The debate over whether CEOs add value to firms has come under renewed scrutiny in the wake of the global financial crisis. Recent indignation over seemingly exorbitant CEO compensation in the face of poor company performance have given rise to the question: Does CEO pay accurately reflect CEO ability? If so, does the CEO make a difference to company performance? Practitioners intuitively know the importance of top CEOs, however does academic research concur? Despite its extreme importance, there is surprisingly little direct evidence whether CEOs contribute positively to firm value.

It is plausible to assume that the firm’s performance is largely determined by the nature of its core competence, the quality of its products, other employees and stakeholders, its life cycle, and even possibly by ‘luck’. According to this view, CEO ability is relatively unimportant for firm value, and in fact there are reports that say that in any well-run company that’s conscientious about grooming its managers - candidates for the top job are so similar in their education, skills, and psychology as to be virtually interchangeable. All that matters is that someone be in charge. An even more cynical view is that, CEOs are in fact in a unique position to deeply establish themselves in such a manner that they obtain uncompensated value without making any real contribution to productivity (called rent extraction). Some argue that CEOs can easily capture their boards and essentially set their own pay, which is then determined more by managerial power than by ability.

In this paper, we test the proposition that CEO ability matters. In addition, if ability difference exists across CEOs, we examine whether these differences are reflected in CEO pay. We look at entire cross-section of firms, and find that compensation is actually a positive predictor of performance. The main takeaway is this: remuneration is reasonably well aligned with performance - i.e. better compensated CEOs deliver higher performance and are better valued by both financial markets and other employers. However, these positive relations disappear when the corporate governance of the firm is bad.

The Study

The main stumbling block has been how to measure CEO impacts on a firm. We fill that gap with a study of CEO departures so that we can take a ‘before and after’ snapshot. And we find that yes, CEOs do matter.

The study assesses 298 voluntary and forced CEO departures in the US from 1992-2002 on three factors: the stock market reaction to the departure news, the subsequent success of the CEO in the managerial labor market, and the performance of the firm after the CEO leaves. We examine how these factors relate to the past performance of the firm while under the CEO’s management, and the CEO’s pay relative to the other highest paid executives of the firm.

Examination of the stock market’s response to the departure of a CEO is very informative about a CEO’s contribution to firm value. However is this perception or
actual ability? To find out, we also examine whether the firm’s post-CEO-departure performance is related to the prior performance, relative pay and abnormal returns around the announcement date.

The Findings

Do CEOs really matter to firm profitability? Here are our key findings:

- Stock market reactions to CEO departures link CEO ability with firm performance. The market reacts more negatively when a more capable manager who generated higher stock returns leaves a company. Past firm performance and CEO pay also have an impact on a CEO’s subsequent career. Those from stronger performing firms and with higher pay were more likely to progress to the expected top positions in public or private companies. Moreover, the firm who sees a capable CEO depart has a poorer stock and operating performance in the one to three years after he or she leaves.

- Collectively, our results reject the view that differences in firm performance stem entirely from non-CEO factors such as the firm’s assets, other employees, or ‘luck’, and that CEO pay is unrelated to the CEO’s contribution to firm value.

- Even when comparing differences within a particular industry or with other companies, our results are consistent with the view that firm value and performance are related to ability differences across CEOs.

- We also find evidence against the view that CEOs are paid well simply because they are in a position to extract better compensation from their boards.

All of this adds up to evidence that top managerial ability has been a factor in the firm’s success. The insight for management is that the CEO’s pay is often justifiable with respect to the market for CEOs and when the CEO’s influence on company performance is considered.

The advantage of our multi-pronged approach is that it leaves little room for alternative explanations. For instance, it could be argued that CEOs ‘jump ship’ or are forced to quit when the firm’s future prospects look dim, but this would not explain why the manager’s subsequent job prospect is positively related to past pay.

It comes down to Governance

Previous important research revealed that in firms where manager are entrenched, the CEO’s pay relative to the pay of the four other highest-paid executives in the company is negatively associated with firm performance – interpreting this evidence that high CEO relative pay represents rent extraction by CEOs. We found that CEO relative pay is no longer significant in firms with poor governance characteristics. However, our results are stronger, both economically and statistically, in the firms with good governance characteristics. These results suggest that governance plays a very important role in determining the pay-performance relationships.