

World Conference on Technology, Innovation and Entrepreneurship

Upper Echelon Theory Revisited: The relationship between CEO Personal Characteristics and Financial Leverage Decision

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Abstract

From the upper echelons perspective, we investigate the financial leverage decision of publicly listed companies in Bursa Malaysia for the period from 2002 to 2011. Using pooled OLS and fixed-effect regressions, we examine the impacts of CEO personal characteristics on financial leverage. Our measures of CEO personal characteristics such as CEO overconfidence based on CEO profile photo, CEO age, and CEO prior experience are significantly and negatively related to leverage. However, CEO education level and CEO tenure are significantly and positively related to leverage. Furthermore, we partition our sample of companies based on CEO age and CEO education level. In the CEO-age group, we find that female CEOs are greater risk takers as compared to male CEOs in Malaysia. With respect to CEO education level, we show that younger CEOs, female CEOs, and longer-serving CEOs are risk takers and more aggressive. This paper contributes to the debate of the UET as well as determinants of leverage decision from several dimensions. First, this is the first study that investigates the impacts of CEO personal characteristics on financial leverage of Malaysian firms. Second, we make the first attempt by classifying CEO certain characteristic (age and educational level) into groups to make a further comparison on the impact of CEO personal characteristics on financial leverage. Third, this study uses a larger data sample and a longer study period than the previous studies in the literature. Fourth, the paper also makes a methodological contribution. This study employs different methods (pooled OLS regression and fixed effects panel regression) for the analysis. It is hoped that the result of this paper can fill the gap of the literature on the relationship between CEO personal characteristics and financial leverage as explained by Upper Echelon Theory.

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Peer-review under responsibility of Istanbul Univeristy.

Keywords: Upper Echelon Theory; Financial leverage decision; Malaysian public listed companies; CEO personal characteristics

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1. Introduction

Based on Modigliani and Miller's (1958) seminal work in leverage decision, academicians studying leverage decision have been trying to examine determinants of a firm's financial leverage (Myers 1984). Two main theories are currently available in the leverage decision studies: the trade-off theory (TOT) (Miller 1977) and the pecking order theory (POT) (Myers 1984, Myers and Majluf 1984). Studies on leverage decision have been conducted in different countries: United States (Titman and Wessels 1988); Asia-Pacific region (Deesomsak et al 2004); Latin American firms (Céspedes et al 2010). However, many existing empirical studies do not incorporate human factors in studying determinants of firms' financial leverage. An emerging body of finance literature considers bounded rationality and associated behaviors of decision makers as attributes of financial phenomena (Subrahmanyam 2008). Additionally, Oliver (2005) states that an individual manager's characteristics may play a role in a firm's financial leverage. The Upper-Echelon Theory (UET) explains this phenomenon in the behavioral finance study.

The UET states that the managerial background traits or characteristics estimate organizational outcomes, planned choices and the performance levels (Hambrick and Mason 1984). The theory suggests that the more complex a decision, for example strategic measures, the more important the personal characteristics of the decisions makers, such as age, tenure and specialization. The principle of the UET recognizes that top managers' different characteristics such as age or career experiences affect their decisions on strategy and structure and it will directly affect firm's strategic choice and organizational performance (Nielsen 2010). Furthermore, the UET emphasizes that leaders characterized by bounded rationality will make a decision based on their cognitive, social and physiological characteristics. The diagram below explains how upper echelon characteristics affect corporate strategic choices.

