Review of Financial Economics xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

Review of Financial Economics

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

Excess pay and deficient performance☆

Mary Ellen Carter [a], Lei Li [b], Alan J. Marcus [a], Hassan Tehranian [a,*]

[a] Carroll School of Management, Boston College, Chestnut Hill, MA, USA
[b] School of Business, University of Kansas, Lawrence, KS, USA

ARTICLE INFO

Article history:
Received 19 August 2015
Accepted 22 August 2015
Available online xxxx

JEL classification:
G30
G34

Keywords:
Agency problems
Governance
Executive compensation
Abnormal pay

ABSTRACT

We investigate the link between abnormal CEO compensation and firm performance, asking whether high unexplained compensation relative to several benchmarks is a sign of hard-to-measure but desirable executive attributes or is instead a symptom of unsolved agency problems. We find that abnormally high CEO pay predicts worse future firm performance. Abnormally high compensation that is performance-contingent is a less ominous signal about the future success of the firm. But abnormal levels of even performance-contingent compensation predict worse future performance. We conclude that abnormally high CEO pay can be useful as an independent indicator of agency problems.

© 2016 Elsevier Inc. All rights reserved.

1. Introduction

The impact of corporate governance on the firm and its management has long been a central focus of the accounting and finance literatures. High-quality governance arrangements, including for example, meaningful oversight by outside directors and institutional investors, are associated with improved firm performance (e.g., Brickley, Coles, & Terry, 1994, Byrd & Hickman, 1992, Rosenstein & Wyatt, 1990, Yermack, 1996). Similarly, effective governance is associated with greater restraint in executive compensation packages (Boyd, 1994, Core, 1997, Hartzell & Starks, 2003, Lambert, Larcker, & Weigelt, 1993).

Of course, available empirical proxies for quality of governance are by their nature crude, and cannot capture the complexity of actual relations among managers, boards, investors, and other interested parties. The coarseness of available proxies will necessarily muddy the empirical evidence directly linking firm performance to governance arrangements. But the impact of governance on CEO pay offers a complementary path to investigate those connections.

Because effective governance appears to engender moderation in compensation packages, measures of "abnormal pay" potentially may provide information about the quality of the underlying governance process and ultimately, firm performance. While an efficient-contracting model of the firm would predict that apparently abnormal executive pay must reflect commensurately superior executive qualities not fully reflected by standard performance metrics, an agency-problem framework would suggest the opposite, that abnormal pay is a symptom of some failure in the governance framework.

In this paper, we investigate the link between CEO compensation and firm performance. Core, Holthausen, and Larcker (1999) show that the component of abnormal compensation that can be predicted from governance variables has a negative relation with future firm performance. They therefore make explicit the link between agency problems that show up in excessive pay and those that show up in worse firm performance. We start from this insight but ask whether even excess pay that *cannot* be linked to standard governance variables predicts firm performance. Such pay may be a symptom of unsolved agency problems not captured by those governance measures. This is a tougher test of agency problems, because in some circumstances, high unexplained compensation may be a sign of hard-to-measure but desirable executive attributes. As it turns out, however, we find that abnormal pay predicts worse future firm performance.

We begin by adopting three measures of abnormal pay that have appeared in earlier papers which use a variety of approaches to determine compensation benchmarks. Larcker, Ormazabal, and Taylor (2011), or LOT, use a comparison firm approach for benchmark pay. They compare CEO pay to median pay of CEOs in similar firms. Both Cai and Walkling (2011), or CW, and Core, Guay, and Larcker (2008), or CGL, use regression analysis to construct models of "normal" pay. Employing these models of normal pay, we calculate abnormal pay for the CEOs in our

☆ We thank Jim Booth, Mark Bradshaw, Marcia Cornett, Iraj Fooladi, Amy Hutton, Sugata Roychowdhury, Ronnie Sadka, Susan Shu, Phil Strahan, Jerome Taillard, Ross Watts, Pete Wilson, and seminar participants at Boston College, University College Dublin, and University of Kansas, for helpful comments and suggestions.
* Corresponding author. Tel.: +1 617 552 3944; fax: +1 617 552 0431.
E-mail address: Hassan.Tehranian@bc.edu (H. Tehranian).

http://dx.doi.org/10.1016/j.rfe.2015.08.003
1058-3300/© 2016 Elsevier Inc. All rights reserved.

Please cite this article as: Carter, M.E., et al., Excess pay and deficient performance, *Review of Financial Economics* (2016), http://dx.doi.org/10.1016/j.rfe.2015.08.003

ARTICLE IN PRESS

sample, and ask whether abnormal pay in a base period predicts the subsequent performance (specifically, return on assets) of the firm.

Using a sample of 13,905 firm years obtained from ExecuComp over the period 1997–2010, we find that higher levels of abnormal CEO total pay predict lower future ROA. This is consistent with the hypothesis that abnormal pay reflects an agency problem rather than otherwise-unmeasured positive attributes of the CEO. Our results extend those of Core et al. (1999), demonstrating that abnormal pay has predictive power for subsequent firm performance *even after* controlling for the impact of governance on compensation. While it is certainly plausible that individual instances of high CEO pay reflect superior performance, as a general rule, abnormal pay in our sample therefore appears to be a symptom of agency problems between the board and the CEO that are not captured by observable governance variables.

