CHAPTER II

LITERATURE REVIEWS

2.1 Concept and Theoretical Background

There are ten incentive mechanisms that affect financial performance based on www.encycogov.com. First, decision systems are defined as the systems by which corporate decisions are distributed between shareholders, board of directors, and management team. Second, performance monitoring systems are defined as the systems that gather and analyze information about the firm such as corporate disclosure rules and discounted cash flow approach used to estimate fundamental corporate value.

Third, remuneration systems are defined as the systems that regulate the compensation of managers for their 'sale' of management services. Fourth, bankruptcy systems are defined by the bankruptcy procedures; those that specify the transfer of corporate control from stockholders to creditors when a firm goes bankrupt. Fifth, ownership structure is defined by the distribution of equity with regard to votes, capital and the identity of the equity owners.

Sixth, creditor structure is defined by the distribution of debt and the identity of the creditors. Seventh, capital structure is defined by the firm's policy with regard to leverage and dividend payments. Eighth, the market for corporate control is defined as equity transactions that are large enough to change corporate control. Ninth, the market for management service is defined as the market for managerial labor. Finally, product market competitions are defined as the competition in the firm's product markets and the competition in the product markets of the firm's owners.

Focusing on the decision systems, there is the management team which initiates and implements projects, formulates the corporate strategies and hires or fires the lower level managers. It consists of a top executives and the CEO who becomes their leader. Next, there are some previous literatures which study the effect of each CEO's characteristic on firm performance.

The first CEO's characteristic is relationship with founding family. Casson (1999) state that founding families maximize firm value in long term because they view the firm as an asset to pass on to their descendants. However, Anderson and Reeb (2003) argue that founding families concentrate on their own interests such as excessive compensation, related-party transactions or special dividends more than shareholders' wealth.

The second CEO's characteristic is leadership structure with combined functions as the CEO and Chairman. Fama and Jensen (1983) argue that agency costs in large organizations can be reduced by a separation of decision management (management team) from decision control (board of directors) and it is only an effective device for decision control if it limits the decision discretion of top managers. Moreover, Jensen (1993) in his Presidential Address to the American Finance Association recommends "The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO. Clearly the CEO cannot perform this function apart from his or her personal interest. Without the direction of an independent leader, it is much more difficult for the board to perform its critical function. Therefore, for the board to be effective, it is important to separate the CEO and chairman positions."

Although, Lorsch and Lipton (1993) state that separated titles may indirectly affect firm performance by reducing the influence power of CEO in decision making, creating a rivalry between CEO & Chairman and having two public spokespersons leading to public confusion. Brickley, Coles, and Jarrell (1997) suggest that separated titles increase the firm expense from the agency costs of controlling the behavior of Chairman and extra compensation.

The third CEO's characteristic is insider ownership. Loderer and Martin (1997) state that managers' stockholdings in their firms give them incentives to avoid share-price-decreasing decisions and to seek out share-price-increasing ones. In contrast, Morck et al. (1988) argue that manager can indulge in non-value maximizing activities when his ownership is high.

The fourth CEO's characteristic is tenure. Sturman (2003) states that tenure accumulates relevant knowledge, skills and abilities leading to better firm performance.

Finally, the last CEO's characteristic is business related educational background. Several papers in the management literature (Thomas et. al (1991), Wiersema and Bantel (1992), and Wally and Baum (1994)) find that CEOs with graduate degrees have a greater capacity to process information and more receptive to change than CEOs with lower educational attainment.

2.2 Empirical Study

2.2.1 Relationship with Founding Family

Anderson and Reeb (2003) study about founder related CEO and firm performance on 403 non utility/non banking US firms in S&P500 over the 1992-1999 periods by using OLS regression. They find that founder CEO has a positive effect on return on assets (ROA) and Tobin's Q and founder direct descendant CEO has a positive effect on ROA. However, Daily and Dalton (1992) examine 186 US small firms in 1988 by using MANOVA and find no difference in ROA and return on equity (ROE) between founder CEO managed firms and non founder CEO managed firms. Moreover, Jayaraman et al. (2000)

examine 94 US firms which 47 firms are founder managed firms over the 1980-1991 periods by using OLS regression and find that founder CEO does not affect stock return.

