Firm Performance versus Managerial Power

In determining CEO compensation: A Critical Study

أداء الشركة مقابل السلطة الإدارية في تحديد تعويضات المدير التنفيذي: دراسة انتقادية

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<u>Abstract:</u>

To answer the question if chief executive officers (CEOs) are compensated according to their performance or to their power in the company, the current study attempts to provide a rich literature review concerningAgency Theory (AT)and Management Power Theory (MPT) in explaining top management compensation.

In practice, some empirical studies tie senior compensation tomanagement power in order to test MPT and find that management power is an important determinant of senior compensation; whileotherstudies tie senior compensation to firm performance in order to test ATand find that top management compensation is affected essentially by firm performance.However, many studies' results show no support for the theories, which is used by researchers as a basis for criticism.

Studies' results vary from supporting to not supporting either AT or MPT perhaps because results are conducted in different circumstances and use different proxies for variables. This is why the debate ofhow senior management compensation is decided is still ongoing.

<u>Key words</u>: CEO Compensation, Agency Theory, Managerial Power Theory, Firm Performance and Pay-Performance Sensitivity.

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الملخص :

تهدف هذه الدراسة إلى عرض كل من نظرية "الوكالة" ونظرية "قوة الإدارة العليا" في تفسير تعويضات الإدارة العليا في الشركات، وهذا لشرح على أي أساس يدفع أجر المدير العام في الشركة، هل على أساس أدائه أو على أساس قوته.

بعض الدراسات التطبيقية حاولت ربط تعويضاتالإدارة العليا بالقوة الإدارية لاختبار نظرية "قوة الإدارة العليا"، في حينحاولت بعض الدراسات ربط تعويضات الإدارة العليا بأداء الشركة لاختبار نظرية "الوكالة". إلا أن نتائج بعض الدراسات لم تدعم كلتا النظريتين والذي استعمله الباحثون كأساس لانتقاد النظريتين.

تباينت نتائج الدراسات بين دعم وعدم دعم كل من نظرية "الوكالة" ونظرية "قوة الإدارة العليا"ربما بسبب كونها أجريت في ظروف مختلفة، إضافة إلى أنها استعملت مقاييس مختلفة لمتغيرات الدراسة. ولهذا يبقى محل نقاش إذا ما يدفع أجر المدير العام على أساس أدائه أوعلى أساس قوته.

الكلمات المفتاحية:تعويض المدير العام، نظرية الوكالة، نظرية قوة الإدارة العليا، أداء الشركة، وحساسية الأجر للأداء.

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1. Introduction :

Compensation paid to the top executive manager is a major issue and a sensitive area in corporate finance. Corporations argue that they need to pay well to attract and motivate qualified people;some argue that the amount paid is the most important element, while others argue that it is not how much to pay but how to pay that matters (Jensen and Murphy, 1990).

Because of the importance of this issue, a great deal of empirical research has been conducted. Some of them have tried to uncover the determinants of the CEO compensation package;others have related the executive compensation to the corporate performance, while others related compensation to the power of managers. Not only in practice, but also in theory, the debate on what determines executive pay levels is still ongoing and many different theories are used to explain executive pay. The field is dominated by Agency Theory as introduced by Jensen and Meckling (1976) and Managerial Power Theory which is proposed by Bebchuk and Fried (2004) and built on the work of Finkelstein (1992).

Problem of the study: the problem in this study is what determines the top manager's compensation. In other words, are senior executives compensatedaccording to their power in the company or to their performance?

Purpose of the study: the current study attempts to provide a rich literature review concerning both Agency theory and ManagerialPower theory in determining and explaining managers' compensation. In addition, it tries to supply a constructive criticism for both theories.

Organization of the study: the present study is organized in 4 sections. Section 2 provides the theoretical framework for Agency Theory and Managerial Power Theory. Section 3 reviews empirical studies on both ofAgency theory and Managerial Power Theory, in addition to a criticism for the theories. Section 4 summarizes the main conclusion of the study.

2. Theoretical Framework :

2.1. Agency Theory

Jensen and Meckling (1976, p5) defined the agency relationship as "a contract under which one or more persons (principal (s)) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision making authority to the agent". In both public and private capital markets, individuals who do not have either skills or the desire to manage the business meet individuals who have good ideas or products and may not have the funds necessary to bring those products to the market. This relationship between owners and managers in a business represents a pure agency relationship where shareholders from most corporations delegate decision making authority to the board of directors, and the BOD in turn delegates power to the chief executive officers.

