Advances in Accounting, incorporating Advances in International Accounting 33 (2016) 35–46

Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

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

CEO excess compensation: The impact of firm size and managerial power☆

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ARTICLE INFO

Article history:
Received 24 April 2015
Received in revised form 28 April 2016
Accepted 29 April 2016
Available online 24 May 2016

Keywords:
CEO compensation
Excess compensation
Managerial power

ABSTRACT

Chief executive officer (CEO) compensation has received a great deal of attention over the past several decades. Critics assert that CEO compensation is "excessive" because it is only weakly linked to firm performance (i.e., managerial rent-extraction). On the other hand, defenders suggest that CEO compensation is "justified" given the incremental shareholder wealth created by CEOs, or that large CEO compensation packages merely reflect labor market forces. Prior research documents that CEO power and firm size are associated with larger compensation, but providing evidence that the larger compensation is excessive (i.e., not economically justified) has proven difficult. For each test firm we identify a potential replacement CEO (i.e., an executive-specific, within-country (US) compensation benchmark) and create an empirical test of excess compensation. We also examine the possibility that excess compensation is conditional upon firm size or CEO power. In spite of an inherent bias against finding excess compensation, the results suggest that the most powerful CEOs receive compensation that is not economically justified. We find no evidence of CEO excess compensation in the largest firms.

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1. Introduction

Chief executive officer (CEO) compensation has received a great deal of attention over the past several decades. Shareholders, regulators, politicians, the business media and academics have all weighed in on the appropriateness of the level of CEO compensation (e.g., Bogle, 2008; Conyon, 2006; Core & Guay, 2010; Dvorak, 2009; Pandher & Currie, 2013). Critics assert CEO compensation is "excessive" because it is only weakly linked to firm performance and the problems associated with CEO compensation are so pervasive that most CEOs receive excessive compensation. For example, Bertrand and Mullainathan (2001) find that CEOs are paid for luck, and Bebchuk and Fried (2006) argue that a breakdown in the governance structure has resulted in the relationship between the board and the CEO no longer being arms-length. However, recent research argues that the level of CEO compensation is "justified" given the incremental shareholder wealth created by CEOs (e.g., Core & Guay, 2010; Gong, 2011), or that large CEO compensation packages merely reflect labor market forces, particularly the shortage of talented CEOs (Chen & Leng, 2004; Fulmer, 2009; Gabaix & Landier, 2008; Kaplan, 2008; Oyer, 2004; Rajgopal, Shevlin, & Zamora, 2006). Thus, whether CEO compensation is "justified" or "excessive" remains largely an unresolved empirical issue.

While there is a general public perception that CEO compensation is excessive, there is little empirical evidence to support this notion. There is research suggesting that larger firms pay substantially more than smaller firms (Hallock & Torok, 2010), and that executive characteristics related to CEO power are associated with more favorable compensation terms (Abernethy, Kuang, & Qin, 2015; Kalyta & Magnan, 2008; Skantz, 2012). However, this research has not been able to determine if the larger compensation is economically justified. Providing empirical evidence on whether CEO compensation is justified or excessive has proven to be difficult. The empirical challenge is succinctly described in Conyon et al. (2011, 405) when they note that "if the pay of *every* CEO within an economy is considered excessive (a notion advocated by critics of CEO pay), then there is no within-economy control group against which to evaluate the compensation package of any given CEO." The implication of this problem is that comparisons between US CEOs are biased towards not finding excess compensation. Conyon et al. (2011) address this issue by comparing US CEOs to UK CEOs, and they conclude that US CEO compensation is not excessive. However, they find that even though sales and assets are similar between US and UK firms, 2003 mean total pay for UK CEOs is 42% smaller than US CEOs and that mean equity incentives for UK CEOs are 82% smaller than US CEOs, which suggests that there are material, structural inter-economy differences between the US and the UK.

In addition to identifying reasonable benchmark firms, determining the presence of excess compensation also requires a framework for estimating the economically justified level of pay. We use the framework described in Core and Guay (2010), which states that CEO compensation

☆ Data is available upon request.

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http://dx.doi.org/10.1016/j.adiac.2016.04.007
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can be thought of as the sum of four separate components: 1) compensation for ability (i.e., the minimum amount necessary to attract the CEO to the job and persuade him to forgo his next most attractive opportunity), 2) a payment that increases with the level of effort required of the CEO, 3) a premium for risk stemming from performance-based incentive risk, and 4) any excess pay (i.e., any portion that is unexplained by the other three components and that likely stems from unresolved agency conflicts and governance problems). Core and Guay (2010) make clear that if one wishes to suggest that CEOs are overpaid, it must be shown that the compensation received by the CEO cannot be explained by ability, effort or a risk premium.

In this paper, we advance CEO excess compensation literature by 1) measuring excess compensation as the difference in compensation between US test firm CEOs and potential replacement CEOs, also drawn from US firms, that is not explained by factors related to economically justified pay (i.e., ability, effort and risk), and 2) examining conditions which prior research suggests may be more prone to excessive compensation (i.e., sample partitions based on firm size and CEO power). This empirical approach has an inherent bias against finding evidence of excess compensation because the potential replacement CEOs may receive excess compensation, thus inflating the benchmark. Therefore, results indicating that excess compensation is not present should be interpreted with caution, while evidence of excess compensation suggests that the result is of sufficient magnitude to overcome the bias.