Hayes and Schaefer (2000) document a positive relation between future performance and the portion of cash compensation that is unexplained by current performance, arguing that firms contract on measures that are unobservable outside the firm and that foreshadow performance improvements. Our finding that firm performance tends to fall with abnormal levels of compensation appears to contradict theirs. While there are several reasons that may explain these different results,[1] in important respects, our conclusions are consistent with theirs. When we distinguish between abnormal levels of incentive versus non-contingent pay, we find that high incentive pay is less likely to signify agency problems; similarly, variation in bonuses, a key component of incentive pay, appears to drive the Hayes–Schafer results. When managers and boards share private information about management quality, as in their framework, one would expect them to negotiate more highly incentive-based compensation schemes. What appears to outsiders as excessive incentive-based compensation may be a rational response to their private information. Our results are largely consistent with this reasoning, in that we find that abnormal incentive pay (largely their compensation measure) moderates the deleterious effects of excess total pay. In contrast, other forms of compensation, when outside normal bounds, are associated with lower future performance.

Our findings are robust to a series of tests designed to rule out alternative interpretations or explanations of these patterns. First, we examine abnormal levels of various components of executive compensation, distinguished by the extent to which they are contingent on firm performance. When management skill may be more easily observed by the board than by an outside researcher, it is plausible that high unexplained incentive-based compensation may be related to high unobserved skill while high unexplained non-contingent compensation is more likely to reflect agency problems. Consistent with this interpretation, we find that abnormal levels of incentive-based compensation at least partially offset the lower performance predicted by high levels of total abnormal pay. These results show that the inverse relation between abnormal pay and firm performance is more than just an "on average" association. Conditioning on type of pay tightens the (inverse) link between abnormal pay and performance.

Moreover, our main results are robust to changes in both the measure of firm performance as well as to sample selection criteria related, for example, to changes in CEO, to M&A activity, or to exclusion of extreme compensation levels. Abnormal pay therefore is robustly related to firm performance, even after controlling for a range of standard governance variables.

We also examine stock option grants as a separate category. This attention is due in part to its large share of total compensation, particularly in the earlier part of our sample before option grants were required to be expensed. The change in expensing rules in 2006 also presents an opportunity for an additional test of the relation between agency issues and compensation schemes. We find that in the pre-2006 period, when at-the-money grants were not expensed and might be more easily dispensed by lax boards, excessive grants were strongly negatively associated with future performance. However, in the latter period, that negative relation essentially disappears.

These results shed additional light on the pay–performance relation. While the association between pay and future performance has been the subject of a very extensive literature, the predictive value of *abnormal* pay for firm performance has received comparatively scant attention. Our results indicate that abnormal pay is a robust signal of unsolved agency issues.

The next section lays out a short survey of the literature. Section 3 presents our data and Section 4 contains our hypotheses and empirical analysis. Finally, Section 5 concludes.

2. Literature and research questions

Corporate governance is widely recognized to have an important impact on firm performance. Management behavior may be affected by mechanisms that encourage and allow for meaningful monitoring of its behavior, for example, significant representation of outside board members (Brickley et al., 1994), large shareholdings by institutional investors (Hartzell & Starks, 2003), CEO/Chair duality (Brickley, Coles, & Jarrell, 1997), board size (Jensen, 1993; Yermack, 1996), or strong shareholder rights (Gompers, Ishii, Metrick, 2003).

Governance also affects executive compensation. Lambert et al. (1993) find that CEO compensation tends to be lower when a board member owns at least 5% of the shares and is generally higher when the CEO has appointed a greater proportion of the board. Core (1997) shows that CEO compensation is higher when there is greater insider control of share votes. Hallock (1997) observes higher CEO compensation at firms with interlocked outside directors. Hartzell and Starks (2003) conclude that corporate monitoring by institutional investors with the resources to monitor, discipline, and influence managers can constrain their pay and make it more sensitive to performance.

Core et al. (1999) examine the impact of several governance variables on CEO compensation. They find that compensation tends to be higher for dual CEO/Board Chairs, when boards are larger, when insiders are a smaller fraction of board directors, when boards are less independent of management (as indicated by their appointment by the CEO, by pay beyond explicit director fees, or by interlocked relations with the outside director's company), or when board members are "busy," serving on more than two other boards. Noting that compensation tends to be higher when CEO oversight is laxer along these several dimensions, they fit a regression model of "predicted excess compensation" using these variables and then treat fitted excess pay as a summary measure of the (in)effectiveness of governance. They demonstrate that ROA tends to fall with their measure of predicted abnormal compensation, thus buttressing the hypothesis that it proxies for ineffective governance.

In this paper, we extend the Core et al. (1999) argument. If abnormal pay could be cleanly partitioned into components due to governance problems versus components having to do management quality, then only the portion fitted onto governance variables would reflect agency-related performance problems. But governance variables that outside researchers can measure are in fact limited and not capable of capturing the subtleties of the full governance environment. Therefore, while the portion of excess compensation captured by these variables should predict firm performance, it is entirely possible that other

[1] Hayes and Schaefer obtain their data from a Forbes survey covering the period 1974–1995, while we use ExecuComp, for which coverage begins only in 1993. In addition, they focus on changes in cash compensation, which are dominated by changes in bonus, whereas we focus on the *level* of compensation. Finally, we have access to components of pay that were not available at the time of the Hayes-Schafer study; furthermore, compensation practices have changed in the intervening years.

Please cite this article as: Carter, M.E., et al., Excess pay and deficient performance, *Review of Financial Economics* (2016), http://dx.doi.org/10.1016/j.rfe.2015.08.003

Download English Version:

https://daneshyari.com/en/article/5104410

Download Persian Version:

https://daneshyari.com/article/5104410

Daneshyari.com