Separation of ownership from management functions leads to conflicts of interest between managers and owners because they have different concerns. Agency theory assumes that both agents and principals are utility maximizers (Jensen and Meckling 1976). Thus, owners (principals) are interested in maximizing the firm value while managers (agents) are interested in the maximization of their well-being (maximization of wealth and minimization of efforts). Therefore, managers may not manage in a value maximization way, they might pass up profitable investments because taking those investments requires more efforts from their part.

Agency problems arise when conflict of interest between managers and owners occurs. In other words, when self-interest behavior happens and managers take actions in counter to the agreement with owners, agency problems arise (Bendickson et al, 2016). To overcome these agency problems, principals establish appropriate incentives for the agent and found a monitoring system to limit the deviant activities of the agent. In addition, sometimes the agent expends resources (bonding cost) to guarantee that he or she will not take action in counter to the principal, or to compensate the principal if he/she takes some deviating actions. Jensen and Meckling (1976, pp. 6) refer to the costs arising from agency problems as agency costs, and define them as “the sum of 1) the monitoring expenditures by the principal, 2) the bonding expenditures by the agent, and 3) the residual loss (the reduction in welfare experienced by the principal as a result of divergence between the agent’s decision and the decisions which would maximize the welfare of the principal)”.

According to Gomez-Mejia and Wiseman (1997), to solve the problems of agency there are two cases. The cases of no asymmetries of information exist between principals and agents; where the principal is aware of all the agent’s actions and behavior. In this case providing the agent with incentives is enough to make him work for the benefit of the principal, since this latter is completely aware of how results are achieved. The second case is where the principal has incomplete information on the agent’s behavior. To solve this problem of asymmetric information, the principal has two options; either by increasing monitoring to get more information about the agent’s movements or by providing the agent with more incentives in a way that interests of the principal and the agent become aligned.

Later, in 2002, Balsam gave more details about controlling conflicts of interest between managers and owner citing the following mechanisms: monitoring by large shareholders and the board of directors, equity ownership by executives, the market for corporate control, and compensation contracts that provide incentives to increase shareholder value (pp. 6).

In line with Gomez-Mejia and Wiseman (1997), Balsam (2002) believes that monitoring is a key means to control managers’ actions by getting more information about this latter. But it has its limitations since the board cannot review every decision the manager makes, and even if they could, they may luck the expertise to evaluate those decisions. Furthermore, a director’s incentive may not be aligned with those of other shareholders given that most directors have limited investment in the corporation.

Ownership by executives softens incentive conflicts by aligning executives’ interests by those of shareholders. By making the executive shareholder, he or she will be interested in maximizing firm value similar to other shareholders. But executives have small and limited resources compared to the market values of their employers. So when their wealth constraint is combined to risk aversion, it may not be in the best interest of other shareholders.

The market for corporate control encourages executives to make their best to increase the firm value. If executives manage the corporation in a way that meets their own interest deviating from the interest of shareholders, and if a group from another corporation believes it could manage the corporation more efficiently, they will purchase the corporation to benefit from the increase in firm value from improved management. If such purchase happened, the ineffective executives would be fired.

Compensation package contract of managers can be an effective means to achieve common benefit for both managers and shareholders and also to reduce agency costs resulting from conflicts of interests (Zhang, 2016). Executives are rewarded for taking actions that increase shareholders' wealth. However, it is difficult to base compensation on actions alone because owners may not have the expertise to evaluate these actions even they (actions) are observable. (Balsam, 2002)

2.2. Managerial Power Theory

According to agency theory, compensation is considered as a tool to overcome problems of agency between managers and shareholders. In contrast to agency approach, the managerial power approach does not view executive compensation as a remedy for agency problems; however, compensation is itself seen as a major part of the problem (Bebchuk and Fried, 2004, pp.62). This approach does not assume that the board of directors always faithfully serves shareholders' interests when negotiating executive pay. There are many reasons for assuming that the members of the board side with managers' interests; for example, board members do not care about the economic consequences of high pay (Bebchuk and Fried, 2004). Or, board members may simply be generous to the CEO because he or she is their friend (Main, O'Reilly, & Wade, 1995).

