A CONTEMPORARY APPROACH FOR MITIGATING AGENCY CONFLICTS: A CONCEPTUAL REVIEW

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Abstract

Excessive CEO compensation can be justified in any way as it can raise severe agency conflicts in a firm. Cases of excessive CEO compensation have observed all over the world, therefore, this paper proposes a new solution to mitigate agency conflicts. This paper surveys the recent literature of CEO compensation and its determinants. Along with previous conventional determinants, this study proposed a new determinant, i.e. market share, which is omitted by prior studies and should be statistically validated with CEO compensation. Moreover, this study proposed plausible moderators, namely, corporate governance (ownership structure and board characteristics), dividend policy and risk taking. This study has provided enough evidences and room for research, which will benefit researchers in term of future empirical studies on different markets in the world.

Keywords: Agency Conflicts, CEO Compensation, Dividend Policy, Corporate Governance, Market Share, Risk Taking

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1 Introduction

Due to economic meltdown and financial crises, excessive and flawed executive compensation became focal concern (Lorsch & Khurana, 2010). Specifically, media has highlighted this issue after the financial crises of 2008 (Datta, 2014). Therefore, in academic literature and popular press, great significance regarding executive compensation has observed (Boyd, Santos, & Shen, 2012). Moreover, policymakers and business communities also show keen interest in this issue (Graham, Li, & Qiu, 2012). Evidences show that re-examining the effectiveness of current compensation system has become the public demand these days (Lin, & Wang, 2013).

Through the evidences from the Wall Street, Hodgson (2004) purported that CEOs are rewarded with high compensation when market is up but if the market is down, this trend remain same. He also revealed that there is lack of long-term performance measures and lack of pay-performance link. Similarly, Hindery Jr. (2008) labelled excessive CEO compensation as the cancer, which could damages the image of an economy. The average compensation of a company CEO is 400 times greater than the average employee.

Cases of “exorbitant” pay level have observed in many countries around the globe, which further leads to agency conflicts in an organization. However, consistent to agency theory, Jensen and Murphy (1990) argued that “how” CEO is paid is significant rather than “how much” they get. They also recommended further research as they establish weak performance and pay link. Researchers have demonstrated many studies pertaining to the CEO compensation and its impact on shareholder value or firm performance. However, their relationship is inconsistent in most of the researches.

Cooper, Gulen and Rau (2014) revealed that excessive compensation of executives could affect the shareholder wealth negatively. In addition, Pathe (2014) discovered that higher paid CEOs exhibit overconfident behaviour by taking excessive risk which affect the future returns of an organization. Therefore, over past two decades, theorist and researchers argued that compensation of CEO should be aligned to firm performance (Grossman & Hart, 1983; Jensen & Murphy, 1990).

Owing to the inconsistent previous literature, researchers have determined mixed results on the relationship between CEO compensation and firm performance. For instance, Sun, Wei and Huang (2013), purported a positive relationship between CEO compensation and firm performance. For instance, Sun, Wei and Huang (2013), purported a positive relationship between CEO compensation and firm efficiency in US insurance industry. Similarly, a prior study by Akhigbe, Madura and Ryan (1997) found positive impact of CEO compensation on accounting and market based performance. However, Nourayi and Mintz (2008) determined opposite results. They revealed that both accounting and market based measures of performance negatively correlates CEO compensation. Therefore, due to inconsistent relationship between these variables, further research is required.

Not only in practice, but also in theory, the debate on what determines executive pay levels still seems interminable. For instance, the tournament theory by Lazer and Rosen (1981) illustrated that pay is the prize, which is received by highest-ranking
employees. With the increase in rank or promotion, there is also increase in pay, which is a prize for working hard. Therefore, CEOs are getting highest salaries in the company. Conversely, according to equity theory, CEOs should be rewarded as per their contribution to the firm (Gerhart, Minkoff, & Olsen, 2005). However, the field of executive pay is still dominated by agency theory suggested by Jensen and Meckling (1976), regardless of other theories in the academic literature.

