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# CEO ability and corporate opacity

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## ABSTRACT

This paper examines the effect of CEO ability on corporate opacity. High-ability CEOs may seek to create greater transparency to convey their ability to the market, while low-ability CEOs may signal-jam the market's inferences about their talent by limiting the available information. An analysis of S & P 500 firms indicates that firms with high-ability CEOs are significantly less opaque than firms with low-ability CEOs, and that corporate opacity decreases value more for firms managed by low-ability CEOs. Low-ability CEOs hiding behind opacity get away with it owing to lack of strong corporate governance, suggesting that corporate governance is critical for hiring and retaining talented CEOs, and also for preventing low-ability CEOs from exploiting corporate opacity. These findings are robust to the use of samples that are propensity score matched on firm complexity and past firm performance, and also to the use of alternative ability proxies and alternative measures of CEOs' choice of transparency.

## 1. Introduction

Publicly traded firms are required by regulators to provide extensive disclosure, yet considerable variation still exists in the additional information provided to the capital markets. Firms have substantial discretion about the informativeness of the mandatory disclosures and the details provided (Lang & Lundholm, 1996). There has been a remarkable body of research evaluating the consequences of variations. Healy and Palepu (2001), for example, consider the main consequences of firm transparency to be the reduction of information asymmetries and mitigation of agency costs. Information asymmetry problems may lead capital markets to undervalue good firms (Akerlof, 1970). Abundant information allows precise valuations and induces investors to hold the company's stock. Such an increase in liquidity also increases the demand and therefore raises the stock price, in turn decreasing the cost of capital (Diamond & Verrecchia, 1991; Easley & O'Hara, 2004; Healy & Palepu, 2001). In addition, Verrecchia (1983, 2001) suggests that investors interpret withheld information as unfavorable and consequently discount the firm's value. Studies also associate corporate opacity with the agency problem between controlling and outside shareholders. Faccio, Lang, and Young (2001), for instance, suggest that high opacity makes it difficult for outside shareholders to recognize expropriation. Leuz, Nanda, and Wysocki (2003) argue that controlling shareholders may increase firm opacity to enable them to capture private benefits. In addition, Anderson, Duru, and Reeb (2009) report that corporate opacity can lead to severe conflicts of interests between founding family members and minority shareholders.

CEOs, along with a group of well-experienced directors, lead corporate decision making, which undoubtedly includes the decision about corporate opacity. In this paper, I argue that the CEO's ability level may be an important factor in corporate opacity. While the CEO is aware of his/her own abilities, investors may not be able to observe them fully. The CEO, then, is also aware that the market will assess his/her abilities through firm characteristics, such as firm performance or the success of investment and/or R & D decisions (Holmstrom, 1999).

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Several papers establish an empirical link between CEO ability and firm performance, suggesting that CEOs with greater ability provide better firm performance for their shareholders (Bertrand & Schoar, 2003; Falato, Li, & Milbourn, 2009; Pérez-González, 2006; Uygur, 2015). Very able CEOs may also choose to disclose more information in order to signal the market about their superior skills, whereas less able CEOs may signal-jam the market's inferences about their ability levels by not providing full information and misleading the market, so that they hide behind the shield of high corporate opacity (Fudenberg & Tirole, 1986; Holmstrom, 1999; Narayanan, 1985; Stein, 1989).[1] This argument is similar to Holmstrom's (1999) suggestion that an undervalued manager would be willing to take more risky projects in order to prove himself/herself, whereas others would jam the signals by not taking the investments; thus risk-taking in itself would signal talent. Similarly, I argue that high-ability CEOs promote corporate transparency. If so, we could expect to observe a negative relation between CEO ability and corporate opacity.

An alternative explanation for any association between CEO ability and corporate opacity may involve the CEO's choice of employer—or the firm's choice of CEO. A low-ability CEO may seek to work in a highly opaque firm to make it difficult for outsiders to evaluate his/her performance. Less transparent firms might want to hire the best CEOs, but they probably cannot, because high-ability CEOs want to signal their abilities to the market and will not be willing to work in a company that impedes such signals.