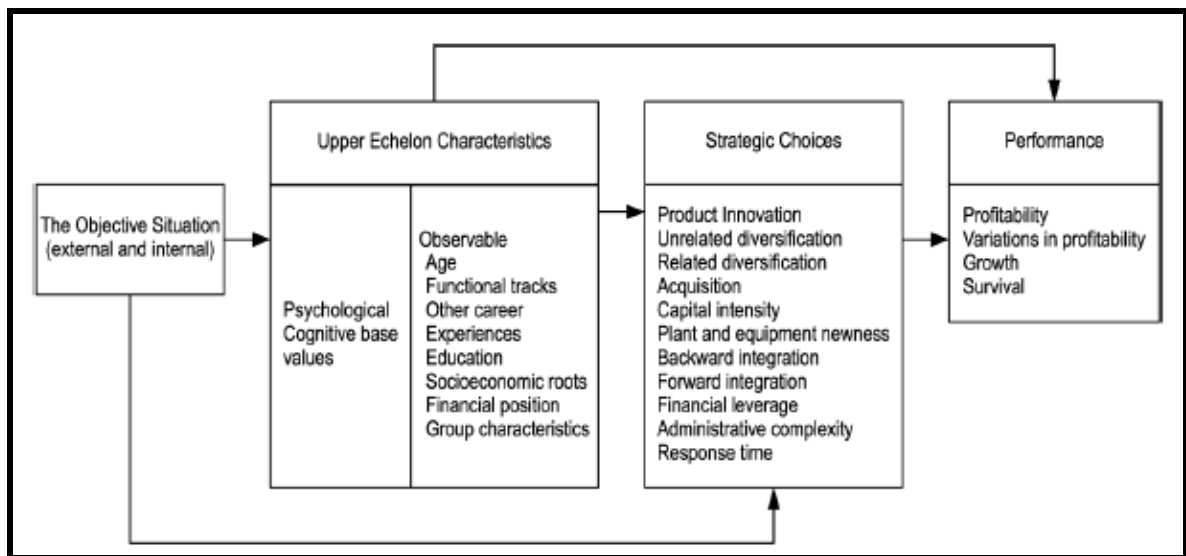


Fig. 1. Upper echelons perspective of organizations
Source: Hambrick and Mason (1984)

Numerous researches have been carried out on the UET, examining the relationship between leader demographics and organizational outcomes such as innovation (Kitchell 1997), R&D spending (Barker and Mueller 2002), corporate disclosure (Bamber et al 2010), firm performance (Weinzimmer 1997), and cash holding (Orens and Reheul 2013). However, the empirical significance of these studies remains largely unknown especially in terms of the relationship between a leader's cognitive, social and psychological characteristics and financial leverage. In Malaysia, such research is understudied. Thus, this paper attempts to bridge the gap by exploring the effects of

human, particularly CEO personal characteristics on financial leverage in the Malaysian context. Furthermore, the study will further examine the preference of CEO in their corporate financing decision based on two classifications (CEO age group and educational background).

This paper contributes to the debate of the UET as well as determinants of leverage decision from several dimensions. First, to the best of our knowledge, this is the first study that investigates the impacts of CEO personal characteristics on financial leverage of Malaysian firms. Second, we make the first attempt by classifying CEO certain characteristic (age and educational level) into groups to make a further comparison on the impact of CEO personal characteristics on financial leverage. Third, this study uses a larger data sample and a longer study period than the previous studies in the literature. Fourth, the paper also makes a methodological contribution. This study employs different methods (pooled OLS regression and fixed effects panel regression) for the analysis.

The remainder of this paper is organized as follows. Section 2 reviews the relevant literature. Section 3 describes the data and methodology used in this study, while Section 4 presents our empirical findings and discussion. Finally, conclusions and recommendations are presented in Section 5.

2. Literature Review And Hypotheses

2.1 CEO overconfidence level (CEOOF)

Previous studies have proved that managerial irrational behavior brings significant impact to corporate financing decisions. Malmendier and Tate (2005) confirm that overconfident managers may choose debt financing as preference in their leverage decision. Abor (2007) shows that optimistic CEOs exhibit a stronger relation between debt issue and financing deficit as compared to non-optimistic managers. Graham et al (2009) find consistent evidence where more optimistic CEOs prefer to use more short term debt. Equivalently, in China, Brick et al (2006) also agree overconfident managers prefer debt over equity financing. Consistently, Wei et al (2011) suggest that managerial irrationality, especially overconfidence does have a significantly positive effect on the financing decisions of firms in Shanghai and Shenzhen stock exchange from 2002 to 2006. In contrast, Jing et al (2013) have found a different finding from their study. They conclude that overconfidence of entrepreneur may lead to lower corporate value, and it may also make the venture enterprise with a negative return from their investment.

Therefore, H₁: The presence of managerial overconfidence is significant affecting firm's leverage decision.

