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© Academy of Management Journal
2010, Vol. 53, No. 5, 1029-1049

AGENCY THEORY REVISITED: CEO RETURN AND SHAREHOLDER INTEREST ALIGNMENT

ANTHONY J. NYBERG
INGRID SMITHEY FULMER
University of South Carolina

BARRY GERHART
MASON A. CARPENTER
University of Wisconsin-Madison

Agency theory suggests that managerial mischief may occur when the interests of owners and managers diverge and that a solution to this agency problem is alignment of owner and agent interests through agent compensation and equity ownership. We develop the theoretical concept of CEO return and measure and estimate financial alignment as the relationship between CEO and shareholder returns. Our results, based on this new conceptualization and corresponding measurement, suggest stronger alignment than reported in previous work. The magnitude of this alignment is associated with subsequent firm performance, but in ways not clearly articulated or tested in prior research.

Agency theory suggests that there is potential for "managerial mischief" (Dalton, Hitt, Certo, & Dalton, 2007: 1) when the interests of firms' owners and managers (agents) diverge; one posited solution to this "agency problem" is that firms align owner and agent interests through agents' equity ownership and the structure of their compensation (Fama & Jensen, 1983b; Jensen & Meckling, 1976). Such incentive alignment involves two related components: (1) financial alignment, whereby an agent's economic rewards covary with those of owners through ownership and/or compensation and (2) alignment of preferences and actions, whereby the agent's preferences become more aligned with those of owners, and the agent's choice of actions, though still motivated by self-interest, are more consistent with owner interests. How financial alignment is created (e.g., through the use of outcome-based contracts, stock options, etc.), however, may also affect agents' risk preferences, causing them to make either riskier or less risky decisions than is optimal from the shareholders' perspective.

Although management researchers exhibited early optimism about the potential for agency theory to further understanding of organizational behavior (cf. Eisenhardt, 1989), this enthusiasm is clearly waning. Management researchers increasingly question the validity of agency theory as it pertains to financial alignment and the alignment of managerial preferences and actions. Summarizing this view, Dalton et al. stated that "the evidence regarding chief executive officer (CEO) compensa-

tion as a monitoring mechanism remains unsettled" (2007: 18). Two meta-analyses of CEO compensation studies generated much more pointed criticism. "Incentive alignment as an explanatory construct for CEO pay is weakly supported at best," wrote Tosi, Werner, Katz, and Gomez-Mejia (2000: 329); and Dalton, Daily, Certo, and Roengpitya (2003), citing a negligible relationship between CEO equity ownership and organization performance, similarly concluded that there is little evidence to support agency theory's emphasis on alignment of financial interests and of agent preferences and actions through equity ownership.

The uncertainty and skepticism about the incentive alignment predictions of agency theory has been accompanied by the development of alternative sociological and sociopolitical theories of CEO pay. For instance, focusing primarily on financial alignment, Tosi stated that "managerial power dominates the nature of CEO compensation" (2005: 485); he compared those who continue to believe that U.S. CEOs have strong pay-for-performance incentives (e.g., Core, Guay, & Thomas, 2005) with those who resisted the idea that "the earth is round, not flat" (2005: 485-486). Admittedly, theories are supposed to fit patterns in data, and at some point, misfit should lead to rejections or revisions of the theories (Fetterman, 1989). At the same time, empirical anomalies (Kuhn, 1970) are meant "to enhance our ability to challenge, rethink, and illustrate theory" (Alvesson & Kärreman, 2007: 1265). Agency theory may not tell the whole story, but its propositions about alignment remain an important

1029

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JOURNAL ARTICLE

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The Academy of Management Journal

Vol. 53, No. 5 (October 2010), pp. 1029-1049 (21 pages)

Published By: Academy of Management



<https://www.jstor.org/stable/20788807>

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Abstract

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