106)

	Minimum	Maximum	Mean	Std. Deviation
Outsiders	0	1	0.21	0.22
Blockholder (Dummy)	0	1	0.20	0.40
Excess compensation (log)	-0.50	0.44	2.3E-16	0.18
Industry ROA	-0.35	0.15	-0.01	0.06
Industry stock return	-0.60	1.04	-0.08	0.26
CEO holdings	0	0.18	0.05	0.04
CEO tenure	2	47	25.93	11.13
Debt ratio	0.09	0.88	0.38	0.14
Assets (log)	1,311,545,000	83,000,000,000	8,765,078,000	13,000,000,000
Investment opportunity	0.55	4.37	1.76	0.64

Table 3. Correlation Matrix for variables (Non-family businesses, n=184)[1]

	1	2	3	4	5	6	7	8	9	10
1	1									
2	.10	1								
3	-.01	.04	1							
4	.06	-.06	.13	1						
5	.04	-.06	.14	.51	1					
6	-.08	-.04	-.05	.04	.005	1				
7	.06	-.02	-.21	.01	.015	-.06	1			
8	-.04	.35	-.02	-.05	.017	-.25	.25	1		
9	-.21	-.01	-.01	-.10	-.04	-.17	.09	.03	1	
10	.18	-.12	.013	.50	.30	.09	.01	-.23	-.04	1

Table 4. Correlation Matrix for variables (Family businesses, n=106)[2]

	1	2	3	4	5	6	7	8	9	10
1	1									
2	.27	1								
3	-.06	-.18	1							
4	.17	.008	.25	1						
5	-.02	-.01	.00	.00	1					
6	-.15	.13	-.15	-.20	.00	1				
7	-.09	.07	.12	.13	-.15	-.02	1			
8	.09	.20	-.13	-.13	.04	-.23	.41	1		
9	.08	.23	.12	.22	.00	-.01	.13	-.15	1	
10	-.06	.09	-.12	-.15	-.04	-.01	-.07	.25	-.05	1

Table 5. Logit Regression Estimates of the Probability of CEO Turnover (non-family businesses samples = 184)

Estimated model: Probability (Turnover) = f (Outsiders, Blockholder Excess compensation, and control variables)				
	Industry ROA		Industry Stock Return	
Intercept	-9.5439	(0.1369)	-9.4707	(0.1352)
Outsiders	3.1615*	(0.0128)	2.9113*	(0.0182)
Blockholder (Dummy)	0.0974	(0.8543)	0.2075	(0.6933)
Excess compensation (log)	-0.3092	(0.8066)	0.4832	(0.7057)
Performance	-7.7942*	(0.0495)	-0.6400	(0.5309)
CEO holdings	6.8312	(0.0665)	7.1485	(0.0524)
CEO tenure	0.0215	(0.2809)	0.0204	(0.3000)
Debt ratio	-4.7161*	(0.0240)	-3.5154	(0.0746)
Assets (log)	0.5621	(0.3761)	0.5352	(0.3878)
Investment opportunity	0.3754	(0.3505)	0.3889	(0.3936)
Chi-Square	15.893	(0.0692)	12.376	(0.1929)

a. P values are in parentheses.
b. * p<0.05.

Table 6. Logit Regression Estimates of the Probability of CEO Turnover (family businesses samples = 106)

Estimated model: Probability (Turnover) = f (Outsiders, Blockholder Excess compensation, and control variables)				
	Industry ROA		Industry Stock Return	
Intercept	1.3378	(0.8915)	6.1895	(0.5443)
Outsiders	1.0471	(0.3936)	1.3533	(0.2931)
Blockholder (Dummy)	0.7149	(0.3170)	0.4799	(0.4954)
Excess compensation (log)	-1.6487	(0.3033)	-1.4059	(0.3752)
Performance	-6.7013	(0.1358)	1.1495	(0.3465)
CEO holdings	-4.1916	(0.5871)	-4.0591	(0.5813)
CEO tenure	-0.0090	(0.7503)	-0.0093	(0.7375)
Debt ratio	-0.9521	(0.6939)	-0.2902	(0.9040)
Assets (log)	-0.3488	(0.7370)	-0.8100	(0.4474)
Investment opportunity	0.2293	(0.6051)	-0.0087	(0.9854)
Chi-Square	6.851	(0.6527)	5.537	(0.7852)

a. P values are in parentheses.

[1] Definitions of the variables: 1. Industry ROA； 2. Industry stock return rate；3. Ratio of outside directors；4. Outside blockholders (dummy) 5. Excess compensation；6. CEO holdings；7. Debt ratio；8. Total Assets；9. Investment opportunity =(Outstanding share * Price)/ Total common equity 10. CEO tenure.

[2] Definitions of the variables are as same as Table 3.