CEO Decision Horizon Towards Company's Performance

Fitri Ismiyanti[1], Putu Anom Mahadwartha[2] and Andita Jaufatul Laili[3]
[1]*Faculty of Economics and Business, Airlangga University, Indonesia*
[2]*Faculty of Business and Economics, Surabaya University, Indonesia*
[3]*PT Waskita Beton Precast Tbk, Indonesia*
fitri.ismiyanti@feb.unair.ac.id, anom@staff.ubaya.ac.id, andita.jl@gmail.com

Keywords: CEO Decision Horizon, Leverage, Size, Operating Profit Margin, Tobin's Q.

Abstract: This research aims to analyze the influence of CEO decision horizon, leverage, size, and operating profit margin on the firm's performance using manufacturing company listed in Indonesian Stock Exchange over the period 2012-2016. This research used regression method to test the hypothesis. Firm's performance is measured by Tobin's Q as the dependent variable and CEO decision horizon, leverage, size, and operating profit margin as the independent variable. The results showed that CEO decision horizon affected by Tobin's Q. Leverage has positive effect to Tobin's Q. Size has positive significant effect to Tobin's Q, and operating profit margin has positive insignificant effect to Tobin's Q using 5% level of significance. Higher CEO decision horizon will increase firm performance because their experience of managing firm useful and beneficial for shareholder wealth.

1 INTRODUCTION

CEO (Chief Executive Officer) or president director is the highest executive in a board of director who held important role as a decision maker in a company to achieve company's main goal, which is increasing company's value. CEO decision horizon defined as a time period of CEO effectivity on their decision-making process that measured by expected tenure (Jensen and Smith, 1985). Expected tenure determined by 2 factors, they are longevity and CEO's age. CEO with a short decision horizon linked with bad company's performances (Antia, 2010) and cause an agencies conflict to surface. Short CEO decision horizon will cause pressure to increase company's performance before the end of the period, one of them is by investing on a short-term with a high-risk project, ignoring the mild risk project. This kind of condition's calls managerial myopia.

Study that has been done by Antia (2010) shows that CEO decision horizon affects company's performance. The effects of CEO decision horizon towards company's performance is an interesting top in to analyze, especially in electing the new CEO for a company. Even though there's already many studies about the effects of longevity or CEO'S age towards company's performance, so far, it's still very hard to find study regarding CEO decision horizon in Indonesia.

2 LITERATURE REVIEW

Based on Jensen and Smith (1985) opinion, CEO decision horizon defined as a period of time that CEO have to produce decision that restricted by 2 things, which are longetivity and CEO's age (Antia, 2010). From Jensen and Meckling study (1979), CEO decision horizon measure by expected tenure. Value of decision horizon result of expected tenure calculation could be positive or negative. Decision horizon is positive if expected tenure of company's CEO in longer than median expected tenure of CEO in a industry. This caused by CEO who just got officiate. On the contrary, decision horizon is negative if CEO's expected tenure is shorter than CEO's median expected tenure in industry which caused by CEO's old age or has been officiate for a long time.

Based on Zahara and Pearce (1989) company's performance determine company's ability to produce earnings on a certain period. The measurement of company's performance done by doing Tobin's Q mehod which defined as a company's market value aset ratio towards company's asset replacement cost

Ismiyanti, F., Mahadwartha, P. and Laili, A.
CEO Decision Horizon Towards Company's Performance.
In *Proceedings of the 1st International Conference on Islamic Economics, Business, and Philanthropy (ICIEBP 2017) - Transforming Islamic Economy and Societies*, pages 400-403
ISBN: 978-989-758-315-5
Copyright © 2018 by SCITEPRESS – Science and Technology Publications, Lda. All rights reserved

(Tobin, 1969). The value of Tobin's Q is more than 1 if the company's value is higher than the book balue (overvalued). Lidenberg and Ross (1981) states that Tobin's Q high ratio shows that company have good investation chance, and a significance competitive advantages.

Agency theory states that agencies relationship surface when one or more people (principal) delegating their rights of decision making to other people (Jensen and Meckling, 1976), which caused a different interest. In a company, stockholders main concern is the return from the funds have invested, while manager's interest is incentive earned by managing stockholder's fund.

Jensen and Mecking (1976) stated that the reason behind different interest between manager and stockholders is because manager didn't have to be responsible for the risk caused by a mistake in business decision. Whereas based on Jensen and Smith (1985), conflicts between manager and stockholder caused by: 1) manager's attempt in managing the company; 2) manager's inability to diversificates risks; 3) horizon problem existence.

Myopic behavior based on Porter (1992) is "sacrificing long-term growth for the purpose of meeting short-term goals". This definition have 3 aspects: (1) there's an underinvestment in creating long-term value; (2) underinvestment happened to fulfill short-terms goal; and (3) underinvestment makes long term growth and value creation weaker.