A number of studies have undertaken by researchers to determine executive pay. They tried to align the CEO compensation with firm performance and other firm characteristics. For instance, researches have contemplated firm performance (Sigler, 2011; Sun, Wei, & Huang, 2013), firm size (Abed, Suwaidan, & Slimani, 2014; Conyon, 2014) and investment opportunities (Elloumi & Gueyié, 2001; Wang, Frostburg, & Providence, 2013) as the major determinants of CEO compensation. Furthermore, due to increase in market competition, CEO have to work harder to gain larger market share, therefore, these days some companies like General Motors Corporation is reshaping their CEO’s compensation on the basis of market share (Phillips, 2014). Nevertheless, according to the best knowledge of authors, researchers have not yet empirically find the relationship between market share and CEO compensation. Thus, this study suggests that the relationship between market share and CEO compensation should be tested in different markets around the globe.

To mitigate the agency conflicts, researchers proposed different solutions, such as efficient dividend policy (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000) and strong corporate governance (Core, Holthausen, & Larcker, 1999). However, moderating role of these variables has not yet extensively validated in different markets as very few studies have drawn the attention of researchers toward this domain. Therefore, there is more need to focus on different variables or strategies that could align the interest of executives with the interest of shareholders. Thus, this study highlighted different moderators, which can influence the pay-setting process or pay-performance sensitivity.

2 Dividend policy

There are two main views pertaining to the association of dividend policy with CEO compensation. According to the series of Bhattacharyya and his fellows’ studies, high quality managers invest retained earnings in positive NPV projects rather than paying them in cash dividends. However, if there are no suitable or profitable options, then managers payout dividends. Therefore, they observed negative association of executive compensation and managerial quality with dividend payouts because low quality managers have less access to profitable projects and those efficient managers who have greater opportunities regarding positive NPVs get more compensation (Bhattacharyya, 2000; Bhattacharyya, Mawani, & Morrill, 2002; Bhattacharyya, 2003).

The other viewpoint is free cash flow hypothesis. According to this theory, free cash flows should be pay out in terms of dividends as the excessive amount of profit could be employed as mean of rent extraction by executives. Jensen (1986) who proposed this hypothesis purported that once the executives will pay the free cash flows as dividends, they will move to banks for debts to invest in positive NPVs and the debts can reduce agency costs. Easterbrook (1984) also supported this view and argued that dividend can reduce the misappropriation of wealth by managers, as they will pursue other capital markets to meet the needs for the future investments, which can restrict executive within discipline and it can also diminish the cost of monitoring executives.

In the same lines, Jensen (1986) and Rozeff (1982) purported that firms with greater agency conflicts could employ efficient dividend policy to reduce these conflicts. Managers want to retain the earnings for future investments though shareholders want dividends, however, a balanced and efficient dividend payout policy could resolve the issue of agency conflicts as in this case, executives will be unable to use the resources for private benefits. In addition, Stouraitis and Wu (2004) also highlighted this issue and proposed that dividend payouts restrict managers from overinvestments. Consequently, managers take more rational decision for the success of organization. Correspondingly, Chen, Zheng and Wu (2011) found negative relationship between dividend payout and manager overconfidence in Chinese listed companies.

Although, the M&M theorem by Modigliani and Miller (1961) assumed that shareholders should not have concern whether company is paying dividends or not because investors can manage their own cash inflows through different stocks, but signalling hypothesis opposed this theorem. According to the signalling hypothesis, insiders (executives or managers) of an organization hold more asymmetric information as compared to outsiders (shareholders). This information regarding the intrinsic actual value of the firm remains inaccessible for the shareholders as share price does not always reveal the actual position of the firm. In this context, to resolve this issue, signalling theory proposed ‘dividend’ as a very suitable method because it could reveal the actual and private information which can be employed for more valid firm valuation. Particularly, it can be purported that dividend announcement by the corporation reveal more information regarding corporate’s future value or earning capability (Connelly, Certo, Ireland, & Reutzell, 2011). Therefore, it is suggested that companies should distribute dividends time to time.

Although Jensen’s cash flow hypothesis assumed that divided policy can diminish the agency costs which leads to improvement in firm value but the study of Emerenciana (2012) exhibits different results in this context. He argued that there is lower pay-performance sensitivity, high CEO’s compensation

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and more rent extraction culture in the firm who pay dividend gradually. Nevertheless, on a single empirical study, it cannot be assumed that dividend policy cannot help in mitigating agency theory unless its effect would be tested on different economies in the world. Nonetheless, there is still enough room for research regarding moderating role of dividend policy for pay-performance sensitivity or for other determinants (firm size, investment opportunities and market share) and compensation. It is still indeterminate in the academic literature that what effect does dividend policy will exhibits among these relationships. Therefore, this study proposed a contemporary framework in Figure 1 to draw the attention of researchers.

