Understanding board remuneration committees

A submission to the Productivity Commission

Dr Savo ('Sam') Kovačević

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Introduction

The Productivity Commission's inquiry into director and executive remuneration is timely. Examinations of rewards for corporate officers often draw attention towards the recipients of those rewards rather than the *processes* and the *antecedents* that shape the rewards. In addition, the oft-cited theories that explain or justify executive rewards are taken as granted and escape scrutiny. Agency theory, for instance, describes the separation of ownership (i.e. shareholders) and control (i.e. managers) in modern corporations. Despite its wide acceptance, such a theory can be challenged when we consider that many executives' packages involve an element of share ownership, thus blurring the line between owners and managers.

This submission critically reviews, analyses and synthesises the literature relevant to executive remuneration committee processes. This submission provides a comprehensive overview of the literature and identifies a number of key issues that prompt questioning of executive salaries.[1]

Corporate governance

Before commencing an analysis of remuneration committee dynamics, an evaluation of contemporary corporate governance issues and the precedents which led to this current focus on corporate behaviour is required. This section briefly covers some of the issues, both in Australia and overseas, which have affected and continue to affect executive pay.

Although the management of the corporation constantly remained an issue of high priority since the emergence of the joint-stock company, it is possible to attribute points of heightened interest or scrutiny to particular periods in the last century. For the purposes of this submission, the period including and following the 1980s through to the beginning of the 21st century will receive the most attention.

The 1980s is seen as a useful starting point when discussing governance and salaries, as it is described as a period when nations became 'business conscious'. In the United States, phrases such as 'insider trading', 'shareholder disputes' and 'hostile takeovers' became commonplace in wider society. Indeed, the 1987 Conference on Issues and the Media found that corporate governance was a *Top 10* issue in 18 of their 26 bi-weekly reviews (Cochran & Wartick, 1988). Towards the end of this decade, North Americans had experienced the Black Monday stock market crash, the Texaco/Pennzoil suit (Cutler & Summers, 1988), insider trading, a number of hostile takeovers and the introduction of anti-takeover legislation, among other episodes. More recently, North Americans have been following the financial crises of Enron, WorldCom and Xerox (Spiegel & Michaels, 2002; Thomas, 2002). More often than not, scrutiny would be directed towards the management and directors of the companies involved (Indjejikian, 1999).

Similarly, Hilmer's (1993) *Strictly Boardroom* makes continuous references to the Australian business climate in the 1980s. His book initially questions whether or not regulation – a recurring theme in the corporate governance debate – could have played any significant role in decreasing the magnitude of some of the corporate collapses preceding the early 1990s

[1] Dr Savo ('Sam') Kovačević is a lecturer in Organisational Behaviour at the Australian School of Business, University of New South Wales. This submission draws from his doctoral dissertation, completed at Monash University under the supervision of Professor James Sarros. The views expressed in this submission are his own and do not necessarily reflect those of UNSW or Monash University.

recession. Sykes (1996, p. 5) paints a colourful picture of the period, but the sentiment is not unique:

> The corporate booms and busts of the 1980s were the greatest ever seen in Australian history. The boom saw a bunch of corporate cowboys financed to dizzy heights by greedy and reckless bankers. Large sectors of Australian industry changed hands. Ownership of the major brewing and media companies changed completely . . . Alan Bond built an enormous empire on debt and creative accounting . . . At the end, investors were left excoriating corporate cowboys such as Alan Bond, Christopher Skase and Laurie Connell . . . What was truly abnormal about the 1980s was the extent to which they were able to lay their hands on money. Never before in Australian history has so much money been channelled by so many people incompetent to lend it into the hands of so many people incompetent to manage it.

While events in corporate Australia were not often on the same scale as in North America or Western Europe, there were a number of cases which crystallised the corporate governance debate. One such case is commonly referred to as the *AWA* case.

In *AWA Limited v Daniels t/as Deloitte, Haskins & Sells & Ors ('AWA case', 1992)*, AWA, a large Australian electronics manufacturer and trader, sued its auditors for alleged negligence in not alerting the management of the inadequacy of internal controls on foreign exchange deals. As a consequence of lax controls, AWA sustained considerable losses in prior deals. The auditors counter-claimed against the company by asserting that the negligence of AWA's directors and others contributed to those losses.

