International Research Journal of Finance and Economics
ISSN 1450-2887 Issue 178 March, 2020
http://www.internationalresearchjournaloffinanceandeconomics.com

The Double-Edged Sword of the Effects of CEO Power on Value Creation of Corporate International Investments

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Abstract

Although previous studies have attribute CEO's demographic and psychological characteristics to corporate decision and performance, empirical evidence about the effect of CEO power is relatively limited. Grounded in agency theory, diversification-of-opinion view, stewardship theory and information-processing perspective, this study examines how CEO power affects the value of corporate foreign direct investments. We argue that CEO power have both positive and negative effects on FDI performance. This study uses the sample of Taiwan firms announcing cross-border acquisitions or greenfields to test the hypothesis. The result shows that the presence of powerful CEOs leads to poor FDI performance. The present study helps a better understanding of the factors influencing corporate FDI outcomes.

Keywords: CEO power, FDI performance, agency theory, stewardship theory
JEL: M16

1. Introduction

Foreign investment has become a critical driver for firms to acquire profitability and competitive advantage (Caves, 1996; Dunning, 1988; Hymer, 1976). With increasing market globalization, optimization of foreign investment decisions has become important issues for many enterprises. As the apex of the decision control system, the CEO (as leader of its top management team) plays a crucial role in implementing these decisions (Boeker, 1997; Daily & Johnson, 1997; Hutzschenreuter et al., 2012). Their preference toward foreign investments exerts a pronounced influence on the performance of these activities and a firm's prosperity. Many studies attribute a firm's internationalization behavior to the CEO's demographic and psychological characteristics, such as CEO's age, tenure, nationality, education, functional background, overconfidence, and narcissism (e.g., Herrmann & Datta, 2002; 2006; Malmendier & Tate, 2005; Nielsen & Nielsen, 2011; Oesterle et al., 2016). Although these implicit and explicit attributes of CEOs are important in illustrating corporate decisions, individuals without power could not effectively impose their decision on a firm (Liu & Jiraporn, 2010).

Power is the demonstrated ability of one person to impose their will on others (Haleblian & Finkelstein, 1993). CEO power indicates how much decision-making power is concentrated in the hands of the CEO, and it appears to be a critical variable that affect several important corporate decisions and outcomes. The role of CEO power has been documented to explain the adoption of corporate practices, such as subprime lending (Lewellyn & Muller-Kahle, 2012), R&D investment (Chen, 2014), and corporate performance (Daily & Johnson, 1997). However, there is very little research regarding its impact on corporate international activities. Considering a firm's

internationalization decision-making, more often than not the firm's CEO performs the role of the agent (Nielsen & Nielsen, 2011; Tihanyi et al., 2000). It is expected that CEO power may be an important factor in explaining the performance of a firm's FDI. Chikh and Filbien (2011) and Fralich and Papadoopulos (2018) have linked CEO power to a firm's acquisition, but they do not explicitly examine how CEO power influence the valuation effect of FDI activities. Investments in foreign countries involve high degrees of complexities and uncertainties, and the judgement and decisions by the CEO are often critically in influencing the performance of these activities. This study uses various theoretical arguments including agency theory, diversification-of-opinion view, stewardship theory and information-processing perspective to investigate this issue. We argue that CEO power has both positive and negative implications for shareholders in assessing the value of corporate FDI.

We test our hypothesis using a sample of FDI announcements by firms listed on the Taiwan Stock Exchange. The sample of 405 cross-border acquisitions or greenfields announcements for the period 2011-2015 were collected from UDN Database. We employ the event study approach to test the valuation effect of corporate FDI and we find a negative relationship between CEO power and FDI performance. This result shows that the negative effect dominates the positive effect of CEO power on the value creation of corporate FDI.

Our study makes several important contributions to the extant literature. First, our study enriches the literature that examines the effect of CEO power on firm outcomes (Adams et al., 2005 ; Daily & Johnson, 1997). Several studies argue and present evidence that executives do matter. To the best of our knowledge, little study directly addresses the influence of manager characteristic of CEO power on the performance of corporate international investment. Second, several important studies attempt to ascertain the impact of corporate governance on firm internationalization (Henderson & Fredrickson, 1996; Oesterle et al., 2012; Sanders & Carpenter, 1998). Bebchuk et al. (2002) argue that CEO power constitute an important governance mechanism that affect agency costs. We contribute to the literature by providing evidence that CEO power dose indeed have a palpable impact on the performance of FDI and thus appears to represent a relevant corporate governance mechanism in firm internationalization.