Finkelstein (1992) defined power as the ability of executives to influence their will or desires on the remuneration decisions made by the board of directors, or perhaps the compensation committee of the board. Thus, managerial power theory assumes that managers have considerable power to influence the board of directors and they use their power to obtain compensation more favorable than they would get. However, compensation captured by power is not only in form of pay or monetary compensation, it comes in different forms: managers prefer to bear less risk and feel less pressure to generate shareholders value;

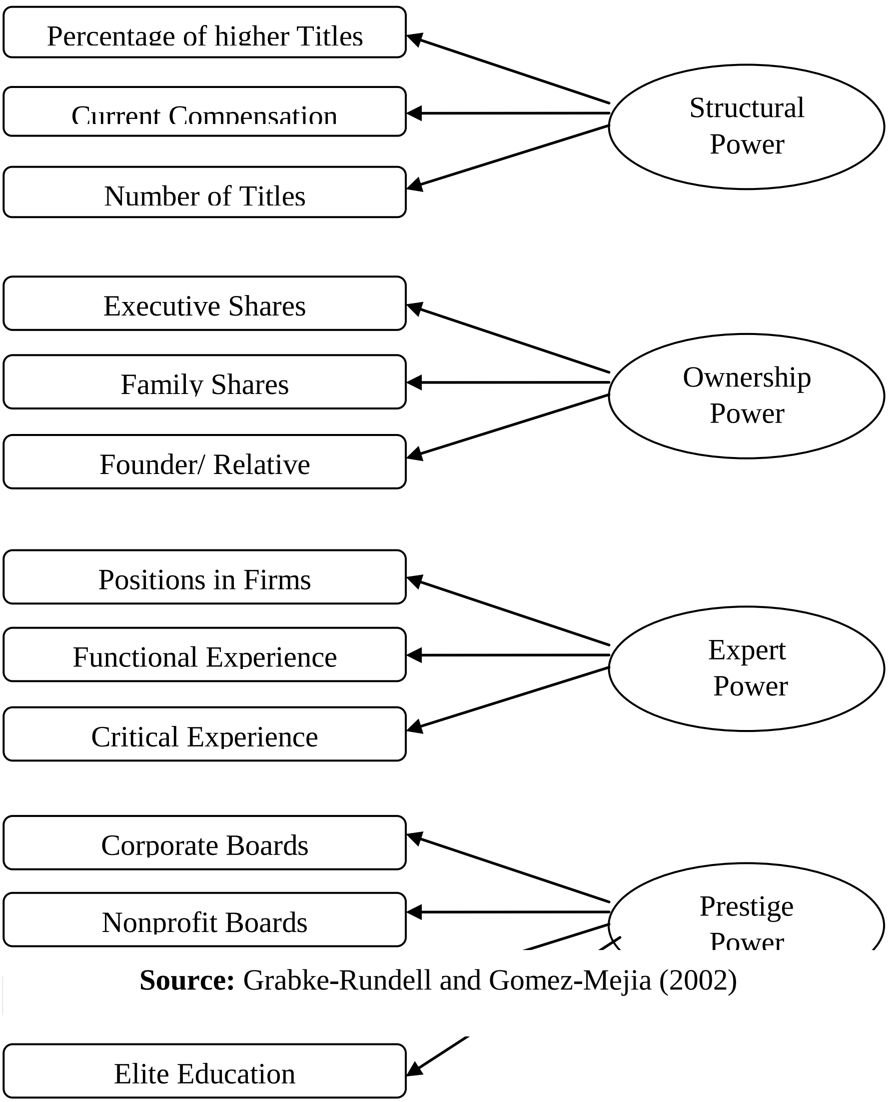
managers like to enjoy as much slack as possible; they prefer to receive a given amount of monetary compensation without cutting managerial slacks; managers like to have compensation decoupled from performance to avoid bearing risk and making efforts (Bebchuk and Fried, 2004).

According to Bebchuk and Fried (2004), managerial power approach predicts a correlation between managerial influence and rent, and the amount of managerial power varies across firms depending on each firm's ownership and governance structure.

Finkelstein (1992) identifies four types of executive power: structural power, ownership power, expert power, and prestige power.