2.2 Age (AGE)

Based on the UET, older CEOs are more risk averse and less aggressive than younger CEOs (Hambrick and Mason 1984). Consequently, they will prefer to choose internal funding as compared to external funding. Bertrand and Mullainathan (2003) explain that older CEOs who have an influence over the board of directors, might be less aggressive in financial policies because of that capability to do so. Serfling (2012) further agrees that firms with younger CEOs would invest more and have bigger growth opportunities.

Hence, H₂: CEO age is significantly negative related to firm's leverage decision

2.3 Education (EDU)

According to the UET, CEO educational is reflected in the characteristics of their organizations (Orens and Reheul 2013). Based on the theory, higher educated CEOs are less risk averse, more open to new ideas, changes and investment opportunities (Barker and Mueller 2002). Rakhmayil and Yuce (2011) agree that higher education levels is significantly positive related to firm financial leveraging.

Therefore, H₃: The education level of CEO is significantly related to firm's leverage decision.

2.4 Experience (EXP)

The UET further explains that managerial decision making is also influenced by the leader's prior experiences. Patzelt et al (2008) argue that prior experience increases CEO's knowledge of markets and it assists CEO to identify the opportunity. Fischer and Pollock (2004) further agree that the CEO's previous experiences will enhance firm efficiency and survivorship. In other words, top managers' expertise and background may bring significant impact to a firm strategy plan and decision making.

Therefore, H₄: The presence of CEO's prior experience is significantly related to financial leverage decision.

2.5 Gender (GEN)

Apart from CEO duality, gender is another main variable to describe the characteristic of CEO. Abor and Biekpe (2007) argue that women-owned businesses are less likely to use debt for a variety of reasons, including discrimination and greater risk aversion. The result is consistent with Faccio et al (2012) who agree that firms run by female CEOs have lower leverage, less volatile earnings, and a higher chance of survival than firms run by male CEOs.

Therefore, H₅: CEO gender is significantly related to firm's leverage decision.

2.6 Tenure (TEN)

By referring to the UET, CEO tenure plays significant role in decision making, specifically financial leverage decision. Hambrick et al. (1993) explain that new CEOs have a more external focus, and is expected to be more risk averse in financing decision, thus, they prefer less debt. As tenure increases, CEOs become more confident and will take more challenges in their financing decision (Orens and Reheul 2013).

Therefore, H₆: There is a significantly relationship between CEO tenure and financial leverage decision.

2.7 Network (NET)

The UET further explains that external network enhances CEO experience. Well-networked CEOs have quicker access to relevant information from a network of contacts and it allows them to look for new business opportunities (Hoang and Antoncic 2003).

Therefore, H₇: The CEO network is significantly related to firm's leverage decision.

2.8 Founder (FOUND)

Founder reflects functional tracks in the UET. Baron-Cohen et al (1999) agree that firm's founder influence the firm's strategy and operations. Fischer and Pollock (2004) claim that CEO founder's involvement in the growth and success of a firm since its perception may motivate the CEO to derive the benefits of a firm.

Therefore, H₈: The presence of a founder-CEO is significantly related to firm's leverage decision.

3. Methodology

3.1 Source of Data

Our sample covers all corporations listed in the Main Board of Bursa Malaysia (Stock Exchange of Malaysia) as at 30 September 2012. We delete firms from finance, insurance and unit trust companies due to differences in regulatory requirement. From 793 companies, we then screen through the data using the following criteria: (1) The firm has a complete data of 10 years period from 2002 to 2011. (2) The firm has a complete report on CEO personal characteristics needed as proxies' measurement. After screening through the sample based on these two criteria, the final sample has 1,404 observations. All the financial data are from Datastream. CEO personal information such as profile photos, educational level, experiences, gender, network and past performance are collected by hand from company's annual report.