One of the reasons why manager prefers short-term project based on Campbell and Marino (1994), is to support their reputation in managerial labor market. While Hirshleifer and Thakor (1992), said that this because manager didn't want to take risk. Stein (1988) says that myopic CEO have incentive to focus on a short-term goal so they can increase company's current stock price faster. This argument supported by Laverty (2004), which stated that company with myopia managerial have correlations with high investment return.

Long CEO decision horizon indicates that CEO have short longetivity. Antia (2010) states that long decision horizon will create an enviromental that push CEO to focus on the stockholder's long-term needs where needs fulfillment of stockholder's needs will increase that company's value.

Long decision horizon also made company's strategy implementation more effective (Antia, 2010) and made CEO have a better market evaluation (Jensen and Meckling, 1979). CEO who pays attention to stockholder's well being will take decision that minimize agencies conflict to happen so they could increase company's value.

On the other side, short decision horizon push myopia managerial to happen. This is an understanable responds regaring CEO'S pressure to increase company's performance in a short term before thair time as CEO ends. As a result, company experienced unedrinvestment because of a few potential long term projects missed (Brickley, 1999).

H_1 : CEO Decision Horizon have positive affect to company's performance.

Leverage defined as a company's ability to use activa as a tools to increase return. Based on Modigliani and Miller (1958) in a condition where there's income tax, leverage can increase company's value. Increase of company's vaue happened because interest downpayment can decrease tax. But the excessive use of debt can lead company's value to decreased, which caused by tax savings that increase only a little of company's value compared to the cost of bankcruptcy which decrease company's value. Therefore, a company have to set an optimum capital structure to maximize company's value.

H_2 : Leverage have positive affect to company's performance.

Company's size is how big or small a company is, measured by total assets. Based on Bantel and Jackson (1989) opinion, a big company also have a big access so it helps company's performance development. A big company also linked with market power (Shepherd, 1986) where an efficient market power will increase company's performance.

H_3 : Size have positive affect to company's performance.

Operating profit margin is a profitability ratio which measures company's ability to produce earning before interest and tax. OPM has a positive effects on company's performance, because a high OPM will give positove perspective towards company's performance.

H_4 : Operating profit margin have positive affect to company's performance

Research model to find out about the CEO decision Horizon effects along with leverage, company size, and operating profit margin towards company's performance formulated as :

$$Tobin's\ Q_{i,t} = \alpha + \beta_1 DH_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 LEV_{i,t} + \beta_4 OPM_{i,t} + \varepsilon_{i,t}$$

$Tobin's\ Q_{i,t}$ = company's performance i on t period
$DH_{i,t}$ = company's CEO decision horison
$SIZE_{i,t}$ = company's size i on t period
$LEV_{i,t}$ = company's leverage i on t period
$OPM_{i,t}$ = company's operating profit margin.

3 RESEARCH METHOD

Sample used for this study in manufacturer company listed on Indonesian stock exchange from 2011-2015 period. Source and type of data used in secondary data from company's annualy financial statements.

To give an idea of the variables used in this study, the operational definition of each variable is described as follows:

1. CEO Decision Horizon proxied with expected tenure. Variable measurements done by using formula below:

$$DH_{i,t} = [TENURE_{ind,t} - TENURE_{i,t}] + [AGE_{ind,t} - AGE_{i,t}]$$

2. Leverage calculated by:

$$Debt\ Ratio_{i,t} = \frac{Total\ Debt_{i,t}}{Total\ Asset_{i,t}}$$

3. Company size calculated by:

$$SIZE_{i,t} = Log\ Natural\ Total\ Aset_{i,t}$$

4. Operating Profit Margin (OPM) calculated by:

$$Operating\ Profit\ Margin = \frac{Earning\ Before\ Interest\ and\ Taxes}{Sales}$$

5. Company's performance (TOBINS'Q) calculated by :

$$Q_{i,t} = \frac{(Outstanding\ sharex\ Price) + (Debt + Inventory) - Total\ Asset}{Total\ Asset_{i,t}}$$

4 RESULTS AND DISCUSSION

Testing using double regression linear with significance level 5%. The result of the test in Table 4.1 shows that CEO horizon decision variable. Company's size, and Operating Profit Margin positively affects company's performance. While leverage variable didn't have any effects on company's performance.

Table 1: Regression result.

