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The CEO pay slice: Managerial power or efficient contracting?
Some indirect evidence

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ABSTRACT

This paper uses the CEO Pay Slice (CPS) to provide insight into the managerial power versus efficient contracting debate on CEO compensation. Based on a sample of 9978 U.S. listed firms for the period 2001–2010 our evidence is inconsistent with managerial power. For instance, we find that the CPS of a newly appointed CEO does not differ to that of the outgoing CEO and also does not increase over time. Furthermore, we find no relation between the CPS and subsequent firm performance, or between a measure of excess CPS and subsequent firm performance. In addition, we show that most firms are quick to reduce excess CPS levels. However, for a small subsample in which excessive CPS persists, we observe a negative relation between CPS and subsequent firm performance. Overall our evidence is largely consistent with an efficient contracting explanation of CEO compensation as opposed to a managerial power explanation.

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1. Introduction

There are two main alternative and much debated theoretical explanations of CEO compensation: (i) efficient contracting (Jensen and Meckling, 1976; Smith and Watts, 1992; Bushman and Smith, 2001), and (ii) managerial power, based on the notion that managers ‘capture’ the board and extract rents (Bebchuk et al., 2002; Bebchuk and Fried 2003, 2006). More recently Bebchuk et al. (2011) argue that the CEO pay slice (CPS), defined as the proportion of compensation paid to the CEO out of the total compensation paid to the top five executives in the firm, is a manifestation of managerial power.

Our objective is to contribute to this debate by testing three predictions of managerial power that relate to the CPS measure: (i) the CPS increases over time for newly appointed CEOs as they capture the board; (ii) the CPS of newly appointed CEOs differs to that of outgoing CEOs since the outgoing CEO has captured the board during their tenure; and (iii) excess CPS persists over time give the power of the CEO. Finally we provide evidence on whether there is an association between CPS (and excess CPS) and subsequent firm performance.

The motivation of this paper is twofold. First, we contend that CPS primarily reflects a rational allocation of decision authority between the CEO and other senior executives arising from a firm’s economic characteristics. We refer to this efficient contracting explanation of CPS as ‘CEO decision authority’, which contradicts the managerial power explanation of CPS (e.g. Bebchuk et al., 2011). Using CPS we are able to test implications of these competing explanations which are unable to be tested using the levels of CEO compensation.¹ For example, if CEOs capture boards the CPS of outgoing CEOs would be higher

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than that of the incoming CEOs.² Similarly, CPS of the newly appointed CEOs would increase over time as boards become 'captured' by CEOs. However, if CPS is primarily driven by the allocation of decision authority arising from firms' economic characteristics, CPS of firms' previous and newly appointed CEOs should be the same and CPS of newly appointed CEOs should not increase over time. Furthermore, there would on average be no association between firm performance and CPS under the efficient contracting perspective.

The managerial power explanation of CEO pay also predicts a negative association between firm performance and excess CEO compensation however it provides no explanation as to why such an association exists (e.g. Core et al., 1999). Excess CPS offers one possible explanation, which is, if CEOs capture a larger slice of the total compensation awarded to executives, then other executives are not receiving adequate incentives to perform and/or firms are unable to attract talented executives resulting in suboptimal decision making. Therefore, a negative relation between CPS and subsequent firm performance can be expected.

Our second motivation arises because following the findings of Bebchuk et al. (2011) accounting researchers are using CPS as a proxy for poor governance (e.g. Mande and Son, 2012; Feng et al., 2011; Jiraporn et al., 2011; Henderson et al., 2010).³ We argue that without identifying the key drivers of CPS, researchers ignore the possibility of multicollinearity and endogeneity when variables which explain a portion of CPS are used alongside CPS in the same regression. For example, prior research has included CPS in several logistic regressions of the likelihood of firms meeting or barely beating analysts' forecasts, expecting to find that 'powerful' CEOs, as proxied for by CPS, are more likely to manage earnings. However, also included in the same regressions are factors which may determine CPS such as the market-to-book ratio, return on assets, CEO share ownership and CEO-chair duality. As these factors may also determine CPS, the reliability of the estimates in the regression is questionable due to endogeneity concerns. We provide an explanatory model of CPS and offer an alternative measure, 'persistent excess CPS', as a better proxy for managerial power.