2. Theoretical Background and Hypotheses

2.1. Negative Effects of CEO Power

From an agency perspective, managerial behaviors are hypothesized as self-interested such that CEOs are predicted to pursue actions and make decisions which are in their own personal best interest. When CEOs are more powerful, they have greater leeway to act in manners advantageous to themselves but not necessarily to shareholders (Core et al., 1999). When considering internationalization decisions, CEOs with more power or that are more entrenched might have more freedom to pursue investments that will provide them private benefits rather than the interests of shareholders. Besides, when the CEO acquires a wider power base, the decision control by the board will be weakened (Morck, et al., 1989). Powerful CEOs may prevent or forestall board involvement in strategic actions by withholding information and by controlling the strategic agenda of board meetings (Kor, 2006). This reduction in board control diminishes the monitoring role of the board over managerial behaviors and facilitates pursuit of the CEO's agenda, which may differ substantially from shareholder goals (Mallette & Fowler, 1992). Thus, based on agency argument, powerful CEOs might negatively affect FDI performance.

In addition, those with greater power are less likely to be influenced by others (Magee et al., 2007), and are less likely to compromise with other top executives (Adams et al., 2005). Therefore, when powerful CEOs are present, they tend to dominate most corporate decisions. Powerful CEOs even tend to restrict the flow of information, and such restriction may happen when other team member with less power fear reporting information or ideas that run counter to those preferred by a powerful CEO (Hambrick & D'Aveni, 1992). In a firm in which the CEO dominates the most relevant decisions,

the risk arising from judgement errors is not well diversified (e.g., Sah & Stiglitz, 1991), resulting in decisions with extreme consequences (Adams et al., 2005). That is, the likelihood of either very good or very bad decisions is higher in an organization in which the CEO is more powerful to influence decisions than in an organization in which many executives are involved in the decision-making process. International investment is a complicated decision, the need for broader participation and information-sharing requirements are high. If the CEO restricts information flow and thereby do not have sufficient information with which to make high-quality decisions, the risk arising from judgment errors can lead to poor performance. Therefore, we propose the hypothesis as it follows.

Hypothesis 1a. There is a negative relationship between CEO power and the valuation effect of corporate international investments.

2.2. Positive Effects of CEO Power

Other perspectives would argue for a very different outcome. According to stewardship theory, CEOs are far from being an opportunistic shirker; instead, they are inherently trustworthy managers, good stewards of company assets, and essentially want to do a good job (Donaldson & Davis, 1994). The stewardship theory proposes that managers would not risk their career and reputation to do corporate decisions against the shareholders' interests. Powerful individuals have more resources and fewer constraints in making corporate decisions (Keltner et al., 2003). Based on the above arguments, when CEOs possess more power, they have greater leeway to facilitate FDI investments that would enhance corporate performance. By doing so, they could not only gain financial incentives, they are also motivated by job satisfaction, advancement and recognition, respect for authority, and work ethic from the success of FDI investments.

An alternative view also argues that powerful CEOs are expected to affect the performance of corporate FDIs positively. Powerful leaders have more abilities and higher tendency to dominate the strategic agenda of board meetings, thereby allowing them to minimize the potential for conflicts, establish unity of command (Finkelstein & D'Aveni, 1994), and speed up strategic response times (Combs et al., 2007). Corporate FDI is characterized with high uncertainty and complexity; such environments benefit from having a strong and decisive CEO, rather than a consensual approach to decision making. Without a powerful CEO, directors engage in more discussion and debates resulting to more diverse viewpoints that may affect which decisions are made (Zahra & Pearce, 1989). On the contrary, a powerful CEO is able to use constructive conflict within the top management team to allow a timely and more unified decision (Shen & Cannella, 2002) for firms to response to dynamic foreign markets. Therefore, the presence of a powerful leader may be an asset for the firm as a whole and leads to beneficial FDI performance. The hypothesis is proposed as:

Hypothesis 1b. There is a positive relationship between CEO power and the valuation effect of corporate international investments.

3. Sample and Methodology

3.1. Data

We test our hypotheses using a sample of FDI announcements by firms listed on the Taiwan Stock Exchange. The sample firms undertaking cross-border acquisitions or greenfields announcements were collected from UDN Database, which provides news-service abstracts from major Taiwanese newspapers. We use the key words of "acquisitions", "takeover" and "greenfields" to search for such FDI activities. Day 0 refers to the earliest date on which the company announced that they undertake FDI investments. The sample period is from 2011 to 2015.