Figure 1. Determinants of CEO Compensation with the moderating role of Dividend Policy

3 Corporate Governance

Researchers believe that corporate governance can reduce the agency conflicts from the organization. For example, Core et al. (1999) purported that firms with effective corporate governance pay their CEOs a lower compensation. They also argued that firms with stronger corporate governance have lesser agency conflicts and higher performance. Therefore, it is assumed that stronger corporate governance can mitigate the agency conflicts. Most of the researchers consider ownership structure and board characteristics to justify the corporate governance structure. Although, researchers have made an effort to demonstrate the moderating role of some corporate governance dimension between pay and performance, nonetheless, there is a lack of research regarding their moderating effect on the firm size-compensation link, investment opportunities-performance link and market share-performance link. Thus, by considering this research gap, Figure 2 illustrated a model regarding corporate governance dimensions.

Figure 2. Determinants of CEO Compensation with the moderating role of Corporate Governance
3.1 Family ownership

In case of family ownership, Gomez-Mejia, Larraza-Kintana, & Makri (2003) labelled CEOs in family owned firms as stewards who receive lower compensation. Moreover, they claimed that family owned firms do not exploit or manipulate the minority shareholders by paying CEOs an extravagant compensation. In the Lebanese companies, Charbel, Elie and Georges (2013) found positive relationship between family ownership and firm performance and support the Stewardship theory in the perspective of Lebanese managers. In addition, due to lower agency costs in family firms, the interests of shareholders and managers remain aligned. Nevertheless, with the reference to lone family member in the firm Combs, Penney, Crook and Short (2010) observed higher compensation.

Furthermore, in relation to agency conflicts in a family owned firm, Barontini and Bozzi (2010) assumed that there is Type-II agency conflicts in a family owned firms, i.e. conflicts between family owners and minority shareholders. Although, agency theorists claimed that pay-performance link is not relevant in the perspective of family ownership. However, by employing ownership as a moderator, Michiels, Voordeckers, Lybaert and Steijvers (2013) perceived pay-performance link in family owned firms. Nonetheless, in relation to the moderating role of family ownership, there is still lack of study to investigate with other crucial determinants of CEO compensation.

3.2 Institutional Ownership

The second important dimension in ownership structure includes institutional investors which has been widely discussed in accordance with CEO compensation. Agency theorists support institutional investors as they align the CEO compensation with performance (Jensen & Murphy, 1990). Additionally, it is believed that institutional investors can reduce agency conflicts in a corporation by monitoring CEOs effectively through their expertise and these investors can also monitor the pay-setting efficiently (Abed, Suwaidan, & Slimani, 2014; Lee & Chen, 2011). Along these lines Almazán, Hartzell and Starks (2005) identified two types of investors, i.e. pressure-sensitive and pressure-resistant. According to these authors, pressure-resistant investors are more likely to influence the CEO pay setting as compared to pressure-sensitive investors by considering the preferences of shareholders. In addition, they purported a negative relationship of institutional investors with CEO pay but positive influence on pay-performance sensitivity. Through Spanish evidence, López-Iurriaga, García-Meca and Tejerina-Gaite (2015) also revealed that pressure-resistant investors possess better monitoring skills as compared to other investors.

Although, theoretical it has been assumed that institutional investors could control CEO pay-setting or align their pay with performance but empirically there is a lack of research in this perspective. Through a meta-analysis, Van Essen, Otten and Carberry (2015) purported that institutional investors can moderate the relationship between firm performance and CEO compensation. However, there is still need to investigate it empirically on different markets. Moreover, moderating role of institutional investors should also be investigated between other determinants of CEO compensation i.e. firm size, investment opportunities and market share.

3.3 Foreign Ownership

Third dimension that is selected within the ownership structure in this paper is foreign ownership due to their influential capability described by prior studies. Contrary to institutional investors, foreign investors pay their CEOs a higher compensation because they focus on hiring highly qualified individuals who can boost firm performance and profitability (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1999). Therefore, prior researches found positive relationship between CEO compensation and foreign ownership (Mäkinen, 2007; Pan, Tian, Ma, Jun, & Tang, 2009; Randoy & Nielsen, 2002). Despite of small portion of foreign investors in the firms, they tried to gain maximum profit and consequently, seek to align the CEO compensation with the profitability of the firm (David, Yoshikawa, Chari, & Rasheed, 2006). They push family owners and institutional investors to pay CEOs more incentive-based compensation to enhance the performance of the firm (Huang, 2010). Therefore, Colpan and Yoshikawa (2012) found positive moderating role of foreign ownership between profitability of the firms and CEO bonus pay. However, still further study is needed in this perspective as shown in Figure 2.

