CEO Contractual Protection and Managerial Short-Termism

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Abstract:

How to address managerial short-termism is an important issue for companies, regulators, and researchers. We examine the effect of CEO contractual protection, in the form of employment agreements and severance pay agreements, on managerial short-termism. We find that firms with CEO contractual protection are less likely to cut R&D expenditures to avoid earnings decreases and are less likely to engage in real earnings management. The effect of CEO contractual protection is both statistically and economically significant. We further find that this effect increases with the duration and monetary strength of CEO contractual protection. The cross-sectional analyses indicate that the effect is stronger for firms in more homogeneous industries and for firms with higher transient institutional ownership, as protection is particularly important for CEOs in these firms, and is stronger when there are weaker alternative monitoring mechanisms.