- Structural power: is based on formal organizational structure and hierarchical authority. Managerial power is generally assumed to decrease as one moves down the organizational hierarchy and thus, CEOs have high structural power over other members because of their formal organizational position.
- Ownership power: is where executive power will be an increasing function of the manager's personal equity holdings. For example, a top manager with significant shareholdings in an organization will be more powerful than a manager without such a base of control.
- Expert power: one of the manager's power sources is when he or she owns some ability to deal with the environmental contingencies and contribute to organizational success. Thus, the manager has some expertise that gives him or her significant influence on strategic choices. "The more managers have developed contacts and relationships with elements of the task environment, the greater is their ability to cope with contingencies of the task environment, and the greater is their expert power", (Finkelstein, 1992, p.509).
- Prestige power: manager's personal prestige or status among institutional environment and shareholders affects others' perceptions. Good reputation of managers sends powerful messages to other top managers of their personal importance. Therefore, managerial prestige promotes power by facilitating the absorption of uncertainty from the institutional environment.

Figure (2.1)
Finkelstein's (1992) Model of Executive Power



Source: Grabke-Rundell and Gomez-Mejia (2002)

3. Review of literature

3.1. **Agency Theory:** One of the bases of agency theory is that executive compensation is a remedy for the conflict of interest between managers and owners.Moreover, CEO compensation helps to align shareholder's interest with those of managers.Shareholders interest is summarized in firm performance as high performance leads to high firm value and thus to high shareholders value.This is why scholars tied management compensation to firm performance, called “the pay-performance relationship”.

Many studies are conducted for the purpose to test the pay-performance relationship and several of them consider performance as an important determinant of CEO compensation: Murphy (1985), Jensen and Murphy (1990), Kaplan (1994), Groves et al (1995), Zhou (2000), Xu (2004), Duffhues and Kabir (2008) and Bu and Shalchian (2017). Here, some of the supporting studies to agency theory are given in more details:

Kaplan (1994) tried to study executive compensation and its relation to firm performance in Japanese and U.S. companies in 1980. The researcher uses four proxies for performance (stock return, sales, negative pretax income and sales growth) which are studied first separately in different models and secondly together in one regression model. Results show that cash compensation for top executives in Japan is statically related to all four performance measures individually. While the variable with the most explanatory power is negative pretax income, and sales growth has the least explanatory power. Results show also that US CEO cash compensation is related to the four performance measures individually. When all performance variables are used in a single regression, results show that cash compensation is negatively related to negative pretax income and changes in pretax income while both stock return and sales growth become insignificant.

Xu (2004) pursued the suggestion of Groves et al (1995) that the provision of incentives might have been an important objective of the managerial compensation policy. They also asked whether the observed provision of incentives was consistent with the predictions of the standard Agency Theory of compensation. In analysis, the researcher related pay to enterprise profitability as a measure for performance because enterprise directors responding to the survey identified performance as the most important target in enterprise plans on which CEO contracts were normally written.Controlling for CEO factors (schooling and experience) and firm factors (size, profitability and average industry performance),strong evidence is found in favor of insurance versus incentives trade off in pay schemes: CEO compensation is less sensitive to enterprise profitability the more uncertain is the latter’s magnitude. They also find that the CEO pay-performance sensitivity increases with the marginal productivity of executive action. Consequently, agency theory is supported.

Bu and Shalchian (2017) analyze executive compensation and corporate performance relationship and find a positive and significant relation between the two variables, indicating that compensation contracts are based on firms' performance. Results indicate some steadiness in executive compensation but it seems to be steadier in local government-controlled firms relative to central government controlled firms. Results show also that executive compensation is steadier relative to risk based performance and less steady relative to operating performance.

The works of Jensen (1994) and Brennan (1994) make the basis of agency theory criticism where they concur that people do not always behave in a rational way and thus managers do not always act in their self-interest. Furthermore, money is not always the best way to motivate people.After, in 1995, Boyd concludes that recent research has demonstrated that agency assumptions only fit particular contexts.

According to Agency Theory, chief executive officers are compensated according to their performance rather than to their power in the company. Therefore, firm performance would be positively correlated with CEO compensation. However, many empiricalstudies find noassociationbetweenCEO compensation and different measures of corporate performance (Firth et al, 1996; Suzan, Mishiel&Samiha, 2014); for the reason that the outcome of manager's performance may take time to be shown on the company's performance, and the present company's performance may be the product of previous managers' policies and performance.