2.2.2 Leadership Structure

Rechner and Dalton (1991) examine 141 US firms in fortune 500 over the 1978-1983 periods by using MANOVA. They find that separated titles firms have ROE, return on investment (ROI) and profit margin higher than combined titles firms. Furthermore, Pi and Timme (1993) examine a sample of 112 US banks over the 1988-1990 periods by using OLS regression. They find that separated titles have a positive effect on ROA. In contrast, Brickley, Coles, and Jarrell (1997) study 661 US firms in 1988 by using OLS regression. They find that combined titles have a positive effect on return on capital (ROC) and stock return.

2.2.3 Insider Ownership

The relationship between insider ownership and firm performance is statistically positive but weak. McConnell and Servaes (1990) examine 1,173 US firms in 1976 and 1,093 US firms in 1986 that listed in New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) by using OLS regression. They find that insider ownership has a positive effect on Tobin's Q. In addition, Loderer and Martin (1997) study 867 US firms over the 1978-1988 periods by using OLS regression. They find that insider ownership has a positive effect on abnormal return and Tobin's Q. Nevertheless, Loderer and Sheehan (1989) examine 181 US bankrupt firms and non-bankrupt firms in NYSE and AMEX over the 1971-1985 periods. They find that the insider ownership in bankrupt firms is not different from non-bankrupt firms.

2.2.4 Business Related Educational Background

Gottesman and Morey (2005) study about the educational background of the CEOs and firm performance on 494 US firms in NYSE over the 1997-2002 periods by using OLS regression. They find that CEO who graduated from MBA degree does not affect excess return, abnormal return, ROA, ROE and Tobin's Q.

2.2.5 Related Studies in Thailand

- Relationship with Founding Families

Tontivanichanon (2004) studies the relationship between founder CEO and firm performance. She uses a sample of 97 listed firms in Stock Exchange of Thailand (SET) over the 1999-2003 periods except the financials industry and firms which are formerly state enterprises. She classifies the characteristic of the CEO into three groups; CEO who is a founder, CEO who is a founder direct descendant and CEO who is the outsider. She finds that founder direct descendant CEO has a positive effect on ROA.

- Insider Ownership

Sitasuwan (2000) studies the effect of insider ownership on firm performance. She uses a sample of 800 observations from listed firms in SET over the 1996-1998 periods. She uses return on equity and excess return from capital asset pricing model as proxies for firm performance. She finds that the effect of insider ownership on the industry adjusted return on equity is non-monotonic by using OLS regression; when the insider ownership is 25-75%, it has a positive effect on industry adjusted

ROE. When the insider ownership is more than 75%, it has a negative effect on industry adjusted ROE. However, when firm size and debt-to-equity ratio are controlled, she finds that insider ownership does not affect industry adjusted ROE.

Tilkanan (2004) studies the effect of insider ownership on firm performance. He uses a sample of the listed firms in SET over the 1998-2002 periods except financials industry and using return on asset and Tobin's Q as proxies for firm performance. He finds that insider ownership has a positive effect on Tobin's Q by using OLS regression. However, he finds that insider ownership has a negative effect on Tobin's Q by using two-stage least square.

Some characteristics such as relationship with founding families, leadership structure and insider ownership have a lot of previous literatures but still cannot conclude about their effects. Next, business related educational background and tenure have a few studies and need more of them in the future. Finally, age and having other insider on board does not have any direct investigation about their relationships in financial field. In Thailand, it has only two characteristics which have a previous research so this study can clarify these relationships and provide the new findings about the other characteristics in this country.