3.4 Board Composition or Independent Directors

The domain of corporate governance could not be covered properly without discussing the role of board of directors. Van Essen et al. (2015) utilized managerial power theory and purported that there is lower cash or total compensation of CEO in a firm, where board is effective as they can empower pay setting process and establish tighter link between CEO compensation and firm performance. Researchers argued that board composed of more independent directors, control the CEO’s power over pay setting process (Conyon, 2006; Zhu, Tian, Gang, & Ma, 2009). Furthermore, a study by Stein and Plaza (2011) also illustrated that those companies who contain more
independent directors are more likely to suspend CEO who underperform. Thus, Agency theorists also emphasize the inclusion of independent board of directors in a corporation (Zahra & Pearce, 1989).

Through 181 Toronto Stock Exchange listed firms, Ben-Amar and Zeghal (2011) emphasized that independent directors also enhance the CEO compensation disclosure transparency. Therefore, generally it is believed that independent directors are unbiased individuals in a firm who can improve the performance and reduce the agency conflicts in a firm. Therefore, this study hypothesized that independent directors positively moderate the relationship between firm performance and CEO compensation. This view has supported by Van Essen et al. (2015) in his meta-analysis and suggested the moderating role of independent directors in tightening the link between firm performance and CEO compensation. However, still it is missed by academic literature if independent directors could moderate the relationship between other firm characteristics and CEO compensation. Nevertheless, due to cross-cultural variations, the effects of independent director on CEO compensation could be different.

3.5 CEO Duality

Agency theorists are not in the favour of CEO duality. In duality of positions, CEOs work only for their own welfare and capital gains, which can affect other shareholder value negatively (Finkelstein & D’Aveni, 1994). Therefore, previous studied empirically tested the influence of CEO duality on CEO compensation and found that CEO duality leads to higher CEO compensation (Core et al., 1999; Cyert et al., 2002; Fahlenbrach, 2009; Jensen, 1993). Although, some of the corporate governance attributes has changed after the recent financial crises but CEO duality remains same in Fortune 500 firms (see Vemala, Nguyen, Nguyen, & Kommasani, 2014).

However, this study is interested to know if CEO duality can moderate the relationship between firm performance and CEO compensation or if it can moderate the relationship of other determinants of CEO compensation discussed by previous researchers. Subsequently, in this perspective, Van Essen et al. (2015) proposed that CEO duality does not moderate the relationship between firm performance and CEO compensation. Conversely, Dorata and Petra (2008) found positive moderating role of CEO duality on the relationship between firm performance and CEO compensation. By employing the U.S. listed firms, Fahlenbrach (2009) also purported that CEO duality have a significant effect on pay-performance sensitivity. However, this domain still needs the focus of the researchers to test the moderating role of CEO duality in both developing and developed countries.

3.6 Board size

Moreover, one more dimension lies within the context of board characteristics, i.e. board size. Board size has the greatest effect on CEO compensation after firm size (Van Essen et al., 2015) as according to Core et al. (1999), with the addition of one individual in the board, CEO earns USD 30,601. Consequently, theorists and researchers argued that larger board size is not effectual for monitoring CEOs (Fama, 1980; Jensen & Meckling, 1976). Therefore, it is assumed that larger board size cannot mitigate the agency conflicts or it can weaken the pay-performance relationship. Fahlenbrach (2009) supported this argument and revealed that pay-for-performance sensitivity is stronger in the companies with smaller board size. According to researchers’ best knowledge, moderating role of board size with the determinants of CEO compensation has not yet tested. Thus, a framework for futuristic research has established in Figure 2.