We match each US test firm CEO with a US benchmark firm CEO. Specifically, we construct portfolios based on firm size, industry, year and compensation structure. For each test firm we select as a benchmark, the firm with the next highest firm performance within that size/industry/year/compensation structure bin. This benchmark represents our empirical proxy for the test firm's next best CEO candidate. We then apply the Core and Guay (2010) framework to test whether the difference in pay between the test firm CEO and the benchmark firm CEO is explained by measures of CEO ability, effort and equity risk premiums (i.e., economically justified compensation). Consistent with Core and Guay (2010), we assert that differences in compensation between test firm CEOs and benchmark firm CEOs that are not explained by the economic determinants of CEO compensation related to effort, ability or compensation risk premiums, represent excessive compensation paid to the test firm CEO.[1]

In addition to evaluating excess compensation for the full sample, we also separately examine sample partitions where the presence of excess compensation may be more likely. Specifically, we examine firm size and CEO power. Academic research supports the notion that over the past three decades CEO compensation for large firms has increased at a dramatic rate relative to smaller firms (Bebchuk & Fried, 2004; Frydman & Saks, 2010; Hallock & Torok, 2010). However, there are mixed results on whether this disproportionate compensation increase for large firms is economically justified. Frydman and Saks (2010) and Gabaix and Landier (2008) suggest that the increases in CEO compensation for large firms are economically justified, while Bliss and Rosen (2001) and Bebchuk and Fried (2006) suggest that size-related compensation is not fully justified by economic determinants. Using these mixed results as motivation we examine the extent to which excess compensation varies cross-sectionally with firm size. If after controlling for CEO ability, effort, risk, and the labor market, firm size contributes to excess compensation as suggested by Bebchuk and Fried (2006), then we should find evidence of excess CEO compensation for the largest firms.[2]

To examine size, we partition the test firms into quartiles based on firm size (i.e., average market value). We find no evidence of excessive compensation in any of the size quartiles. Our evidence does not support the notion that the increases in CEO compensation attributable to firm size are excessive (i.e., not economically justified). However, as previously noted, due to the inherent bias in our empirical design, these results should be interpreted with caution.

Turning to CEO power, managerial power theory suggests that more powerful CEOs can exert influence over their own compensation which allows them to extract additional rents from the firm (Bebchuk, Fried, & Walker, 2002). Empirical studies show a positive association between CEO power and compensation (e.g., Core, Holthausen, & Larcker, 1999; Kalyta & Magnan, 2008; Skantz, 2012). Bebchuk and Fried (2004) use the managerial power theory to argue that, because of the association between CEO power and compensation, the level of excess compensation is increasing in the power of the CEO. On the other hand, Pandher and Currie (2013) suggest that a complex interplay of factors on CEO pay exists such that higher managerial power does not necessarily imply excessive compensation.

To test the managerial power theory, we partition the test firms into CEO power portfolios based on a CEO power index.[3] Consistent with the theory, we find significant evidence of excessive CEO total and cash compensation for only the most powerful executives (i.e., CEOs in the fourth CEO power portfolio). Our evidence suggests that more powerful CEOs earn compensation above that of their domestic benchmark that is not explained by ability, effort, risk premium, labor market premium and other determinants of compensation (i.e., they are paid excessively).

Our results are consistent with the notion that CEO compensation can be excessive (e.g., Bebchuk & Fried, 2004; Bertrand & Mullainathan, 2001). Using a test that is biased towards not finding excess compensation, we find evidence that a portion of the compensation paid to the most powerful CEOs is not economically justified. This paper extends prior research on questionable compensation terms rewarded to powerful CEOs (e.g., Abernethy et al., 2015; Kalyta & Magnan, 2008; Skantz, 2012) by showing that the most powerful CEOs have non-economically justified compensation that is of sufficient magnitude to produce statistically significant evidence of excessive compensation.

The remainder of this paper is organized as follows: Section 2 discusses relevant prior research and develops the hypotheses. The empirical design is described in Section 3, the sample and data are defined in Section 4, the results are presented in Section 5, and the model validation and sensitivity analyses are presented in Section 6. Section 7 summarizes the study.

2. Hypotheses development

2.1. Firm size

It is well-established in the academic literature that firm size is highly correlated with CEO compensation. The extant literature suggests that it doesn't matter whether company size is measured as assets (e.g., Finkelstein & Hambrick, 1989), or sales revenue (e.g., Lambert, Larcker, & Weigelt, 1991), the evidence is clear, bigger firms pay more. According to the 2010 US Top Executive Compensation Report by The Conference Board (Hallock & Torok, 2010) the median total CEO compensation in 2009 for CEOs of the largest 10% of US public companies ($10.2 million) is almost twelve times more than for CEOs heading the smallest 10% of U.S companies ($878 thousand). Hallock and Torok (2010) also report evidence consistent with a disproportionate increase in CEO total compensation across firm size deciles. For example, for the first nine firm size deciles they report a 20–35% increase in median CEO total compensation for each step up in firm size decile. However, when

[1] It should be noted that our estimates of excess compensation are potentially understated since we, by design, include the labor market premium as part of the economically justified portion of CEO compensation. It could be reasonably argued that at least some portion of the labor market premium may in itself represent excessive compensation.

[2] It is widely accepted that CEO compensation is increasing in firm size, and we treat firm size as one of the economic determinants of justified compensation. Therefore it is important to note that the aim of our empirical test is not to evaluate whether *total* compensation increases with firm size, but whether *excessive* compensation increases with firm size.

[3] To partition the sample, we create a CEO power index based on prior research (Combs, Ketchen, Perryman, & Donahue, 2007; Feng, Ge, Luo, & Shevlin, 2011; Haynes & Hillman, 2010; Hill & Phan, 1991). We discuss this index in more detail later in the text.

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