Third-party endorsements of CEO quality, managerial discretion, and stakeholder reactions

Theodore L. Waldron a,⁎, Scott D. Grafﬁn b, Joseph F. Poracc c, James B. Wade d

a One Bear Place #98006, Hankamer School of Business, Baylor University, Waco, TX 76798, United States
b 404 Brooks Hall, University of Georgia, Athens, GA 30602, United States
c Kaufman Management Center, New York University, 44 West 4th St., Tisch 413, New York, NY 10012, United States
d Goizueta Business School, Emory University, 1300 Clifton Road NE, Atlanta, GA 30322, United States

ARTICLE INFO

Article history:
Received 8 August 2011
Accepted 2 May 2012
Available online 24 May 2012

Keywords:
CEO quality
Third-party endorsements
Managerial discretion
Corporate governance
Executive compensation
Firm market value

ABSTRACT

Research on the inﬂuence of third-party endorsements of CEO quality generally does not account for the context in which such signs manifest. To address this limitation, the present study examines how a CEO’s level of managerial discretion shapes boards’ and shareholders’ responses to external endorsements of his or her quality. Managerial discretion refers to the range of strategic options that executives have at their disposal in a given business context. The ﬁndings indicate that boards only react to CEO endorsements in high-discretion settings, and this reaction is positive (i.e., more pay). In contrast, shareholders – regardless of discretion levels – positively respond to CEO endorsements in the short-term, while these responses become more equivocal over the time. These results suggest that – at least in the short term – directors more adeptly interpret and respond to external information about CEO quality than shareholders.

© 2012 Elsevier Inc. All rights reserved.

1. Introduction

Evaluating a CEO’s quality is a crucial task for a ﬁrm’s board of directors and shareholders. CEO quality, however, is sometimes difﬁcult to interpret, since local management decisions are but one of many factors that inﬂuence ﬁrm performance. Various systematic risk factors at the industry and ﬁrm level (Holmstrom, 1982) – such as sunk costs, imperfect information, and internal politics (Hannan & Freeman, 1984) – also affect ﬁrm outcomes. CEOs themselves may further complicate boards’ and shareholders’ evaluations of their quality by attempting to manipulate those entities’ perceptions (Bettman & Weitz, 1983). Given this evaluative uncertainty, we ask, how do boards and shareholders make sense of CEO quality?

One important source of information that may inﬂuence inferences about CEO quality is the endorsement of these individuals by informed third parties, such as the business press, analysts, and other external arbiters of social knowledge (Podolny, 2005; Zuckerman, 1999). Research provides evidence that positive media endorsement or coverage of CEOs positively correlates with their own compensation and ﬁrms’ short-term stock prices (Malmendier & Tate, 2009; Wade, Porac, Pollock, & Grafﬁn, 2006), as well as pay-performance sensitivity (Milbourn, 2003; Wade et al., 2006). Scholars also report that such coverage negatively correlates with ﬁrms’ longer-term stock prices (Wade et al., 2006).

Despite establishing the main effects of third-party CEO endorsements on the actions of shareholders and boards, no research examines how a ﬁrm’s strategic complexity affects the inﬂuence that such information has on these groups’ actions. A construct relevant to this issue is managerial discretion, which describes the range of strategic options that executives have at their disposal within a given business context (Hambrick & Abrahamson, 1995). CEOs with greater discretion have fewer constraints on their choices (Aragon-Correa, Matias-Reche, & Senise-Barrio, 2004); more numerous, diverse strategic options (Hambrick & Finkelstein, 1987); and more opportunities to inﬂuence ﬁrm performance (Finkelstein & Boyd, 1998).