Chief Justice Rogers was required to define and apply standards to a number of stakeholders – in this case, the auditors, the directors, the chairman and senior management. Although there was a wealth of legal and managerial cases and commentaries, Justice Rogers found that the generalities from this body of law were difficult to apply ('AWA case', 1992, p. 274):

> The division of responsibility of directors, auditor and senior management, is not sufficiently clear. The focus is almost entirely on defining the responsibilities of directors. Yet the commercial reality of the matter is that, in these days of conglomerates and perhaps trans-national conglomerates at that, the opportunity for non-executive directors to exercise meaningful control over management is as slight as the ability of ministers to control a vast bureaucracy.

Cases such as AWA also fall into the audit expectation gap debate, which continues to be an integral part of the corporate governance sphere. The gap has emerged due to differences between auditors' understanding of their functions and the expectations of investors and creditors of the auditors' role. Three areas of particular interest to auditors are: (1) detecting fraud and reporting it; (2) detecting illegal client acts and reporting them; and (3) reporting when there is uncertainty about the ability of an entity as a going concern (Porter,1993). Audit issues are beyond the scope of this submission, however Pacini, Hillison, Alagiah, & Gunz (2002) provide a robust coverage of auditor liability in the U.K., Canada, Australia and New Zealand.

Corporate governance issues both in Australia and overseas received considerably more attention during the 1990s and are discussed further in this submission. It is worth noting at this point, however, that levels of share ownership in Australia had increased markedly in the late 1990s and the early 2000s. The Federal government's privatisation policies for some of the largest public assets resulted in Australia having the highest level of share ownership in the world. In a survey which measured share ownership levels in Australia, the U.S., New Zealand, the U.K., Canada and Germany, the Australian Stock Exchange found that 41 per

cent of Australian adults had direct ownership. This figure rose to 54 per cent when all forms of share ownership are taken into account (Australian Stock Exchange, 2000a). A similar survey conducted the following year found that the ownership levels remained stable, with 40 per cent of adults owning shares directly and total ownership was represented by 52 per cent of adults (Australian Stock Exchange, 2000b). Total share ownership would decline slightly over the next two surveys to 51 per cent in 2003 (Australian Stock Exchange, 2003). With the proportion of adult Australian shareholders rising, scrutiny and debate over collapses such as HIH, One.Tel and Harris Scarfe, where combined total losses have been estimated to be $5 billion (Simson, 2001), was guaranteed to be higher than ever before.

The view of corporate control in *AWA* contrasts somewhat with the agency theory rationale, which is discussed in later in this submission. Nevertheless, it also serves to illustrate the inherent difficulties involved in understanding and applying corporate governance issues such as accountability, transparency and disclosure to a contemporary business context. These issues are examined in the following section.

Focus on remuneration committees

This following parts of the submission pay particular attention to remuneration committee practices, both prior to and following the proliferation of codes of best practice and regulation. The impacts of economic climate on remuneration committee decisions and executive reward packages are also considered.

Remuneration committees

The previous section examined some of the broader corporate governance issues. International issues were discussed and Australia's recent history of corporate governance reform as a reflection of developments overseas was outlined. This section adopts a narrower perspective by concentrating on one corporate governance mechanism – the executive remuneration committee. The general nature of remuneration committees is discussed first by looking at their purpose, composition, processes and disclosure requirements. A focus on remuneration committees in Australian companies then follows.

Rationale for and purpose of the committee

To understand why remuneration committees are established and what they do, it may be useful to note how boards perceive the basic functions of their respective committees. In his survey of the *Times Top 100* companies, Sheridan (1993) found that 'remuneration committee' was the most common name employed. Other companies used names such as 'compensation committee', 'senior emoluments committee', 'chairman's committee' and 'the standing committee on corporate governance' which addressed both audit and remuneration issues. The pharmaceutical company Wellcome had two committees: one for executive packages and the other for the chairman's reward packages.

The task of comprehending executive pay generally and executive remuneration committees specifically, is not simple. As Stelzer (2000, p. 1) explains, '. . . the chore of explaining and defending executive compensation is being made more difficult than need be by some corporate governance practices in need of reexamination'. In addition to the perceived burden of excessive and perhaps onerous expectations placed on remuneration committees, groups as diverse as governments, superannuation funds, activist investors and academics are also placing committees under increasing pressure to show relationships between the packages awarded to executives and the performance of their respective companies.

