

## RESEARCH BRIEFS

# HOW DO BOARDS KNOW WHEN TO FIRE THE CEO—AND DOES IT PAY?

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### RESEARCH QUESTIONS

For decades, boards of directors have received increased scrutiny from researchers and the media. Boards are elected by shareholders to hire top managers, incentivize them, monitor their decisions and actions, and, when necessary, replace them. Researchers have spent a lot of time and effort trying to understand the conditions that allow boards to best perform these duties. Research shows, for example, that boards generally do a poor job tying CEO pay to firm performance without the benefit of a large shareholder to press the issue (Gomez-Mejia, Tosi, & Hinkin, 1987). Studies also show that boards fire CEOs in response to poor firm performance, especially when the board is full of independent directors who are not beholden to management. But sometimes performance falls and the CEO stays, even when there is a large shareholder and an independent board. So it seems likely that board members look at more than the “hard” numbers to make decisions about CEOs. What that may be, however, remains a mystery because the information that boards use to judge CEOs is cloaked in secrecy and locked in a “black box” away from researchers.

That is until recently when a group of researchers gained access to the “black box”—not to the live board deliberations, mind you, but to previously confidential information. Like sleuths chasing clues, the research team of Francesca Cornelli (London Business School), Zbigniew Kominek (European Bank of Reconstruction and Development), and Alexander Ljungqvist (New York University) gained access to unique reports containing investors’ and board members’ thoughts about CEO intentions and competence. This gave the researchers access to rich “soft” information that could be compared to “hard” financial numbers. Better yet, these reports were about firms from former communist countries during their transition to a more market-oriented economy, so the data stretch across a time when these governments were changing the rules that govern who can fire a CEO. This allowed researchers to go

beyond asking what kind of information board members use to fire CEOs to include asking how governance reforms affect investors’ ability to act on different kinds of information. It also allowed them to ask and offer a more definitive answer as to whether or not it pays to replace the CEO.

### STUDY DESIGN AND METHOD

Cornelli, Kominek, and Ljungqvist’s data come from the European Bank for Reconstruction and Development (EBRD), which was formed to assist former communist countries’ transition toward market economies. Their sample included 473 private-sector firms from 19 transition economies in Central and Eastern Europe as well as Central Asia. These firms were financed by 43 private equity funds, with an average investment of €93.1 million. Importantly, 80% were *minority* investments that, prior to the collapse of the Soviet Union and ongoing governance reforms, lacked the power to fire CEOs. Firing could only be done by a majority shareholder vote. During the study time, many of these former Soviet republics passed tougher western-style governance reforms that gave boards the power to fire CEOs. These changes gave Cornelli and colleagues the opportunity to compare firing decisions prior to and following policy changes to determine not only if more CEOs got fired (i.e., it should be easier after reforms), but also to see what kind of information boards use to make such decisions. Large minority investors should be able to use soft information and board members’ personal knowledge to convince the board to terminate the CEO when necessary. Without the reforms, such investors would have to convince a large number of small investors based on hard data.

The researchers gained access to investors and board members’ insights about the firm and its CEO from EBRD audits. These audits were performed by the EBRD because they were anchor investors in funds managed by third-party investment managers (think venture capitalists). The audits include

standardized, semi-annual summaries of “hard” (easily verifiable) and “soft” (richer, non-verifiable) information based on interviews with major investors, managers, and notes taken in board meetings. The audits also list problems identified and describe board decisions. Most research in finance only examines hard information, such as the firm’s financial metrics. Soft information such as “The top management team is strong” or “...sees the need for a more efficient sales and marketing strategy...” is rare indeed.

Although Cornelli et al. thought that soft information would be important, they needed to parse out types of soft information so that they could focus on incompetence. They divided investor concerns into those that are due to (1) CEO incompetence, (2) specific actions or decisions that had poor results (honest mistakes), and (3) simple bad luck. This allowed the researchers to isolate reasons for a firing and judge the quality of the board’s decisions. For example, if a CEO was fired due to events beyond her control (i.e., bad luck) that would be a bad board decision.

Finally, the researchers assessed whether firing the CEO pays. Prior researchers have, of course, tried to examine this question. But doing so is tricky because CEOs are usually fired in times of poor firm performance. So any change in performance might be due to the firm’s starting point and not changing the CEO. By looking at a time when CEOs couldn’t and then suddenly could be fired (the reforms), Cornelli and colleagues were better able to isolate from other factors the impact of CEO termination on firm performance. Specifically, they looked at whether the investments were more likely to pay off in terms of an IPO or sale, or were less likely to result in a write-off.