These two arguments are both plausible, and it is very difficult to distinguish between them. However, they both suggest that CEO ability is associated with financial transparency. Thus, I hypothesize that there is a negative association between CEO ability and corporate opacity.

I develop an opacity index to evaluate the relative opaqueness of the firms in my sample (Anderson et al., 2009). As a proxy for CEO ability, I use the firm's performance compared to that of peer firms. *CEO ability* is measured as the average firm performance for the previous three years, adjusted by the industry (Banker, Darrough, Huang, & Plehn-Dujowich, 2012; Hermalin & Weisbach, 1998; Rajgopal, Shevlin, & Zamora, 2006).

Substantial evidence suggests that opacity and low CEO ability impair firm performance, and therefore firm value (Bertrand & Schoar, 2003; Diamond & Verrecchia, 1991; Easley & O'Hara, 2004; Healy & Palepu, 2001). How, then, do low-ability CEOs keep their jobs? One plausible explanation is lack of strong corporate governance. To address this question, I analyze board monitoring effectiveness, measured by CEO duality and governance index (G-index).

In order to test the robustness of my findings, I consider possible endogeneity problems that may be driving my results because of firm complexity and past firm performance. Rosen (1982) and Rose and Shepard (1997) argue that high-ability CEOs are matched with more complex firms. Bushman, Chen, Engel, and Smith (2004) also suggest that organizational complexity may affect corporate transparency decisions. Therefore, any finding that supports my arguments may be driven by firm complexity, rather than CEO ability. To address this concern I create a propensity score matched sample that matches firms with high-ability and low-ability CEOs on their predicted propensities to complexity. I also use alternative ability proxies and more direct measures of CEOs' choice of transparency, such as use of accruals.

This study makes two potential contributions. First, my analysis brings to light the notion that CEO ability is an important factor in corporate opacity. Second, it highlights the possibility that board monitoring effectiveness is crucial to prevent low-ability CEOS from exploiting corporate opacity.

The remainder of the paper is organized as follows. Section 2 describes the data, variables of interest, and control variables. Summary statistics and results of univariate and multivariate analysis are explained in Section 3. Section 4 discusses the impact of corporate governance on the association of CEO ability and corporate opacity. Section 5 presents the results of the robustness tests, and Section 6 concludes the paper.

## 2. Data and variables

The sample consists of the companies included in the S & P 500 Index between 1998 and 2010. The final sample consists of 369 unique firms and 3845 firm-year observations. I obtain the company and industry data from the COMPUSTAT database, and the corporate opacity data from the CRSP and IBES databases.

### 2.1. Corporate opacity

I develop an opacity index to evaluate the relative opacity of each firm in my sample. The index uses four different corporate opacity proxies, namely trading volume, bid-ask spread, number of analysts following the firm, and analysts' forecast error. As in the 2009 study by Anderson and colleagues, the index is constructed so that the degree of corporate opacity increases as the index score increases.

Trading volume (*Dollar volume*) is included in the opacity index as a proxy for information uncertainty (Leuz & Verrecchia, 2000). It is calculated as the natural log of the average daily dollar volume of each firm during the fiscal year. The bid-ask spread (*Spread*), which Diamond and Verrecchia (1991) use to proxy for information asymmetry, is calculated by taking the difference of the fiscal year-end ask and bid prices, and dividing by the average of the bid and ask prices. The data for *Dollar volume* and *Spread* are collected from the CRSP database. Lang and Lundholm (1996) suggest that number of analysts following (*Analysts*) and analysts' forecast error (*Forecast Error*) may be used to measure market scrutiny and information availability. I use the natural logarithm of number of

[1] Although these papers evaluate different questions, they all develop a "signal-jamming" model, in which one player intends to mislead the other player by distorting, manipulating, or selecting information.