3.2 Variables measurement

3.2.1 Independent variables

Based on the UET, we propose different proxies as a measure of CEO personal characteristics. (a) CEOOF: We refer to CEO's profile photo, four points if the CEOs photo in the annual report is equal to at least one half page in size; three points if it is less than one half in size; two points if there are other individuals pictured with the CEO; and one point if there is no photo of CEO (Schrand and Zechman 2012). (b) AGE: it is the numeric variable expressing age of an executive adjusted by year (Wei et al. 2011). (c) EDU: We follow Rakhmayil and Yuce (2011) using scale ranges to distinguish the education level of CEO. The scale ranges from 1 to 7 to measure CEO education level as follows: 1 (did not graduate high school), 2 (graduated from high school), 3 (attended undergraduate school), 4 (earned undergraduate degree), 5(attended graduate school), 6(earned graduate degree), 7(earned PhD/doctorate). (d) EXP: We use dummy variable for CEO experience which code as 1 if he or she served as a CO level executive (e.g., CEO, CFO, COO or CIO) or a vice president in another firm before he or she joined the firm under the study and 0 if otherwise. (e) GEN: We follow Abor (2007) for gender measurement and it is dummy variable, which code as 1 if firm male-owned and 0 if otherwise. (f) TEN: It is numeric variable which express number of years while CEO keeps the title in an analyzed company. (Wei et al., 2011). (g) NET: We follow Yang et al (2011) to measure CEO network by counting the number of corporate boards (other than the CEO's own firm) on which CEO serves plus the number of nonprofit organizations of which the CEO serves as a trustee or board member. (h) FOUND: Is a dummy variable which code as 1 if the founder of the company is CEO at the time and 0 otherwise.

3.2.2 Control variables

Based on previous studies, we also identify few variables as control variables. (a) Ownership concentration (OC5): It is measured by dividing the sum of the shares held by the five largest shareholders with the top 30 shareholders list in the company (Zeitun and Tian 2007, Nurul Afzan and Rashidah 2011). (b) Return on Assets (ROA): The study uses the value of the ratio of earnings before interest and taxes to total assets (Cao et al 2004). (c) Firm Size (SIZE): It is measured by the log of sales (Rajan and Zingales 2012).

3.3 Research Model

To examine the impact of CEO personal characteristics on financial leverage, we establish the research model as follow:

$$LEVE_{it} = \alpha_0 + \alpha_1 CEOOF_{it} + \alpha_2 AGE_{it} + \alpha_3 EDU_{it} + \alpha_4 EXP_{it} + \alpha_5 GEN_{it} + \alpha_6 TEN_{it} + \alpha_7 NET_{it} + \alpha_8 FOUND_{it} + \alpha_9 OC5_{it} + \alpha_{10} ROA_{it} + \alpha_{11} SIZE_{it} + \varepsilon_{it}$$

where α is coefficients of the respective independent and control variables for the Model; Subscript i represents the cross-section dimension and t represents the time series component. LEVE is a measure of financial leverage and the study uses total debts to total assets to measure leverage. Standardized data are used in the panel regressions.

4. Findings And Analysis

4.1 Descriptive statistics

Descriptive statistics of the variables used in the analysis is shown in Table 1. The statistics reveals that Malaysian CEOs are having a confidence level of 1.539 out of 4 averagely. The age of Malaysian CEOs are averagely in between 51 to 52 years old. In terms of education level, the finding also indicates that Malaysian CEOs have earned at least undergraduate degree. The result also shows that 98.1% of Malaysian CEOs are male and generally they have been holding the CEO position for 11 to 12 years in the same company. In terms of networking, the results also point out Malaysian CEOs are not active in serving as a trustee or board member of non-profit organizations. Finally, most of the Malaysian CEOs are not founder of the company he or she served. However,

univariate test is weak in that it does not control for the variables used simultaneously in an empirical model. Therefore, we proceed and run multivariate regression analysis to provide a more robust test to evaluate whether CEO personal characteristics strengthens the relationship between leaders' attributes and the level of leverage.

Table 1. Descriptive statistics of independent variables

Variables	Mean	S.D.
CEOF	1.539	0.787
AGE	51.655	8.410
EDU	4.430	1.447
EXP	0.266	0.442
GEN	0.981	0.141
TEN	11.774	8.831
NET	1.264	1.991
FOUND	0.181	0.385

4.2 The Relation between CEO personal characteristics and Leverage

Table 2 reports the results of our multiple regression analysis, using both pooled OLS and panel regression techniques. A multicollinearity test was conducted to check for correlation among the regressors. Setting the cut-off value for VIF at 5, we find no multicollinearity. Second, we check for heteroskedasticity of residuals using White test (White 1980) and the results suggest to use the White (White 1980) heteroskedasticity-consistent standard errors to report our significance levels.

