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CEO Dismissals - A Financial Analysis

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Master Thesis In Business - Major in Accounting & Business Control

1.0 Introduction

A study conducted by Hjersing, S.W. & Berner, T.M.H. (2018) shows that public leader exits in Norway covered by the media have been an increasing phenomenon from 1945 until today. Public leaders being CEOs and vice presidents, chairmans of the boards and vice chairmans, councilmans, political leaders, CXOs and other leaders. The first case was back in 1945, but from the years of 1980 there has been an exponential growth. Their conclusion was that exiting leaders has become a practice of its own. In the cases pointed out there are listed several reasons as to why a certain leader has been fired, for example political reasons, internal arguments, disciplinary reasons, fraud, and poor results. However, in our thesis we want to look at the financial effects surrounding this trending practice. More specifically, we want to start by looking at the public leader exits presented by Hjersing and Berner which occurred due to poor results and financial data, and conduct a quantitative analysis of the surrounding effects of these exits.

It is important to emphasise that this practice might not bring justice to the CEO, as there are external factors that influence the business' operations that are out of the leader's control. If these factors are not made clear, the boards would oust and replace a CEO simply because of their strategic priorities, without any necessary wrongdoing on the part of the CEO (Rasmussen et al., 2021, p.7). However, this is beyond the reach of our thesis and will not be covered further in our paper.

1.1 Relevancy and interest

Corporate governance can be seen as a toolkit which allows managers and businesses to make better decisions to deal with challenges of balancing the interests of shareholders involved in a company (Chen, 2021). It has had an increasingly active role in businesses over the past few decades, which also makes their interests and level of satisfaction as important. As their demands and influence on the businesses carry more weight in the later decades, also the pressure on the leading positions in businesses is higher than ever before. All this pressure is being carried on one person's shoulders, being the link between the board of directors and operating business, the CEO.

We found the relationship between financial data and CEO dismissals quite interesting in particular, because we believe there can be a driving financial factor motivating the board of directors to act upon. Whether it is financial performance over time, an unexpected financial burden or maybe some key financial indicators based on the balance sheet. By researching this in depth we hope to see a pattern that may infer why the board decides to dismiss the CEO.

2.0 Literature Review

The following part of the paper will outline and highlight some of the relevant literature associated with CEO turnover. Corporate governance is an extensive and broad field, thus making it crucial for us to restrict the research to only the most suitable material for our paper.

To begin with there is historical data indicating that the board of directors are deliberately evaluating CEO's performance over time and deciding whether or not they should fire them. This is tied to believed expectations and how the firm is performing. However, how well the firm is doing can be expressed in several ways, and not necessarily be tied to the top management's competence or ability. Is the stock price a fair indicator of a firm's performance, given that it is a subject of manipulation and market volatility? It certainly was a deciding factor in 1988, where fairly low returns yielded a correlation between CEO and management turnover (B.Warner, L.Watts, & H.Wruck, 1988). Consequently, it is relevant to ask to which extent this translates today and what kind of financial data is influencing the board of directors' decisions in dismissing a CEO, and if there is any data in particular that can signal an upcoming CEO dismissal?

In particular there is research highlighting the influence of external factors on the board's decisions, such as industry performance and market participants. A study conducted in the 80's illustrated that the board's collective decisions were not to be influenced in a great capacity by externalities. Meaning that the CEO would be substituted despite the present market conditions (Morck et al., 1989). However, there seems to be findings to counter this notion of the board's ability to not be influenced by externalities in their decision making. It has been reported that CEO's are frequently let go due to market and industry performance - elements that the management cannot control or regulate. The lack in the board's ability to make neutral decisions seems to penalise CEO's for aspects and responsibilities out of their general operational scope (Jenter & Kanaan, 2015). There are various factors as to why board's are heavily influenced by externalities. One common denominator is the escalating demand from shareholders to take direct measures in order to correct poor business performance. Which in turn, results in a drastic change of management and CEO's without any sound reasoning (Fisman et al., 2014).

An interesting study by Wiersema (2002) shows all instances of CEO turnovers in the 500 largest public companies in the US during 1997-1998. 83 cases were studied closely, and they were compared in terms of results before and after dismissal, and by industry averages. The results showed little to no evidence that the CEO turnover gave improved results, on the contrary, as the process of hiring a new CEO is both costly and time consuming. She pointed out that the board lacks strategic understanding of the business and therefore tends to make sub-bar decisions to please the investors. Even worse, the board themselves does not have the required insight, information, and time to select a new and "better" CEO, and tend to rely on a third-party for the hiring process. Further, the board does not know the proper qualifications required for a new CEO and therefore does not provide enough details to the third-party to make them hire a proper replacement. This downward spiral is what leads to many unnecessary CEO turnovers and could inflict a lot of self-damage.