To avoid confounding effects, we exclude observations that were concurrent with other major announcements made by the firm within 30 days before or after the FDI announcement. We also

exclude sample firms whose stock price information or financial data were not available in the Taiwan Economic Journal (TEJ) Data Bank.

The use of Taiwanese companies as our sample is suitable for this study because that prior studies in corporate governance have predominantly focused on Western companies; while those related to Asian countries are rather few (Kiel & Nicholson, 2003). Taiwanese companies do not have the same corporate governance structure as Western companies, and the empirical findings for Western companies may not apply to Taiwan and other Asian companies. Taiwanese firms operate in the context of a high power distance culture and most of the decision-making activities are centralized and thus performed by CEOs (Hsu et al., 2013). Accordingly, the Taiwan is a good setting in which to test hypotheses regarding the effect of CEO power on international investments.

3.2. Dependent Variables

Our dependent variable is the stock price responses to corporate FDI announcements, which is measured by the announcement-period cumulative abnormal returns (CARs) of corporate FDIs. We employ the standard event study methodology to calculate the stock price responses to the announcements of corporate FDIs (e.g. Lai et al., 2019; Li et al., 2016). We follow Brown and Warner (1985) in using the market model to obtain estimates of expected values of a security, with parameters estimated over a period from 210 to 11 days before the initial announcement. The announcement date (day 0) is defined as the day when the companies announce that they undertake foreign investments, and the abnormal return on day 0 is calculated by subtracting the expected return from the actual return on that day. The two-day cumulative abnormal returns, CAR (−1, 0), are estimated by summing their respective abnormal returns as our dependent variable. Daily stock return information is collected from Taiwan Economic Journal (TEJ) Data Bank.

3.3. Independent Variables

3.3.1. Measure of CEO Power

CEO power has been operationalized in a variety of ways and there are no compelling theoretical arguments for why any one of the measures of CEO power should be more appropriate than another. In this study, we use CEO duality (i.e., whether the CEO is also the board chair), non-independent board (i.e., the ratio of non-independent directors to the total number of directors), founder CEO (i.e., whether the CEO is the founder or the heir of founder family), and CEO ownership (i.e., the percentage of shares outstanding held by the CEO) to indicate CEO power. The four variables are standardized and summed to create an index of CEO power. Data on CEO duality, the number of independent directors, and CEO ownership are taken from the TEJ Data Bank. Information about whether the CEO is the founder or the heir of founder family is drawn from company annual reports. To mitigate potential endogeneity, and to ensure that the direction of causality is from CEO power to the performance of firm FDI and not the reverse, a one-year time lag is taken.

3.4. Control Variables

We include several control variables that may potentially influence the valuation effect of a firm's FDI announcements. Firm size was measured as the natural logarithm of total assets (Kotabe et al., 2002). Leverage was measured as the ratio of total debt to total assets (Chen, 2008). Firm age was measured as the number of years that a firm has been established (Lin et al., 2011). Firm performance was measured as return on assets (ROA) (Lu & Beamish, 2004). A firm's investment opportunity was measured as Tobin's Q. We also control firms' intangible assets. Marketing capability was measured as the ratio of advertising expenditures to the net sales. Technology capability was measured as the ratio of R&D expenses to the net sales. Finally, we use dummy variables to control for any industry-specific effect and time-specific effect on corporate performance.

Table 1 presents the means, standard deviations, and correlations for all variables for the sample of FDI announcements.

Table 1: Descriptive Statistics and Correlations

Variables	Mean	Std.	1	2	3	4	5	6	7	8	9
1. Abnormal return	0.64793	3.68992	1.00000								
2. Power	0.05490	2.02453	-0.10364	1.00000							
3. Firm size[a]	17.65713	1.68086	0.09930	0.09783	0.06334	1.00000					
4. Leverage	0.43975	0.17603	**0.13410**	-0.01216	**-0.45144**	**0.18541**	1.00000				
5. R&D intensity	0.03002	0.06230	-0.03567	-0.04722	**0.25725**	**-0.13594**	**-0.37994**	1.00000			
6. Firm age	27.58025	14.54395	0.00529	**-0.17285**	**-0.36622**	0.00184	**0.28996**	**-0.23410**	1.00000		
7. Firm performance	0.06820	0.06859	-0.04192	0.07487	**0.81584**	0.02111	**-0.31441**	0.08793	**-0.32335**	1.00000	
8. Growth opportunity	1.24279	0.90389	-0.03125	0.03185	**0.74186**	-0.08337	**-0.39126**	**0.30662**	**-0.30316**	**0.81457**	1.00000