4 Risk taking

Although, pay-performance sensitivity is important to reduce agency conflicts but to increase the short-term performance for their higher compensation, CEOs might involve themselves in excessive risk-taking and short-term gambling, which can affect the firm long-term performance negatively. Moreover, shareholders also want their CEOs to invest in profitable projects, which also cause CEOs excessive risk taking behaviour (Bertsh & Mann, 2005; Chiu & Wagner, 2012). Therefore, prior research by Cohen, Hall and Viceira (2000) found positive relationship between CEO compensation and firm’s total risk. Thus, it is hypothesized that risk taking can weaken the relationship if there would be positive relationship between CEO compensation and firm performance. On the other hand, risk taking can strengthen the negative relationship between CEO compensation and firm performance. To test the model, figure 3 demonstrated a framework for futuristic research.

5 Discussion

Agency conflicts are one of the major dilemmas, which firms are facing these days all over the world. Therefore, researchers are continuously proposing the innovative solutions for this problem. This study is a conceptual review, observed with the support of prior studies. The studies shows that stronger pay-performance link is significant to mitigate agency conflicts but in the under developed or developing companies where these conflicts are more severe, pay-performance link is either weak or non-existence, e.g. Kenya (Aduhu, 2011), Pakistan (Anjam, 2011), Brazil (Krauter & de Sousa, 2013) and vice versa. Furthermore, in most of the countries, CEO compensation is aligned with firm size. However, it is
not a good indicator as Jensen (1986) purported that propensity to grow firm size by executives is related to agency conflicts. This argument was further elaborated by Darrough, Guler and Wang (2014). They argued that executives involve themselves in empire building by enhancing firm size through large targets. Therefore, it can be assumed that firms should not solely align their CEO’s compensation with firm size. In addition, previous studies also pointed out investment or growth opportunities as a crucial determinant of CEO compensation, however, researchers have not yet verified the effect of market share on CEO compensation as companies are also aligning the compensation of their CEOs with market share, e.g. General Motors (Phillips, 2014).

The role of corporate governance is important in case of CEO compensation; nevertheless, few studies have focused on its moderating role. Moreover, moderating role of corporate governance is almost non-existent in previous literature. Pertaining to the ownership structure, the role of family, institutional and foreign ownership could be varies culture to culture. Prior studies shows positive role of these ownership structures between firm performance and CEO compensation though they should be validated further on different markets. Moreover, moderating role of these ownerships should also be tested with other determinants of CEO compensation. Researchers also ensured the role of board characteristics in the perspective of CEO compensation, e.g. it is believed that independent directors can resolve agency conflicts but CEO duality and larger board size can further create disputes between shareholders and agents or minority shareholders and majority shareholders. Therefore, moderating role of these board characteristics with the determinants of CEO compensation should be verified for extensive empirical evidences.

Pertaining to the matter of agency conflicts, researchers observed that efficient dividend policy could play a vital role if corporate governance is not stronger in a firm. Cash flow hypothesis and Bhattacharya’s model support this argument but the study by Emerenciana (2012) on dividend paying and non-dividend paying firms have revealed contradictory results. According to the study of Emerenciana (2012), dividend-paying firms pay higher compensation to their CEOs and there is more rent extraction culture in these firms. However, further study is required for the moderating role of dividend policy with the determinants of CEO compensation as demonstrated in figure 1.

One more issue regarding excessive risk taking has risen in this paper. Shareholders pay their CEOs high due to their quality of finding and investing in profitable opportunities or positive NPV. Nonetheless, in the parallel world, CEOs take excessive risk, which can decline the firm performance. Through prior studies, the issue of excessive risk taking in the greed of elevating compensation has observed. Therefore, it is assumed that inclusion of risk taking can change the relationship between CEO compensation and firm performance. According to authors’ best knowledge; prior studies have omitted the moderating role of risk taking between CEO compensation and firm performance as illustrated in the figure 3.

6 Conclusion

It is concluded that agency conflicts backed by excessive CEO compensation are affecting the firms negatively. This conceptual review proposed different models to test for futuristic research to mitigate agency conflicts from the firm. Along with conventional determinants of CEO compensation, we have a new determinant, market share, has been proposed in the study to validate its effect on CEO compensation in different markets. Moreover, this study anticipated the moderating role of corporate governance, dividend policy and risk taking, with the help of previous academic literature, which should also be verified with the help of different stock markets in the world to ensure their effects in mitigating agency conflicts from the firms. Overall, it concludes that strong corporate governance and efficient dividend policy can reduce
agency conflicts and constrain the excessive CEO compensation. Additionally, it is also suggested that there should not be excessive and abnormal risk taking which could affect the firm performance negatively. This study provides enough room for future research.

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