The purpose of this study is to predict and test how managerial discretion inﬂuences the salience of third-party endorsements of CEO quality in shaping key stakeholders’ actions. Scholars study managerial discretion at the ﬁrm and industry levels of analysis. Since the level of discretion for individual ﬁrms varies greatly within industries (Finkelstein & Boyd, 1998), this study focuses on discretion at the ﬁrm level. This study examines the notion that managerial discretion moderates how third-party endorsements affect shareholders’ short- and long-term perceptions of CEO quality, expectations of ﬁrm performance, and ultimately reactions in stock markets. The present study also explores the premise that discretion moderates how such endorsements shape boards’ perceptions of CEO quality and subsequent compensation decisions.

Addressing the moderating role of discretion is important, because third-party endorsements do not occur in a vacuum. Rather, the effects of such endorsements on key constituents’ actions depend on...
the strategic complexity of the business context. Prior studies largely ignore how the environment in which external signs of quality manifest may influence the importance of such information to and the uniformity of reactions across multiple stakeholder groups. Indeed, accounting for strategic context can help us to better understand when third-party assessments influence different stakeholders' reactions. The following text theorizes and tests why and how managerial discretion affects the relationships between third-party endorsements of CEO quality and boards' and investors' reactions to these endorsements.

2. Theory and hypotheses

2.1. Third-party endorsements of CEO quality, discretion, and stock price

Wade et al. (2006) find that shareholders positively respond to public, media-based endorsements of CEO competence with short-term increases in share prices. Endorsements may generate this effect by fostering shareholder perceptions that CEOs enhance firm performance through adept strategic decisions (Dalton, Barnes, & Zaleznik, 1968; Hayward, Rindova, & Pollock, 2004). These authors, however, do not distinguish between high- and low-discretion contexts. High-discretion contexts offer numerous strategic options, require greater managerial judgment, and provide more opportunities for CEOs to influence firm outcomes. This complexity may increase shareholders' uncertainty when assessing executive quality. Third-party endorsements can disambiguate the link between CEO quality and organizational outcomes in these situations of evaluative uncertainty by providing accessible and interpretable information (Podolny, 2005). In this manner, such endorsements in high-discretion contexts can positively shape shareholders' perceptions of CEO quality and yield short-term increases in share prices.

Low-discretion contexts conversely reduce the number of strategic alternatives available to CEOs, constrain managerial judgment and latitude, and reduce opportunities for CEOs to influence firm outcomes. Finkelstein and Hambrick (1990:488) argue that “under conditions of restricted discretion, managerial predispositions become less important and environmental and organizational factors become more significant in influencing strategy and performance.” Third-party endorsement of a CEO's quality in low-discretion contexts therefore may not be as meaningful, because constraints on executive influence reduce the perceived complexity of linking CEO quality to firm performance. This logic suggests that shareholders will positively respond in the short-term to third-party endorsements of CEO quality in high-discretion contexts, but they will pay little attention to such information in low-discretion contexts.

H1A. Managerial discretion moderates the positive relationship between third-party endorsements of a CEO's quality and his or her firm's short-term share price, such that this link becomes stronger in high-discretion – but not in low-discretion – firms.

Third-party endorsements of CEO quality have a negative effect on firms' long-term share prices by generating a burden of celebrity for endorsed executives (Fombrun, 1996; Wade et al., 2006) and increasing these individuals' hubris (Hayward & Hambrick, 1997). The former fosters shareholders' perceptions that endorsed managers individually shape corporate performance (Meindl, Ehrlich, & Duikerich, 1985), which consequently increases shareholders' long-term performance expectations and amplifies their dissatisfaction when firms fail to meet such expectations (Fombrun, 1996). The latter can help to ensure that endorsed CEOs' firms do not meet shareholders' expectations by inflating an executive's self-confidence and facilitating performance-harming strategic decisions (Chatterjee & Hambrick, 2007; Hayward & Hambrick, 1997; Hayward et al., 2004; Hiller & Hambrick, 2005; Li & Tang, 2010).