Using a pooled OLS regression, the empirical evidence depicts a significantly positive relationship between the CEOOF and leverage. This finding is consistent with Wei et al. (2011) indicating that when there is a greater confidence level of CEO in a company, the level of debt will be higher. The regression results also claim that CEOs educational levels are significantly positive related to leverage decision. Other than that, the coefficient on CEO age is negative and statistically significant, suggesting that elder CEOs tend to be more risk averse and thus taking less debt and it is consistent with Wei et al. (2011).

Simple pooled OLS regression cannot adjust for firm-specific or time-specific effects. The fixed effect model (FEM) and random effect model (REM) can solve this problem. To determine a better model between FEM and REM, we conduct a Hausman Test (Greene and Hensher 2003, Wooldridge 2003). The Hausman test statistics suggest the use of FEM. The panel regression results in Table 2 show a consistent relationship between CEO age, CEO education and leverage, confirming that the younger and higher educated CEOs in companies will tend to choose higher debts in their leverage decision except for CEOOF. The results also show a negative coefficient on CEO experience and leverage at 99% confidence level. This could be explained as CEO's previous experiences will enhance firm efficiency, survivorship and avoid financial distress position. Thus, they will tend to choose internal financing as compared to external financing. On the other hand, tenure is significantly positive related to financial leverage and it is consistent with the UET. As tenure increases, CEOs become more confident and will take more challenges in their leverage decision. All F-values are statistically significant at the 1% level, implying that the regression models are reliable for prediction.

Table 2. Regression results

Variable	Pooled		FEM	
	Coefficient	t	Coefficient	t
Constant	0.367***	3.162	0.576***	3.440
CEOF	0.031**	2.465	-0.035**	-1.863
AGE	-0.002**	-1.773	-0.004**	-1.924
EDU	0.025***	3.672	0.033***	2.822
EXP	-0.037	-1.597	-0.176***	-4.676
GEN	-0.140	-2.124	0.027	0.297
TEN	0.000	0.324	0.005**	1.706
NET	-0.007	-1.398	-0.003	-0.340
FOUND	0.015	0.592	0.0024	0.019
OC5	-0.079	-1.273	0.062	0.554
ROA	-1.040***	-12.392	-0.833**	-10.377
SIZE	0.019***	2.937	-0.003	-0.239
Hausman test			P < 0.05	
Adjusted R ²	0.110		0.443	
F-statistic	14.043***		7.530***	

Note: *, **, and *** denote the statistical significance at the 10%, 5%, and 1% level, respectively.

4.3 The Relation between CEO personal characteristics and leverage by grouping

The results of the preceding sections suggest that AGE and EDU are significantly interacting CEO personal characteristics to financial leverage decision. To investigate this issue in detail, we adopt Ross et al (2012) to classify CEO's age based on income generating potential and partition the sample into 3 groups which are; i) less than 46 years old; ii) 46 to 59 years old and; iii) more than 59 years old. To ensure the robustness of the results, we run the regression test based on the three groups. Based on Table 3, the regression results claim that CEO confidence level and education background is significantly positive to firm leverage when CEO is 46 years old and above. In terms of experiences, regression result shows that when the age of CEO is reaching 46 and above, prior experience increases CEO's knowledge in identifying business opportunity and they will tend to choose less debt in their business expansion. In regardless the age of CEO, the finding claims than female CEOs tend are a greater risk taker as compare male CEOs in Malaysia.