### KEY FINDINGS

Cornelli et al. made several interesting discoveries. They started by examining the effect of hard and soft information on CEO termination. Both matter, but soft information matters more. Missing hard performance targets increases the odds of CEO termination by 8.5%; being deemed incompetent in soft information increases the odds by a whopping 30.6%. Further, hard and soft information is used differently. In about 89% of the cases where the firm missed its hard target, the board ignored it because soft information showed that the poor performance was due to factors outside the CEO’s control. In contrast, incompetent CEOs (soft information) were fired even when they made or beat their hard budget target. Overall, board members use both kinds of information, but soft information

is more important in that it brings the meaning of hard information into focus.

The countries’ ongoing governance reforms also mattered. Eighteen countries strengthened boards’ power to control management during the study period. Reforms, on average, caused CEO terminations to jump from 3.2% to 13.3%. Prior to reforms, soft information was used only by majority owners who had the power to fire. After reforms, minority owners could also use soft information to convince the board of needed change. The importance of soft information in firing decisions doubled while the importance of hard information remained unchanged. This means that a key way reforms work is by giving boards power to use more and richer information in evaluating CEOs.

But what happens after CEOs are fired? Exactly what board members hope: the results strongly suggest that CEO turnover has a large, positive effect on firm performance. Holding other factors constant, firing the CEO nearly doubled the chances that an investment would payoff in an IPO or successful sale, and reduced the probability of a write-off by about two-thirds. In contrast, when boards fail to fire a CEO they deem incompetent, performance continues to decline.

### CONCLUSIONS AND IMPLICATIONS

This study broke open the proverbial locked doors of the boardroom and, for the first time, examined the role of soft information in CEO turnover. By gaining access to soft information, Cornelli and colleagues’ study shows that boards act on soft information and that soft information carries more weight than hard information. Also, acting on soft information, and reforms that allow boards to act, lead to CEO terminations that improve future performance.

These results offer promising avenues for exploring the role of soft information in boardrooms. One logical extension, for example, might be to ask what role soft information plays in publicly held firms. It might be that boards in publicly held firms weigh hard information more than soft information because of the scrutiny they receive from outside analysts. Such analysts are, by default, more in tune to hard financial metrics. Another potential area to explore might be the role of soft information in firms with less concentrated ownership. Funds in this study owned, on average, a 33.7% equity stake, which gave fund managers a seat on the board and clear incentives to monitor closely. But what about considerably smaller shareholders, for example those with around 5% equity? What about big shareholders who don’t sit on the board? Would

they monitor soft information as closely? With less at risk financially, perhaps this category of investors might not show the same level of interest in soft information.

Cornelli et al. had access to a unique data set that included rich information about how boards acted on soft information—data that most other board researchers lack. On the other hand, they did not have access to board composition data—data that most other board researchers have. One limitation of their study was that they did not know what the boards looked like, for example board members' average tenure, the mix of unaffiliated outsiders and firm insiders, the number of board members, and other key factors. Merging soft information with board composition data could answer additional questions. For example, does board member tenure influence the utilization of soft information? Do boards with a large majority of outsiders utilize soft information differently than boards with a slim majority? As board size increases, is there a shift away from soft information toward greater reliance on hard information? Understanding these contextual factors would help advance our knowledge of board monitoring.

The research team of Cornelli, Kominek, and Ljungqvist provide new insights as to how boards act following corporate governance reforms. It

would be interesting, though, to see how *CEOs* act following such reforms. Do *CEOs* take riskier actions after reforms? Without the threat of termination, *CEOs* might have little incentive to take risks. Reforms mean soft assessments matter and risk taking might become necessary to preserve employment.

In summary, this study provides a peek into the boardroom and the role of soft information in board decisions about *CEO* performance. We now know that boards use soft information to evaluate *CEOs* and that it helps put hard information into focus for board members. Using soft information to fire *CEOs* also leads to improved performance. By combining this study's insights with those from studies that focus on *CEO* pay and other aspects of board monitoring, we believe that this study can be a catalyst toward integrative research that offers a more complete view of how boards work behind closed doors.

## REFERENCES

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