Besides, if managers are compensated according to their performance rather than to their power, then how would be the significant effect of CEO duality on CEO compensation be explained? Many studies have founda positive association between CEO duality and CEO compensation (Elloumi and Gueyié, 2001; Suzan et al, 2014) which means that the board of directors is influenced by the presence of the CEO among them in deciding his/her compensation. In other words, the chief executive officer is more powerful when he /she is a member of the board of directors. Thus, it can be said that the CEOs is compensated according to their power rather to their performance.

Managerial Power Theory

Finkelstein (1992) aimed to develop and validate a set of power dimensions and their measurement through three studies. In the first study four dimensions of power (structural, ownership, expert and prestige power) were measured and results have provided strong support for all the four power dimensions.

Quan et al (2010) have tried to study the compensation rigging behavior of top managers of state-owned enterprises and their value effect. They find that more managerial power of top managers of state-owned enterprises lead to higher private benefits, the top managers of state-owned enterprise controlled by the central government prefer to hidden non-monetary private benefits, while the top managers controlled by local government prefer explicit monetary private benefits. Moreover, from the pay performance sensitivity point of view, findings show that the greater power of top managers, the higher sensitivity between pay and rigging performance. This indicates that top managers with stronger power tend to use earning rigging to entrench performance compensation. Finally, finding show that incentive compensation has significant positive value effect, but rigging compensation has significant negative value effect.

Lu et al (2010) have tested the impacts of managerial power on perquisite consumption and firm performance from the perspective of CEO duality, ownership dispersion and long-term tenure of top executives. Findings have shown that companies with higher managerial power tend to incur higher perquisite consumption, while their performance does not improve accordingly. Furthermore, perquisite consumption fails to offer effective incentives to managers, and non-state-controlled companies have greater managerial power, higher perquisite consumption, and worse performance that that of state-controlled peers. Results show that managerial power is an important factor that influences compensation incentive.

Zhang et al (2016), based on managerial power approach, have investigated whether senior executives of Chinese listed companies use their power to own their private benefits. The researchers have also compared compensation contracts between state and private-owned companies to test whether there is a significant difference between senior executives from different ownership types of enterprises in term of compensation contracts. Taking one comprehensive indicator of managerial power from four indicators (whether the management level holds shareholders or not, proportion of shares held by the biggest shareholder, proportion of independent directors, and whether the chief manager is a director), results have showed that senior executives of Chinese listed companies can make use of their power to increase their own salary, at the same time, company performance and company size are important factors influencing senior executive compensation. Findings further argue that senior executives of private-owned companies are more likely to use their power to increase their compensation.

Although the findings of many empirical studies support managerial power theory, there are some other studies that find no relationship between managerial power and CEO compensation. Laan (2010) tests the relationship between CEO power and compensation structure and finds that most of multidimensional measures of power do not appear to have a strong effect on compensation.

In addition, according to Managerial Power Theory, managers are compensated according to their power in the company.Power can't be gotten in one day, otherwise it is the outcome of a career and years of work; which means that new graduated or young people don't have the power to be well compensated. Therefore, CEO age would be positively correlated with compensation. Nevertheless, results of a study conducted on Jordanian industrial companies (Suzan, Mishiel & Samiha; 2014) showed that CEO age is negatively correlated with compensation meaning that younger executives (have no power) are more compensated than older ones. The researchers gave explanation that younger people who have recently graduated dispose of new certificates like Certified Management Accountant (CMA) Certificate and Certified Financial Accountant (CFA) Certificate which are required in labor market.

4. Conclusion :

The present study sheds light on two contradicting theories in explaining top managers' compensation: Agency Theory and Managerial Power Theory. According to Agency Theory, top managers are self-interested and work to maximize their benefit rather than shareholders' one. Moreover, compensation package contracts make an effective means to achieve common benefit for both managers and shareholders. Managerial power theory does not consider compensation as a remedy for the conflict of interest between managers and owners;on the contrary, it sees that managers have the power to influence their compensation (structural power, ownership power, expert power, and prestige power).

Results:

In practice, many empirical studies are conducted to test Agency and Managerial Power theories. Findings differ from supporting Agency Theory to supporting Managerial Power Theory, whereas others don't support the theories but criticize them. Studies reach diverse results perhaps because they are conducted in different circumstances and use different proxies for variables. The debate of how senior compensation is decided is still ongoing.

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