Remuneration committees or, more precisely, their members, become the connection between the influences broached in the previous paragraph and the executive's reward (Gregg, 2001, p. 41): ‘All such factors make executive compensation packages very difficult to determine and underline why, in the end, such decisions are often wisely left to the market’. More fundamentally, especially in the case of director rewards, Williamson (1985, p. 313) believed that the absence of a separate remuneration committee meant that directors would ‘appear to write their own contracts with one hand and sign them with the other’. In a similar vein, John Kenneth Galbraith (Cox & Power, 1991, p. para 1) wrote that:

> The salary of the chief executive of a large corporation is not a market award/or achievement. It is frequently in the nature of a warm personal gesture by the individual to himself.

Lublin (1999) also describes several instances in which the distance between the chief executive and the packages awarded to them is less than arms’-length. She also cites the efforts of activist investors and organisations such as the U.S. AFL-CIO to remove CEOs from their own remuneration committees.

The mere proliferation of codes of best practice has not been the sole or dominant driver of the adoption of remuneration committees. Main and Johnston (1993, p. 352) took a broader view:

> The complexities of present day remuneration packages demand a degree of expert knowledge and specialised information. If pay is to be linked to performance then it seems wise to give some attention to this detail, and it also seems wise that the dominant perspective on such matters comes from those who most obviously represent the shareholders, i.e., the Board and the non-executives in particular.

Despite contributions to public debate such as the *Cadbury Code* (Cadbury, 1992) and *Strictly Boardroom* (Hilmer, 1993), Conyon (1997, p. 104) believed that, apart from knowing that directors' pay is set by a remuneration committee, there was very little further evidence about the way remuneration committees actually operated. Advances have since been made. Annual reports now disclose the committees’ membership composition, the mix of executive and non-executive directors, the frequency of meetings and who else attends commitee meetings.

Committee membership and composition

Accepting the need to understand the intricacies of the remuneration committees and following on from previous studies,[2] Newman and Mozes (1999) examined how the composition of the committee influences CEO compensation practices in U.S. *Fortune 250* firms. Specifically, the study was interested in the respective influences of directors who could be cast as either ‘insiders’ or ‘outsiders’. Newman and Mozes (1999) adopt an interpretation of the insider director which is similar to the ones employed by Byrd and Hickman (1992). ‘Insiders’ were defined as ‘any compensation committee member who is likely to be positively biased in determining CEO compensation (Newman & Mozes, 1999, p. 42).

In the prescription of optimal remuneration committee compositions, codes and guidelines would often advocate that the committees were either solely or mainly comprised of non-executive, independent, or outsider directors. The rationale behind the recommendation for at least a majority of non-executives appeared to be based on the widely-held belief that a

[2] The studies include those conducted by Brickley, Coles, and Terry (1994), Brickley and James (1987), Byrd and Hickman (1992), Rosenstein and Wyatt (1990) and Weisbach (1988).

committee populated largely by directors who had strong relationships with the firm were also likely to be associates of the CEO (Crystal, 1991; Lowenstein, 1994; and Zajac & Westphal, 1994). Such relationships could be considered to be significant in the awarding of above-average salaries to CEOs. The social aspects of CEO-remuneration committee relationships has been discussed in studies by Belliveau, O'Reilly, and Wade (1996) and O'Reilly et al. (1988) and are discussed further later in this submission.

Analysing a sample of 105 *Fortune* 500 firms from the mid-1980s, (O'Reilly et al., 1988) found that approximately 65 per cent of remuneration committees were comprised of current or retired CEOs (see also, Kesner, 1988). Studies such as Conyon and Peck's (1998) have shown that the proportion of non-executive directors on remuneration committees has increased since the early 1990s. Two main factors could be attributed to this development. First, reports such as the U.K. *Cadbury Code* advocated the benefits of excluding executives from the executive reward process. Second, the 'flow-on' effects from the disclosure of corporate governance practices in annual reports allowed companies who were initially slow to adopt best practice recommendations to alter their practices more quickly.

Newman and Mozes (1999) found that CEO compensation practices were not necessarily more favourable for the CEO when insiders were a part of the remuneration committee. These results agree with the conclusions from Daily et al.'s (1998) study of *Fortune 500* companies, where greater numbers of 'captured' directors[3] did not lead to greater levels of, or changes in, CEO remuneration. Newman and Mozes' (1999) findings are consistent with those of Main and Johnston's (1993, p. 358) in which the presence of a firm's highest-paid director as a member of the remuneration committee did not justify the 'natural alarm at seeing executives sit on the committee that determines their own pay'.

However, O'Reilly et al. (1988) found that the appointment of a highly-paid executive as an outside member of the board would lead to a rise in the pay of the company's CEO. Anderson's (1997) study observed 50 CEOs who sat on their remuneration committees (and were subsequently removed). The pay from the respective firms was compared to a control sample. Based on data from company reports from 1985 to 1994, Anderson (1997) found that CEOs who sat on their own committees received lower levels of pay and had a tendency to have high levels of share ownership. This behaviour is more typical of an owner-manager than the self-interested, risk-averse agent often described in agency theory. Agency theory is discussed in shortly.

Committee roles and processes

To better understand the size and structure of executive pay packages, it is useful to also understand the processes involved in the design of executive pay. One common view of the remuneration committee process is that it is highly collusive. The prominent U.S. remuneration commentator Graef Crystal believes that there is 'a great opportunity for collusion,' and that there is 'a lot of evidence of collusion' (as cited in Cox & Power, 1991). Cox and Power (1991, p. Is the process fair?) further illustrate this contention:

> It's the job of the board of directors to recruit top executives – but the board, in turn, relies upon compensation specialists, executive search firms, and human resource professionals whose interests are all closely tied to the CEO's. Headhunters, or executive search consultants, for example, are generally paid a percentage of their candidates' pay – giving them a direct interest

[3] In Daily et al.'s (1998) study, 'captured directors' include 'affiliated directors', 'interdependent directors' and 'CEO directors'.

> in keeping compensation high. Human resource people work for the CEO, so their future with the company is tied to that of the boss. Even the surveys of CEO pay compiled by compensation specialists tend to be skewed upward – because companies that respond don't want to appear miserly and impair their ability to recruit and keep talent.

Ezzamel and Watson (1997, p. 73) proposed that 'a "cosy collusion" exists between executive and non-executive directors, who sit on each other's remuneration committees and thereby bid up executive earnings'. Crystal (1992), Earle (1989) and Hermalin and Weisbach (1988) have also questioned the veracity of the remuneration process. The sentiment described above is not novel, given that the functioning and composition of boards has also come under suspicion from some arenas (Davis & Kay, 1993, p. 200):

> Imagine a system of government in which there are annual elections, but these are almost never contested. Whenever they are, the incumbent government wins by an overwhelming majority. All the information about the state of the nation which the voters receive is controlled and distributed by the government and is glossy and self-congratulatory in tone. Changes in the senior leadership do take place, normally through an orderly process of retirement in which incumbent leaders select and groom their successors. Occasionally there is more violent change. Sometimes this takes the form of an internal coup d'état. Or it may occur as a result of the intervention of the hostile government of another state. This is not a description of Eastern Europe before perestroika and glasnost. It is a description of the system by which public companies in Britain are controlled and governed.

Following the release of the *Cadbury Code*, Main (1993) conducted a series of 24 interviews with senior executives at some of Britain's largest firms in order to improve the understanding of board practices and processes in setting executive pay. Main (1993) concluded that the popular view of pay processes overrun by 'cronyism' could not be substantiated. As for the claim that external parties such as remuneration consultants were driving up the rates for executive talent, Main (1993) offered the following explanation. Committees (and their members) found themselves caught between senior management, to whom they owed their appointments as non-executives, and the shareholders and the public, who carefully watched executive salaries. The compromise, therefore, was to pay the 'going rate' often published in remuneration surveys. Bates (2002) adds that developing and fostering links with the human resources, legal and finance functions of the company is growing in necessity as firms adopt multidisciplinary approaches not only to their corporate governance systems, but to a number of their other activities as well. The move towards broader understandings as to what constitutes good practice appears to be consistent with the growing interest in organisational stakeholder research.

Disclosure issues

The disclosure of executive salary packages has always been, and continues to be, a sensitive topic. The recent trend towards transparency in the remuneration process under the auspices of best practice and regulation may have created as many problems as it has attempted to solve. Disclosure requirements affect several aspects of the remuneration process. Companies are now expected to disclose if they have a remuneration committee or a similar instrument; the composition of the committee, as well as details of its individual members; the number of times the committee meets in a financial year; the size and composition of the packages that the full board has accepted, as well as who will receive the rewards and the rationale that underpins the company's remuneration process.