A similar trend of sacrificing the CEO based on poor performance can be seen within the world of football, where Arnulf et al. (2012) tried to justify these dismissals. They conducted a study of whether or not a team in the top division of Norway will improve their results after firing the manager. They found a positive relationship between firing a manager and results in terms of average points gained in the upcoming 15 matches. However, they found teams that chose to keep their manager in a similar position to rebound quicker, and actually perform significantly better during the same period. We want to find out if this relationship translates to the world of business, and if we will find similar results through the dismissals of CEOs.

Another factor to consider is that poor market performance and results may highlight and accentuate a CEO's performance in greater detail, by bringing his or her capabilities to the forefront and under examination. This can in turn impact and guide the decision making of the board and advocate for a lay off of the given management in charge of the operational activities (Jenter & Kanaan, 2015). Furthermore, downturns or deficient returns can be signs of existing issues that are attributable to the competence or expertise of the management in charge. Consequently, this can lead to a lay off based on the lack of adaptiveness and the required competence of the CEO to operate optimally in the current market or industry conditions. Highlighting the fact that the board makes decisions based on the performance of the management rather than the external factors that are currently present (Eisfeldt & Kuhnen, 2013).

An important factor to be accounted for is the power-position of the CEO and his influence over the board. A powerful CEO, meaning CEOs that can influence key decisions of a firm, tend to deliver more variable results (Adams et al., 2005). This is because they tend to dominate the decision-making process and their power-position might lead to less democratic choices. This can go both ways, as a powerful CEO is not the equivalent of a good CEO. However, in bad-case scenarios the board might be prevented from firing this powerful CEO because of his position, which could lead to biased results in our study. Therefore, this is something that has to be controlled for when analysing our results.

3.0 Research Question and Objective of the Thesis

Given the literature review above, most of the studies are qualitative analyses of the surroundings regarding CEO dismissals. The few quantitative analyses we have found are mostly focused on the after-effects of the dismissals, however little to no analysis of the situation leading up to the dismissals. Therefore, our objective of this thesis is to address this area of pre-CEO dismissal and hopefully bring some insight to the already existing literature.

This is where we want to bring our expertise by analysing key-numbers in the balance sheet, and other significant factors, leading up to the dismissals. Are there any recurring themes amongst the businesses, and if so, could the dismissals be predicted in advance? We imagine key-numbers like operating earnings/costs/profits, different ratios, and specific industry factors will be highly relevant and studied closely. Further, we will have to include dummies for other non-financial differences between the businesses, as they will probably affect the decision-making process of the board, like board composition and power-position of the CEO.

Based on this, we developed to the following research question:

Do financial data predict CEO dismissals?

4.0 Plan for Data Collection and Thesis Progression

4.1 Research Method

Our research of choice will be a multiple case study, as we see it most fit for our purpose. By conducting a multiple case study we can focus on a specific target group, and perform an in-depth-analysis on our selected sample. We have chosen to limit ourselves to the Norwegian market, as the study mentioned in the introductory part also does this. This makes it so we can start by using this already existing data actively in our study and go even more in-depth on the subject, and later expand the sample size beyond the data we started with, if needed. Based on our research question we assume that there would be differences across different industries, being private and public sectors, heavily competitive industries etc. Therefore, we will limit ourselves to the private sector, where the businesses are more result-oriented and the CEO is more exposed for sacrifice. As the thesis prolongs we expect to limit ourselves further, but this is yet to be unknown.

4.2 Data collection

For our primary data collection method we will use archival research, meaning using public available data sources. These sources are high quality and reliable, and therefore very usable for our research topic. By accessing this quality data we would be able to clean, and combine it with other datasets in order to apply it in whatever way we see fit for our research.

As our study will require a large sample of quantitative data, we have to access relevant and reliable databases. Luckily, in Norway the data is very accessible, and we expect to find useful data within the domestic databases, for example “Brønnøysundregisteret”, “Proff forvalt”, and “Oslo Børs”. Further, depending on the sample size we include in our study, we can use businesses’ own annual reports to get a deeper understanding of their operations. In this way we can extract all the information we need, and possibly discover new and interesting factors that can give insight into the phenomenon of CEO dismissals.

4.3 Thesis progression

While researching literature we realised how complex this topic is and got insight into the scope of the task. The thing we see as the most important over the next couple of months is to keep researching and get a really deep understanding of the literature. We have to make limitations where we see them fit, and if we want to change anything we have to do it as early as possible, thereby also landing our research question. We expect this to proceed through January and February.

Once the research is done, limitations are set, and the research question is settled, we have to start data gathering. We will gather data from the businesses we see fit for our research, primarily from the already existing dataset from Hjersing and Berner. Further, we have to clean the data, run regression analyses, and analyse key-numbers and ratios from the datasets. We expect the process of data gathering and analysing to go through March and April.

Finally, the discussion of the findings and results, as well as perfecting the writing of the thesis is made in the remaining time frame.

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