Firms that purport to value shareholders pay CEOs more, study finds

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Ever wonder why CEOs at poorly performing companies continue to receive exorbitant pay packages? According to a study from a University of Illinois labor professor, firms that trumpet how much they value shareholders actually pay their CEOs more, regardless of the quality of their performance as executives.

Using compensation data from 290 chief executives at large U.S. firms over an 11-year period, Taekjin Shin, a professor of labor and employment relations at Illinois, shows that CEOs at firms with the appearance of a "shareholder-value orientation" receive greater compensation in the form of higher pay and greater stock options.

"You would expect that if a company has espoused the principle of shareholder-value maximization – that is, focusing solely on maximizing the financial returns for investors through corporate governance mechanisms – then executive compensation should be less, and sensitivity toward the overall performance of the firm should be greater," Shin said.

But the study, published in *The Economic and Social Review*, finds empirical evidence to the contrary, Shin says.

"All these sorts of corporate governance mechanisms intended to curb excessive pay and constrain CEO influence over the pay process is actually working in reverse," he said. "And not only has it failed to work, it provides chief executives with further justification for greater pay."

Moreover, when firms strengthen the appearance of having a shareholder-value orientation, CEO pay increases the subsequent year, suggesting that firms tend to adopt monitoring and incentive-alignment governance mechanisms in order to gain the appearance of shareholder-value orientation rather than to curb executive compensation, Shin says.

"All sorts of structural appearances by the firm, such as having more independent board members and a greater level of institutional investor ownership – those kind of things are well-intended but ultimately don't amount to much," he said. "It creates the appearance to outsiders that the firm is really following the mainstream model of corporate governance."

According to the study, by employing such symbolic management tactics, top executives earn greater legitimacy, a better reputation and a higher valuation of both the firm and executive talent.

The findings also suggest that executive compensation has played an important role in providing incentives for top managers to make strategic decisions that conform to the shareholder-value maximization principle.

"We've known for decades that CEOs have tremendous power and influence over the corporate world," Shin said. "But it's only been from the 1980s onward that shareholders have begun to take a more activist role in publicly-traded companies. One would expect that with all these kinds of changes and the empowerment of shareholders, the CEO would probably have lost both power and pay, or at least their influence over their pay. The evidence suggests that the opposite has happened, which is kind of a paradox."

Shin chalks it up to CEOs, already politically-savvy insiders, knowing how to "game the system."

"They know that the dominant paradigm right now is shareholder maximization and that shareholders are king, so they say, 'Let's at least have a smokescreen of serving them by instituting all sorts of changes in the board of directors, in compensation policy and stock options,' " Shin said. "But those reforms are often just a fig leaf, and

serve CEO interests by further justifying their hefty compensation packages."

By carrying the flag for shareholder value, chief executives have diverted corporate resources and profits away from traditional business lines toward finance-related activities such as mergers and acquisitions, leveraged buyouts and stock repurchases – what Shin calls the trend toward the "financialization" of the U.S. economy.

"Fundamentally, the principles of business decisions have changed," he said. "Prior to what I call the 'Shareholder Value Revolution,' a lot of business decisions, including mergers and acquisitions, and diversification, had been based on sound business logic in terms of efficiency and operation. And society in general, including investors, trusted CEOs to make sound business decisions based on the long-term fiscal health of the firm."

But all of that changed during frenzied leveraged buyouts of the 1980s, which served as a wake-up call for executives to start thinking differently.

"From that point forward, it became, 'Publicly traded corporations should think about one thing and one thing only: Maximize shareholder value,' " Shin said. "Once we focus on that, everything else will be taken care of – products will improve, efficiencies will be realized. And to ensure that the CEO focuses on that, a board of directors would typically tie part of a CEO's compensation to the firm's share price through stock options and stock grants. So you have a board of directors who are independent and vigilant enough to make sure the CEO is doing the right thing, and outside investors powerful enough to influence the CEO's behavior so that they focus on the one thing that matters – shareholder value."

In the aftermath of that epoch, the decision-making process for executives became more and more focused on financial interests, funneling attention away from traditional business interests in operations, innovation, research and development, and human capital, Shin says.

"Now everyone is shifted toward profits – profits strictly in terms of shareholder value," he said. "That's been a fundamental change, because that impacts what kinds of decisions executives make and what kinds of incentives they have. And the CEOs who are rewarded for doing this not only accrue great wealth, they also receive acceptance and praise from the business community."

The study also considers what effect the shareholder-value revolution has had on other countries, including those more prudent countries that were on the other side of the executive-compensation spectrum.

"Until the Great Recession, just about everyone held up the corporate governance system in the U.S. as a shining example of how publicly-traded corporations should be run," Shin said. "Even famously stingy countries like Germany and Japan had begun to adopt the U.S. model. But then the recession and credit crisis hit. So it's an interesting time in history – the U.S. has exported the system, but it continues to struggle. There's a lot of finger-pointing at too much risk-taking in the short-term, and how the manipulation of stock prices has really gotten us into this mess, so everyone is really hesitant to adopt the U.S. model."

More information: "CEO Compensation and Shareholder Value Orientation Among Large US Firms," *The Economic and Social Review*, 2013.

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