Independent Variable	Regression Coefficinet	Std. Error	t-Statistic	Sig.
(Constant)	-1,851	0,822	-4,161	0,027
DH	0,008	0,023	2,402	0,017
LEV	-0,016	0,230	-0,095	0,648
SIZE	0,096	0,059	3,367	0,005
OPM	2,740	0,555	5,689	0,000
Std. Error of the Estimate				0,56328
R Square				0,314
F – Statistic				13,272
Sig. F				0,000

The result of this study shows that CEO decision horizon (DH) positively and significantly affects company's performance. Long CEO decision horizon will minimize agencies conflict between manager and stockholders because of stockholder's fulfillment needs considered as a way to increases company's performance rapidly. When CEO prioritize stockholder then stockholder's trust will increase so the company's value will also increase. Long CEO horizon also dodge company from CEO longetivity negative effects, like decreased in CEO's information access from external party, and on a work challenge. While short CEO decision horizon encourage managerial myopia happens on CEO. Myopic CEO focused more imto short term goals and increases in profit with taking a short term projects with high return. As a result, company will experience underinvestment because many of potential long term project didn't get chosen and will decreased earnings and company's value (Gibbson and Murphy, 1982).

From the result of this study, leverage don't have significance effects on company's performance. This happen because not every investor or stockholdelrs in indonesia is a rational type who considers financial information, including leverage, in giving views towards company's value. The existence of investor with intuitive and emotional type cause leverage effects towards company become biased. Other than that, high or low leverage or big or small the debt is, isn't being a main concern by investor because company put their concerns more on how company use their fundings effectively and

efficiently to achiever company's value (Bonn, 2004).

Regression test result shows that company size positively nd significantly affects company's performance. This happened because big company have a better ability to optimize their resoirces so it could help company increases their performance compared to small company. Big company also have better access towards cost of capital and also having more stable cash flows which allows big company to produce better financial performance, and will increase stock proce which reflects company's value.

Based on regression test, operating profit margin have a posotive effect towars company's performance. This happens because company that hase great performance generally produce big profit because of efficient company's performance. Furthermore, high operating profit margin value also give positive perspectives towards company's value. This result is compatible with the hypothesis which stated that OPM positively affects company's performance.

5 CONCLUSIONS

This research concluded that CEO decision horizon (DH) affects company's performance. Long horizon of CEO decision will decrease agency conflict between manager and stockholders. Satisfying stockholder's needs considered as a way to increases company's performance. While short horizon CEO decision will support managerial myopic behavior.

REFERENCES

Antia, M., 2010. CEO decision horizon and firm performance: an empirical investigation. *Journal of Corporate Finance.*

Bantel, K. A., Jackson. S. E., 1989. Top management and innovations in banking: Does the composition of the top team make a difference? *Strategic Management Journal.*

Bonn, I., 2004. Effects of board structure on firm performance: a comparison between Japan and Australia. *Asian Business Management.*

Brickley, J. A., 1999. What happens to CEOs after they retire? New evidence on career concerns, horizon problems, and CEO incentives. *Journal of Financial Economics.*

Campbell, T. S., Marino A. M., 1994. Myopic investment decisions and competitive labor markets. *International Economic Review* 35.

Gibbons, R., Murphy., 1992. Optimal incentive contracts in the presence of career concerns: theory and evidence. *Journal of Political Economy*.

Hirshleifer, D., Thakor, A. V., 1992. Managerial conservatism, project choice, and debt. *Review of Financial Studies* 5.

Jensen, M. C., Smith, C. W., 1985. *Stockholder, manager, and creditor interest: applications of agency theory*. In: Altman, E.I., Subrahmanyam (Eds.) Recent Advances in Corporate Finance. Irwin, Homewood, II.

Jensen, M., Meckling, W., 1976. Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure. *Journal of Financial Economics 3.*

Jensen, M., Meckling, W., 1979. An application to labor-managed firms and codetermination. *The Journal of Business*, 52, 4, 469-506.

Laverty, K. J. 2004. Managerial Myopia or Systemic Short-Termism? The Importance of Managerial Systems in Valuing the Long Term. *Management Decision*, 42(8), 949-962.

Lindenberg, E. B., Ross, S. A., 1981. Tobin's Q ratio and industrial organization. *Journal of Business.*

Modigliani, F., Miller, M., 1958. The cost of capital, corporate finance and the theory of investment. *American Economic Review*, 48, 261-297.

Porter, M. E., 1992. *The causes and cures of business myopia.* Research Report to the US Government Council.

Shepherd, W. G., 1986. Tobin's Q and the structure-performance relationship: comment. *The American Economic Review.*

Stein, J., 1988. Takeover threats and managerial myopia. *Journal of Political Economy* 96.

Tobin, J., 1969. A general equilibrium approach to monetary theory. *Journal of Money*, Credit and Banking.

Zahara, S. A., Pearce, J. A., 1989. Boards of directors and corporate financial performance: A review and integrative model. *Journal of Management*.