The influence of discretion on the degree to which third-party endorsements affect long-term share prices is unclear. Given the strategic complexity of high-discretion firms, shareholders may use endorsements to attribute positive firm performance to CEOs; this attribution can raise long-term performance expectations to unattainable levels as shareholders grow to believe that endorsed CEOs can overcome internal and external performance obstacles. Further, if endorsed CEOs begin to believe their own press, the resulting overconfidence might cloud executives' decision-making capabilities in strategically complex contexts, decrease their decision-making effectiveness, and inhibit the fulfillment of shareholders' high performance expectations (Chatterjee & Hambrick, 2007; Hayward & Hambrick, 1997; Hayward et al., 2004; Hiller & Hambrick, 2005; Li & Tang, 2010). Failure to meet such expectations can frequently result in share-price reduction.

Although these effects also are possible in low-discretion contexts, third-party endorsements of CEO quality are not as prominent in shaping investors' long-term performance expectations and share prices in such environments. Given the reduced role of CEOs in determining the outcomes of low-discretion firms, shareholders are less likely to attribute long-term performance outcomes to endorsed CEOs and thus to formulate lofty long-term performance expectations based on CEO quality. Endorsements also can cause CEO hubris in low-discretion contexts and reduce decision-making effectiveness; however, the constrained role of CEOs in the performance of low-discretion firms attenuates the impact of such decisions on firm performance. Accordingly, investors' negative long-term reactions should be stronger for CEOs operating in high – than in low – discretion situations.

H1B. Managerial discretion moderates the negative relationship between third-party endorsements of a CEO's quality and his or her firm's long-term share prices, such that this link becomes stronger in high-discretion – but not in low-discretion – firms.

2.2. Third-party endorsements of CEO quality, discretion, and CEO compensation

Researchers have established that third-party endorsements have a positive effect on CEO compensation for various reasons (Wade et al., 2006). First, despite access to inside information, boards may consider third-party assessments to provide objective information regarding their CEOs' relative quality (Wade et al., 2006). Second, boards may take and publicize symbolic actions—such as pay increases—to reinforce key stakeholders' (e.g., shareholders) perceptions of the endorsed CEOs' importance to firm performance (Milbourn, 2003). Finally, endorsements can increase a CEO's visibility, generate demand for that person's services at other firms, and prompt the board to retain his or her services through a compensation increase (Finkelstein & Hambrick, 1989).

The amount of managerial discretion that CEOs enjoy likely increases the salience of third-party executive endorsements to boards. In line with this logic, prior research uncovers a strong positive relationship between managerial discretion and CEO compensation (Finkelstein & Boyd, 1998; Sanders & Carpenter, 1998). First, CEOs in high-discretion contexts must make sense of more complex, voluminous bodies of strategic information, and thus deserve higher compensation (Finkelstein & Hambrick, 1989; Henderson & Fredrickson, 1996). Second, discretion alters the level of risk that executives bear, because there is greater variability in the performance of high-discretion firms (Hambrick & Finkelstein, 1987; Rajagopalan & Finkelstein, 1992). The CEOs of such firms therefore can receive more pay as a reward for bearing greater risk (Eaton & Rosen, 1983; Walsh & Seward, 1990).

As managerial discretion increases, third-party endorsements develop additional significance to board members by suggesting that CEOs can competently manage complex, risky environments. Indeed, such signs of quality in high-discretion settings help board members to recognize and appreciate endorsed CEOs' ability to navigate and bear the risks of such business contexts. Further, the difficulties associated with operating in high-discretion contexts amplify the symbolic importance of employing capable executives; as such, endorsements in these
دریافت فوری
متن کامل مقاله

✅ امکان دانلود نسخه تمام متن مقالات انگلیسی
✅ امکان دانلود نسخه ترجمه شده مقالات
✅ پذیرش سفارش ترجمه تخصصی
✅ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
✅ امکان دانلود رایگان ۲ صفحه اول هر مقاله
✅ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
✅ دانلود فوری مقاله پس از پرداخت آنلاین
✅ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات