

# Directors' Incentives and Corporate Performance

Anish Shah

Vice President, Strategic Development, GE Capital

and

Shyam Sunder

Carnegie Mellon University

## Abstract

We examine the effect of the incentives of the members of the board of directors on shareholder wealth, CEO compensation and the sensitivity of this compensation to corporate performance in laboratory setting. Two methods of appointing the board, one by the CEO and the other by the largest shareholder, constitute the main treatment. The board sets the compensation for the CEO, who makes production, investment and dividend decisions for the firm. The investors receive information about dividends, earnings and capital of each firm, and use this information to manage their portfolios by buying and selling shares in these firms.

We find that the sensitivity of the pay-performance link increases with the fraction of equity owned by the directors. Further, the wealth generated in the economy as a whole, as well as the shareholders' part of this wealth, is greater when a large shareholder serves the role of the board of directors; when CEOs choose the director, outcomes are less efficient. Implications of these findings on the role of directors and associated agency costs; on accounting standard setting, especially with regard to accounting for options; on limits to executive compensation; and on standardization of reporting requirements are discussed.

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