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The pattern of investment surrounding CEO retirements: UK evidence

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Abstract

The recent spate of corporate scandals worldwide has again raised serious concerns about the quality of corporate governance. We examine the governance effects on investment expenditure in the year of CEO retirement. Based on a sample of the 460 largest UK listed companies during 1990–1998, we find no evidence of changes in capital or research and development expenditure when CEOs are on the verge of retiring. In addition, neither board size nor leadership structure (separating the posts of CEO and chairman) influence corporate investment during the CEO's final year. However, we do show that there are some important governance effects. Cutbacks in fixed asset spending at the time of CEO departure are less likely in firms with executive-dominated boards. There is evidence that stock ownership of outside directors is associated with increased capital expenditure when the CEO retires. Finally, further analysis suggests that insider board monitoring and outsider equity ownership may act as substitute mechanisms in ensuring that retiring CEOs focus on value creating activities.
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1. Introduction

Is there a horizon effect when CEOs retire from their firms? We investigate this question by looking at the pattern of corporate investment when the CEO is on the verge of retiring. As a manager reaches retirement any incentives generated from career concerns within that firm can diminish or evaporate (Gibbons and Murphy, 1992b). A promotion prospect represents a valuable option to the manager, and when it is absent (the "no tomorrow" feature of the job separation), sub-optimal current behaviour and actions by the manager can ensue. Dechow and Sloan (1991) show that the prospect of weakening career concerns motivates CEOs to reduce investment in research and development (R&D), during their last year, in order to boost earnings and bonuses. In contrast, Murphy and Zimmerman (1993) investigate the behaviour of R&D, fixed capital, and advertising expenditures during the CEO's final year and find little support for horizon effects (i.e. that impending CEO departure affects economic variables).

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In our paper, we investigate whether such a horizon effect materializes when using British data. Such an exercise is worthy given the mixed evidence from prior studies. In addition to the direct effect of a CEO retirement on corporate investment we test whether the pattern of investment is different for firms with different governance structures. The design of certain "best practise" governance institutions—for the purposes of enhancing monitoring quality—may help assuage self-interested opportunistic behaviour by the manager. Our main contribution to the corporate governance literature is to empirically model the firm's investment decision and to identify whether or not there is a "horizon effect" in the data. In addition, we examine how the institutions of corporate governance interact with the CEO's retirement and affect the pattern of investment.

Why does corporate governance interact with CEO retirement to alter the pattern of corporate investment? Here one can develop several predictions. The most obvious one is that effective boards are more likely to constrain investment manipulation surrounding CEO departure. Investment activity, at the time of CEO retirement, may, therefore, differ depending on the proportion of outside directors, board size and leadership structure (i.e. separating CEO and chairperson positions). Moreover, stock compensation might strengthen the directors' incentives to effectively challenge opportunistic behaviour on the part of the departing CEO. Accordingly, cutbacks in investment expenditure at the time of CEO retirement may be less likely in firms with higher equity-based remuneration of directors.

To provide evidence on all these issues, we collect data on a large sample of UK publicly quoted firms from 1990 to 1998. We then track CEO departures and record expected retirements. To investigate CEO discretionary behaviour, we model the firm's decision to invest on capital and R&D expenditure, conditional on proxies for board effectiveness and directors' stock-based compensation.

Our main empirical results may be summarised as follows. In our econometric models we find no evidence of changes in capital or R&D expenditure when CEOs are on the verge of retiring. Therefore, in line with prior US-based studies (e.g. Murphy and Zimmerman, 1993) the horizon effect is not empirically established when using British data.[1] In addition to the direct horizon effect of CEO retirement on investment behaviour we also test for indirect effects via interaction terms with various governance variables. Here we find an important role for governance affecting the pattern of investment around CEO retirement. Specifically, we test whether investment patterns for retiring CEOs are different in companies with different leadership and board structures, as well as different equity ownership by board members. Once again, in our empirical analysis we do not find any evidence that board size or leadership structure (separating the posts of CEO and chairman) influence investment expenditure in the year of CEO retirement. Contrary to the view that outside board members are effective monitors, we find that cutbacks in fixed asset spending during the CEO's final year are less likely in firms with a strong presence of executive (i.e. inside), rather than outside, directors. We attribute this to the presence of low information asymmetry between executive directors and CEOs, which, in turn, enables the former to evaluate the CEO's investment choices effectively. Finally, we find that capital expenditure increases in firms where the CEO is retiring and the fraction of common equity owned by outsider directors is high. Equity ownership of executive board members does not seem to matter. There are no differences among capital expenditure patterns around the time of CEO departure for executives either with high or low ownership of common equity or stock options. We explain this by showing that stock-based compensation for executive directors of UK companies is relatively small whereas equity-based remuneration of outsiders, although not high in absolute terms, may still be an important component of their total compensation.

Further analysis suggests that board monitoring (i.e. monitoring by executive directors) and stock-based incentives (i.e. stock ownership of outside directors) are substitute mechanisms to ensure that a CEO, who is on the verge of retiring, is motivated to focus on value creating activities. Empirical findings regarding the indirect effects of CEO retirement via interaction terms with governance variables are robust to several sensitivity tests, including the application of a different retirement period, the use of additional control variables (e.g. the type of new CEO appointment, prior firm performance) and, the introduction of industry-wide movements in fixed asset investment.

[1]We are indebted to an anonymous referee for extremely useful guidance in the interpretation of the empirical results. Especially with respect to the association between investment patterns and CEO retirement.

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