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Executive pay and performance in Portuguese listed companies

Paulo Alves [a,b,*], Eduardo Barbosa Couto [c,d], Paulo Morais Francisco [c,d]

[a] Instituto Superior de Contabilidade e Administração de Lisboa, Av. Miguel Bombarda, 20, 1069-035 Lisbon, Portugal
[b] Portuguese Securities and Exchange Commission, Rua Laura Alves, 4, 1050-138 Lisbon, Portugal
[c] Instituto Superior de Economia e Gestão, Technical University of Lisbon, Rua Miguel Lupi, 20, 1249-078 Lisbon, Portugal
[d] ADVANCE, Portugal

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ABSTRACT

This essay analyses the relationship between corporate governance practices and Chief Executive Officer (CEO) wages from a sample of Portuguese listed companies over the period from 2002 to 2011. The relationship between CEO total compensation and shareholders return, firm characteristics, CEO characteristics, board of directors and shareholders characteristics is analysed. It is found that firm specific factors accounts for the majority of the variance in total CEO pay, while firm performance accounts for less than 5%. It is also found that the CEO characteristics, board of directors' structures, and shareholders features are related with the CEO pay.

1. Introduction

Public listed firms are characterised by the separation of ownership (the principal – shareholders) and control (the agent – management). Therefore, agency-costs caused by the different principal-agent interests are incurred and firm value reduced (Jensen and Meckling, 1976; Fama and Jensen, 1983). A particular manifestation of agency costs is excessive Chief Executive Officers (CEO) compensation. Governance practices endeavour to align those interests, thus the natural hypothesis is that a firm with more efficient governance practices in place should observe CEO compensation more aligned with firm performance. The question is which corporate governance devices are more efficient?

The present study analyses the relationship between corporate governance practices and CEO earnings in Portuguese companies from 2002 to 2011, by means of several panel data estimation models, including a dynamic micro panel data

* Corresponding author at: Instituto Superior de Contabilidade e Administração de Lisboa, Av. Miguel Bombarda, 20, 1069-035 Lisbon, Portugal.
E-mail addresses: pauloalves@cmvm.pt (P. Alves), ecouto@iseg.utl.pt (E.B. Couto), paulofrancisco@iseg.utl.pt (P.M. Francisco).

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model (Arellano and Bond, 1991). Several sets of factors are analysed: firm performance, firm specific characteristics, CEO specific characteristics, board of directors and ownership structure. The present research contributes to the corporate governance literature in several ways. First, it adds new insights as to whether a more independent board of directors' can in fact limit the ability of CEO's to earn excess earnings. Although this hypothesis has been tested empirically no consensus has yet been achieved (Chhaochharia and Grinstein, 2009; Guthrie et al., 2012). Secondly, different corporate governance devices can have complementary or substitutive effects (Farinha, 2003). In that sense, analysing the effect of a single set of corporate governance devices on the level of CEO pay may provide biased results. To address that potential problem, in addition to firm specific variables, this paper includes a larger than usual set of corporate governance variables, including ownership variables, shareholders meetings data and CEO individual characteristics. Additionally, instead of looking at the executive management earnings as whole, this paper focuses specifically on the CEO earnings. This approach is more interesting when one is addressing the board of directors' entrenchment hypothesis. Finally, the majority of the empirical research on CEO compensation builds on either US or UK data, where financial markets are more efficient and corporate governance practices are potentially more developed when compared with small European countries such as Portugal.

The results reveal that total return to shareholders is positively associated with total CEO pay; however this variable explains only a small fraction of total CEO earnings. Firm specific characteristics are found to explain a larger amount of the CEO earnings variability. Particularly, firm size and dividend yields are positively associated with higher CEO earnings. Moreover, the CEO earnings are lower in family and regulated firms. With respect to CEO specific characteristics it is found that CEO age and the fraction of the CEO earnings that are variable drive the executives' earnings up. The results also show that CEO education and stock based compensation might reduce CEO total earnings. With respect to the board of directors' characteristics it is found that the existence of a remuneration committee does not restrict the CEO's to extract over paid earnings. On the other hand, the results support the view that a large fraction of independent directors might lower CEO excess earnings. Finally, with respect to the shareholders characteristics, the results found support the view that anti-takeover devices such as shareholders agreements and voting caps might enable CEOs to extract extra rents. On the other hand, the level of participation in the shareholders general meetings and the free float are found to be negatively associated with the CEO earnings.

The policy implications of the present research are therefore as follows. First, the effective roles of the remuneration committee and other governance commissions should be screened; as it is not clear that they properly limit the CEO's earnings. Second, minimum requirements for percentages of independent members on boards should be instituted, as result of the positive effect found on restricting the CEO's earnings. Third, the inclusion of stock-based compensation as a part of the CEO's earnings should be promoted because stock-based compensation limits excessive earnings for CEOs. Fourth, variable cash based bonuses should be rethought as this sort of payment is driving upwards CEOs earnings. Fifth, CEO education should be disclosed as it seems that a lack of education might reveal some entrenchment and the ability for executives to earn excess earnings. Finally, anti-takeover devices such as shareholders agreements or voting caps should be discouraged and the shareholder participation on general meetings promoted.

The paper is organised as follows. In Section 2, the literature review and hypotheses are presented. Section 3 presents the data and the methodology. Section 4 discusses the results. Finally, Section 5 concludes the paper.

2. Literature review and hypotheses

Hermalin and Weisbach (1998) provided a theoretical framework that related pay and performance to the board composition. In theory, the CEO's salary is fixed by the corporate board depending on supply and demand. If proper board structures are in place, the pay-performance contracts are optimal and reflect the economic determinants of performance. Four sets of factors that explain the CEO's earnings have been suggested in the literature: (1) company performance (e.g., Coughlan and Schmidt, 1985; Jensen and Murphy, 1990); (2) firm specific characteristics (e.g., Jensen and Ruback, 1983; Core et al., 1999; Gosh and Sirmans, 2005); (3) CEO specific characteristics (e.g. Core et al., 1999; Ozkan, 2011); (4) board of directors structure and composition (e.g. Conyon et al., 1995; Conyon, 1997); and (5) shareholders and ownership characteristics (e.g. Shin and Seo, 2011).

2.1. Performance hypothesis

2.1.1. Return to shareholders

Under the agency theory hypothesis, CEO compensation packages are designed to provide incentives for the CEO to increase the shareholders' wealth (Jensen and Murphy, 1990). If payments are designed this way, it should be observed a positive relationship between the CEO's compensation and the firm's performance. To test this relationship, this paper follows Core et al. (1999) and uses the total return to shareholders (TRS) as proxy for firm performance. TRS is defined as the market stock price annual return including any dividends paid out to shareholders.

H1. CEO earnings are a positive function of total return to shareholders (TRS).