Table 3. CEO Age Grouping

Variable	CEO Age < 46		CEO Age between 46-59		CEO age > 59	
	Coefficient	t	Coefficient	t	Coefficient	t
Constant	0.811***	3.460	0.168	1.557	0.474***	2.708
CEOF	0.007	0.421	0.038***	4.082	0.033**	2.484
EDU	0.025***	3.061	0.024	1.571	0.029***	5.102
EXP	0.220	1.603	-0.053***	-4.871	-0.047*	-1.734
GEN	-0.472***	-3.327	-0.062**	-2.078	-0.313***	-6.066
TEN	0.000	0.161	0.000	-0.131	0.001	0.962
NET	0.000	0.009	-0.006**	-2.354	0.003	0.758
FOUND	0.005	0.162	-0.028	-1.334	0.172***	5.930
OC5	-0.239***	-2.763	-0.124**	-2.492	-0.017	-0.240
ROA	-0.382***	-2.946	-1.373***	-5.451	-0.140	-0.811
SIZE	0.016	0.937	0.021	1.588	0.001	0.098
Adjusted R ²	0.116		0.149		0.103	
F-statistic	3.457***		13.721***		3.240***	

Note: *, **, and *** denote the statistical significance at the 10%, 5%, and 1% level, respectively.

Following Romanelli (1989), we relate CEO's aggressiveness based on level of education. Hence, the study classifies CEO's education level in 2 groups which are CEOs have an undergraduate degree and postgraduate degree. Based on Table 4, CEO with higher confidence level will prefer more debts when he or she obtains undergraduate degree. Contrary to it, CEO with higher confidence level will tend to be less aggressive in choosing debt as financing when he or she has a higher educational level. This is consistent with Bantel and Jackson (1989) who agree that highly educated top managers are positively related to strategic change in order to reduce company's

risk for a better growth. An interesting finding here is well-networked CEO will tend to choose more debt when his or her highest education level is undergraduate degree. This could be explained as with a network of contacts, it allows CEO to manage firm's transformation and take the challenges to go for more debt even lower educational level. Contrary to it, with a better external network, CEOs who earn at least postgraduate degree will prefer internal financing as compared to external financing.

Table 4. Education level Grouping

Variable	CEO has Undergraduate degree		CEO has Postgraduate degree	
	Coefficient	t	Coefficient	t
Constant	0.250***	6.607	0.710***	3.843
CEOF	0.043***	5.212	-0.008**	-2.539
AGE	-0.002***	-5.698	-0.004***	-6.105
EXP	0.011	0.507	-0.027	-1.425
GEN	-0.035	-0.793	-0.093*	-1.899
TEN	0.003***	4.217	0.001***	5.502
NET	0.007**	2.026	-0.014***	-6.317
FOUND	0.003	0.281	-0.025**	-2.438
OC5	-0.019	-0.675	-0.214***	-4.756
ROA	-0.796***	-10.559	-0.900***	-3.154
SIZE	0.017**	2.531	0.028**	2.560
Adjusted R ²	0.130		0.102	
F-statistic	12.613***		11.052***	

Note: *, **, and *** denote the statistical significance at the 10%, 5%, and 1% level, respectively.

5. Conclusion

This study examines the relationship between CEO personal characteristics and financial leverage for the period from 2002 to 2011. By classifying CEO certain characteristics (age and educational level) into groups, we evaluate the effects of CEO personal characteristics on financial leverage. The findings can be summarized as follows. (1) CEO overconfidence based on CEO profile photo is significantly and negatively related to leverage (fixed effect model); (2) CEO age is significantly and negatively related to leverage. (3) The higher the education, the higher the debts of a firm. (4) CEO prior experiences is significantly and negatively related to leverage; (5) CEO tenure is significantly and positively related to leverage; (6) In regardless the age of CEO, the finding claims that female CEOs tend are a greater risk taker as compare male CEOs in Malaysia; (7) Younger CEOs, female CEOs and longer serving CEOs are risk taker and more aggressive in regardless their educational background.

Although the findings of this study may give policy makers an insight about the effects of CEO personal characteristics on financial leverage, we caution readers and investors that our measurement of CEO personal characteristics may have shortcomings. More direct measurements may be considered in the future. In addition, there may have been other incentives that we have not examined; we have shown that the most obvious (at least to us) possible CEO personal characteristics in determining leverage decision. One obvious future empirical extension to this study is to explore the effect of CEO perspective, CEO compensation and CEO race on cost of debt. It was also particularly time-consuming to hand collect the CEO information from the annual reports of our sample companies.

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