The evidence in this paper is based on a sample of 9978 firm-years of U.S. publicly listed companies between the years of 2001 and 2010. Prior to providing evidence on our predictions, we estimate a Bebchuk et al. (2011) inspired model of the key determinants of CPS. Our model differs from that of Bebchuk et al.'s (2011) as we include additional determinants of CPS which we believe to be related to the concentration of decision authority in the CEO versus other executives. These include industrial and geographical diversification, growth options, whether the firm is 'regulated', the number of executive directors, relative firm size, CEO shareholdings and the total number of executives reported by the firm in Execucomp. We use this more complete model of CPS as the basis for estimating a measure of "excess" CPS which we use to examine our predictions.⁴

Our first set of tests provides evidence on two predictions. Prediction one is that if CEOs capture boards and extract rents, then CPS of newly appointed CEOs would increase over time. Our findings suggest that up to four years after an appointment of a new CEO, CPS does not increase regardless of whether it is an outside or inside appointment.⁵ Given that the average CEO tenure is six years, one would expect that if CEOs capture the board it would happen within the first two thirds of their tenure. Hence, our results do not support the managerial power prediction.

Our second prediction is that if outgoing CEOs have captured the board during their tenure, then CPS of newly appointed CEOs would be lower than CPS of outgoing CEOs since boards would use this opportunity to realign CEO compensation to an efficient level. We find that incoming CEOs hired from outside the firm actually receives higher CPS than outgoing CEOs. However, this is not the case for CEOs that are appointed from within the firm. These findings do not support the managerial power explanation of CPS, as it would be irrational for boards to further increase an already inflated level of pay arising from prior CEOs' power. Higher CPS awarded to newly appointed CEOs from outside the firm likely reflects the need for significant changes within the firm (hence outside CEOs are given greater decision authority).⁶

Finally, we test the association between CPS and excess CPS and return on assets. If CPS were efficient one would expect no relation between CPS and firm performance because firms would be unable to increase their value by changing CPS (i.e. all executives are incentivised at the optimal level to maximise firm value). However, if CEOs capture boards and increase their compensation (and hence CPS), then firms have concentrated most of the limited dollars they have available to contract with executives on the CEO rather than other individuals who possess the specific knowledge and skills to increase firm value. Hence, under the managerial power explanation of CPS one would expect that firms with larger CPS or excess CPS would experience lower firm performance than firms which have more optimal compensation structures. Generally we do not find any association between firm performance and CPS or excess CPS notwithstanding a small subsample of 536 firm-years (out

² Given inefficient contracts are unlikely to persist over time; firms should correct excessive levels of CPS over a short timeframe. This is based on the contention that firms have a limited pool of funds for contracting with executives and they face continued pressure from the public and shareholders to pay their executives what are deemed 'reasonable' pay packages. The scrutiny of executive pay has increased following the introduction of 'say on pay' legislation and the fact that shareholders vote against executive remuneration packages as a whole rather than separate components. Therefore, we believe that firms are concerned with the total payout to executives that is reported to shareholders and not just the CEO's pay.

³ Using the CPS Bebchuk et al. (2011) provide evidence of an association between the CPS and industry-adjusted Tobin's q, industry-adjusted return on assets, acquirer returns and performance sensitivity of CEO turnover. The inference from these findings is that the CPS is not efficiently determined and that CEOs are extracting rents.

⁴ Our model of excess CPS is based on the idea in Core et al. (1999, 2008) and discussed in Section 2.5.

⁵ We exclude the year of appointment due to sign-on bonuses, initial large equity grants, and possible partial year employment if the CEO joined half way through for example.

⁶ For example, Lou Gerstner at IBM and Jim McNerney at 3M are examples of high-profile outsider CEOs who became effective change agents for those firms (Karavaeli and Zajac, 2012).

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