Despite the pressures associated with increased disclosure, companies have attempted to comply with what has often been promoted as best practice. Main (1993) and Main and Johnston (1993) reported that only 30 per cent of a sample of 220 British companies reported the existence and composition of a remuneration committee in their 1990 annual reports. Main's (1993) study of a smaller sample found that 17 of those companies reported their respective remuneration committee memberships. However, it was noted that the *existence* of a remuneration committee and its *disclosure* were separate issues. A survey conducted at about the same time by Sheridan (1993) found that 11 out of 100 British companies surveyed did not disclose the presence of a remuneration committee. Conyon (1994) studied changes in the prevalence of audit, remuneration and nomination committees in quoted U.K. companies. He found that the proportion of companies reporting a remuneration committee had risen from 54 per cent to 94 per cent between 1988 and 1993. Conyon and Peck (1998) would later find that at least nine out of ten Financial Times Stock Exchange (FT-SE) companies reported remuneration committees.

Compared to the U.K., remuneration committees in U.S. companies have been more prevalent. Worthy and Neuschel (1984) found that almost 90 per cent of *Fortune 500* companies had a remuneration committee by the early 1980s. Byrd, Johnson, and Porter (1998) investigated the motivations behind a company's decision to disclose remuneration practices. From a cost/benefit perspective, Byrd et al. (1998) reasoned that companies would be more likely to disclose their practices when (1) there was a high level of stakeholder concern about the company's reward policies; (2) when the remuneration policies were defensible; and (3) when the company's internal governance structures were effective. A common part of the remuneration process is to employ peer comparisons, or to base pay practices on firms which are perceived as similar in some way. Byrd et al. (1998) found that only 10.3 per cent of their Standard & Poor's 500 sample voluntarily disclosed the peer group used by the boards' compensation committees. The reluctance to fully disclose remuneration practices was investigated by Park, Nelson, and Huson (2001), who found that increased disclosure in Canadian firms led to, among other responses, increases in executive pay in order to remain competitive for executive talent.

Murphy (1999, pp. 24-25) counters the findings of studies such as the ones conducted by Byrd et al. (1998) and Park et al (2001) by offering explanations for some of the popular conceptions of remuneration committees. On the premise that committees are beholden to external consultants (Cox & Power, 1991), Murphy (1999) suggests that most pay data and pay recommendations will initially come from the company's human resources department and will then be sent to senior management for approval and revision before being proposed to the remuneration committee. He adds that the remuneration committee, which is often staffed by directors who have limited experience in the intricacies of executive pay design, and meet between six-to-eight times a year, are more suited to performing oversight and enforcement roles with respect to a company's pay systems and shareholder interests. Murphy (1999) concedes, however, that the committees will often err in favour of the CEO when recommending packages for the full board's approval. While the differences between any two options may be considered inconsequential, they do have implications for the 'ratcheting-up' of pay, an effect that is discussed by Clarke, Conyon, and Peck (1998), Park et al. (2001), Sheridan (1993), Surowiecki (2002) and Wilson (1999). In their survey of 342 company chairmen in the U.K., for example, Clarke et al (1998) found that 43 per cent of respondents

felt that the amount of remuneration disclosure required in annual reports and accounts had resulted in a ratcheting-up of directors' pay.[4]

Remuneration committee research in Australia

Despite increased levels of disclosure in the Australian business environment,[5] there is a paucity of research into remuneration committees in Australian companies. Most of the research conducted into executive pay appears to be performed by corporate and/or remuneration consultancies such as Towers Perrin, Korn/Ferry, Mercer Cullen Egan Dell, Hay Group, Recruitment Solutions (see, for example, Crichton, 2001) and Morgan & Banks (now known as TMP Worldwide eResourcing). The Australian Institute of Management (AIM), among other professional bodies, also conducts an annual *Salary Survey*. The surveys are either commissioned by the boards of Australia's larger companies, or are sold to them in some form or another by the respective agencies. Fund managers and shareholder groups also purchase the reports.

Henry Bosch (see, for example, 1995a, 1995b) and Fred Hilmer (1993) both played prominent roles in reforming Australian corporate governance practices in general during the first half of the 1990s. Organisations such as the Australian Shareholders' Association (ASA), the Australian Institute of Superannuation Trustees (AIST) and the Australian Council of Superannuation Investors (ACSI) have also critiqued and/or influenced governance developments during the 1990s and the early 2000s. Columnists from newspapers such as *The Australian Financial Review*, *The Australian*, *The Age* and *The Sydney Morning Herald* have also contributed to the corporate governance debate.

