J. Account. Public Policy 34 (2015) 175–203

Contents lists available at ScienceDirect

J. Account. Public Policy

journal homepage: www.elsevier.com/locate/jaccpubpol

Executive directors' pay, networks and operating performance: The influence of ownership structure ☆

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A B S T R A C T

This paper examines how ownership structure affects the director networking–compensation relationship. Furthermore, we measure the subsequent impact of this relationship on future operating performance of firms. As in previous research, our study also finds empirical evidence suggesting that higher network activity of executive directors conveys to larger compensation figures. This excess pay has an impact on future operating performance. Our data set of Spanish listed companies, with high average ownership concentration, show that the network related higher compensation for firms with dispersed ownership leads to subsequent negative operating performance.

The implications for executive directors are that networking leads to higher compensation. For dispersed ownership firms, the consequence is that promoting executive networking could be harmful unless other corporate governance mechanisms prevent this outcome. For concentrated ownership firms, this structure allows to capture increases in operating performance. Finally, policy recommendations on corporate governance regulation are that self-regulation is better than imposing the same limit on the

☆ The authors acknowledge the financial support received form the Spanish Ministry grants ECO2010-18567 and ECO2010-21393-C04-02.

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http://dx.doi.org/10.1016/j.jaccpubpol.2014.09.004
0278-4254/

number of directorships to all firms if an effective control mechanism operates. Our results suggest that the presence of controlling owners is a strong corporate governance mechanism.

1. Introduction

The attention paid by the economic press and academic literature to executive compensation level is relevant in the context of the current economic crisis, especially where transfer of public funds to firms occurred. In May 2008, Eurozone finance ministers heavily criticized the practice of presenting top managers with generous bonuses and severance payments at a time, when ordinary Europeans were urged to push only for moderate wage increases. The chair of the ministerial meeting said: "[it] is no longer acceptable to have situations where some top managers have excessive salaries and also benefit from golden parachutes, payments which have no relationship to their performance".[2] Decisions about executive remuneration are taken under different corporate governance settings, sometimes approved or proposed by the board of directors, or through delegated committees, and sometimes decided at the general meeting level. The debate about executive director compensation is especially relevant, when corporate governance practices become determinant factors in understanding the observed remuneration in a situation of potential agency problems.

This paper empirically investigates the determinant factors of board executive compensation, and the consequences on operating performance under different ownership structures. Our analysis focuses on the impact of director connectedness among the business elite. More precisely, our research questions are: Do better connected board executives earn higher compensation than less connected ones? Does potential overcompensation contribute to a larger future operating performance? Are there differences in the networking–compensation–performance relationship among firms controlled by managers compared to firms controlled by owners?

Recent and ongoing literature finds that executive director compensation is higher when they, or their outside directors, have better network connections. It is not conclusive whether this extra compensation aligns executives and shareholders interest or if it is part of the agency problem itself, as Bebchuk and Fried (2003) under the managerial power approach argue. Our research on the subsequent influence on the future operating performance of firms show that the effect of networking connections is different for dispersed than for concentrated ownership structures.

Our findings suggest that when there is strong control by shareholders, the rewarded executive director networking activity is profitable for the firm. Nevertheless, our findings show that when managers have control of the firm, there is a higher probability of lower operating performance when compensation for the networking activity is larger. Our results are complementary to the research of Horton et al. (2012), in the UK, and Engelberg et al. (2013), in the US. Our results suggest that the control of the firm is a key element to disentangle the positive from the negative effect on the operating performance.

Our results also complement the literature on the relationship between corporate governance practices and firm performance (e.g. Brown and Caylor, 2009; Larcker et al., 2007, or Haniffa and Hudaib, 2005), suggesting that director networking activity is connected to firm operating performance. Furthermore, we show that this relationship is contingent on the ownership structure as a strong corporate governance mechanism.

This debate also contributes to a better understanding the position of regulatory bodies across countries concerning the adequateness of director connections. There are two opposite approaches: The first one gives firms freedom to self-regulate the limits of the number of directorships, for example, the corporate governance codes in Italy and Spain. The second approach, is based on the "one size fits all" rule, and sets a unique limit for all firms. These limits differ across countries like the UK, France and Germany, who implement this approach. The unified UK Corporate Governance Code

[2] Eurogroup and Economic and Finance Ministers Council, Brussels, 13 and 14 May 2008.