For numbers in bold, correlation is significant at the 1% level.
[a] Firm size is measured by the natural logarithm of asset

4. Empirical Results

Table 2 provides estimates of abnormal returns around the announcement date and the surrounding days. The results show that corporate FDIs are perceived by investors as value-increasing activities. Our results are consistent with prior studies (e.g. Lai et al., 2019). For the two-day announcement period cumulative abnormal returns, *CAR (-1, 0)*, the FDI announcers experience a positive cumulative average abnormal return of 0.648%, significant at the 1% confidence level. We use *CAR (-1, 0)* as the dependent variable in the following regression analysis.[1]

Table 2: Abnormal Returns for FDI announcements

Period	Mean (%)	t-Statistics	% of Positive
(-5)	-0.066	-0.588	0.442
(-4)	0.001	0.012	0.467
(-3)	-0.160	-1.459	0.420
(-2)	0.069	0.654	0.479
(-1)	0.267**	2.307	0.494
(0)	0.381***	3.089	0.521
(1)	0.219*	1.734	0.489
(2)	-0.084	-0.737	0.444
(3)	-0.063	-0.563	0.447
(4)	-0.161	-1.407	0.405
(5)	-0.138	-1.241	0.432
Car (-1, 0)	0.648***	3.534	0.526

*p<0.10, **p<0.05, ***p<0.01

Table 3 reports the regression results with the dependent variable *CAR (-1, 0)*. Models 1 is the baseline model that include only the control variables. Among the control variables, leverage ratio is found to be positively associated with *CAR (-1, 0)*. This result suggests that higher levels of debt lower the expected costs of free cash flow (Jensen, 1986), and FDI announced by firms with a higher leverage ratio are therefore perceived as more worthwhile. Other control variables are not found to have significant explanatory power in terms of the variation in announcement abnormal returns.

In model 2, we test the impact of CEO power on the stock market reactions to FDI announcements by including the variable of power. We find our Hypothesis 1a is supported, as *CAR (-1, 0)* is negatively related to CEO power. This result suggests that when a firm's decision-making

[1] The results are similar when we use *CAR (-1, 1)* as the dependent variable.

power is more concentrated in the hands of the CEO, the agency effect of CEO power on FDI performance outweighs its positive effect.

Table 3: Regression Analysis of CEO Power on FDI Performance

Variables/Models	1	2
Intercept	-3.402 (2.116)	-3.685* (2.105)
Power		-0.229** (0.093)
Firm size [a]	0.183 (0.113)	0.208* (0.113)
Leverage	3.003** (1.226)	3.048** (1.218)
R&D intensity	0.010 (3.446)	-0.598 (3.432)
Firm age	-0.011 (0.014)	-0.017 (0.014)
Firm performance	-3.249 (5.068)	-3.020 (5.036)
Growth opportunity	0.303 (0.407)	0.308 (0.404)
Industry control	Yes	Yes
Year control	Yes	Yes
Adjusted R^2	0.010	0.023
F-statistic	1.40	1.85**
No. of observations	405	405

*p<0.10, **p<0.05, ***p<0.01. Values in parentheses are standard errors

[a] Firm size is measured by the natural logarithm of asset

5. Contribution

Although extensive research has pointed the impact of CEO characteristics on firm decisions and corporate performance, most of them neglect that CEOs can effectively impose their influence on corporate decisions only when they possess power. A few studies have revealed the importance of CEO power on several important corporate outcomes; however, empirical evidence about how CEO power explains firm internationalization is relatively limited. This study uses various theoretical arguments and empirically examines the impact of CEO power on the valuation effect of corporate FDI. The result shows that FDI decisions made by CEOs with more power do not create value for firms. This evidence corresponds to the findings in Bebchuk et al. (2011) and Liu and Jiraporn (2010) that CEO power aggravates agency costs and leads to poor performance.

This study contributes in our extension of upper echelons view by hypothesizing that CEO power is related to international investment performance. Unlike existing research that is primarily based on either agency theory or stewardship perspective and that has reported mixed findings, this study draws on various theoretical viewpoints (agency theory, diversification-of-opinion view, stewardship and information-processing perspectives) and simultaneously considers both the negative and positive effects of CEO power on the valuation effect of corporate FDI.

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