In the academic arena, among the most notable contributors are Holland, Dowling, & Innes (2001), O'Neill and colleagues (O'Neill, 1995a, 1995b, 1999; O'Neill & Berry, 2002; O'Neill & Iob, 1999), Ramsay (1997) and Stapledon and colleagues (Stapledon, 1996, 2002; Stapledon & Fickling, 2001; Stapledon & Lawrence, 1996). For the most part, O'Neill's and Holland et al.'s (2001) studies have focused on the nature of executive pay, while Ramsay's and Stapledon's work has been concerned primarily with changing board and corporate governance practices in Australian companies. Kiel and Nicholson (2003) and Nicholson, Alexander, and Kiel (2004) have studied board performance and social capital. The contributions of Carson (2002) and Cutting and Kouzmin (2002) have provided insights into board sub-committees. Tomasic and Bottomley (1993) also surveyed directors' thoughts on corporate governance changes in the early 1990s.

None of the contributions referred to above have focussed solely on executive remuneration committees in Australian companies. Exceptions to this oversight were once found in only a small number of newspaper articles by, for example, Chenoweth and Kitney (2000), Lekakis (2001), Mitchell (2000) and Stapledon (2001). Even then, it is arguable whether the articles did much to de-mystify the roles and activities of the remuneration committee (Chenoweth & Kitney, 2000, p. S3):

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[4] Officers occupying both executive and director positions in a company were more common in the U.K. than in Australia. Australian boards traditionally have had a majority of non-executive directors. See Stapledon (1996, p. 171).

[5] For further background on disclosure in Australian companies, see ASA (1999), Australian Stock Exchange (2001), Boreham (1999), Clarke (1999), Dunstan and Lewis (2001), Gettler (1999), Hurst (1998), Johnston (2001), Macfarlane (2001), Matheson (1996), Mitchell (2001), Ravlic (1999a, 1999b, 1999c, 1999d), and Stapledon (2001).

> Remuneration subcommittees, the bodies that determine how much executives take home, can be unpredictable. Sometimes their salary policies seem to reflect anything from management theory to internal politics, to something approaching random number generation. But they always seem to keep an eye on corporate rivals.

One study that did look into remuneration committees was the *Survey on Structure and Operation of Board Remuneration and Nomination Committees* (AIMG, ASX, & Business Council of Australia, 1993). It found that 73 per cent of Australia's 100 largest companies in 1993 had a remuneration committee, with 91 per cent of those committees having a majority of non-executive directors. These figures are reported by Stapledon (1996) to be somewhat higher than the findings of a subsequent study commissioned by the AIMA and the law firm Minter Ellison (AIMA & Minter Ellison, 1995).

Stapledon and Fickling's (2001) report, *Board Composition and Pay in the Top 100 Companies,* shed light on board dynamics and their relation to rewards. Similar and more recent studies have been conducted by ISS and RiskMetrics. Although the study does not directly examine the nature of remuneration committees, it does serve as a robust introduction into board compositions and demographics, the interlocking or overlapping roles of many non-executive directors and the relationship between pay and performance for some of the most highly-paid CEOs. With respect to non-executive directors, the study also manages to highlight the distinction between *non-executive* directors, *professional non-executive* directors and *independent* directors. Similar studies have been produced by (Institutional Analysis, 2001, 2003, 2004).

Another Australian study of interest to this research is that of Evans and Evans (2001), which examined whether the extent of control exerted by non-executive directors and their remuneration package impacted on the CEO pay decision. Like Daily et al. (1998) and Main and Johnston (1993), Evans and Evans (2001) found in their sample of 214 companies (drawn from the ASX's 1997 top 500 list) that remuneration committees which were predominantly comprised of non-executive directors did not have a significant effect on a CEO's pay level. Given the large number of corporate governance codes and publications on what constitutes good practice advocating mainly (if not completely) non-executive directors on remuneration committees, such results are contrary to expectations of tightened governance policies resulting in the deceleration of executive pay.

* * *

In order to develop explanations of executive pay and associated phenomena such as remuneration committees, researchers have developed and tested relevant theories. These theories and their respective applications and utilities, are discussed in the following sections.

Traditional theories in executive pay research

Traditionally, most research into corporate behaviour (both at macro and micro levels) has been borne out of economic theories of the firm. The traditional approach may apply especially in the areas of executive pay research as scholars have attempted to find correlations between managerial pay and firm performance. While this submission does not closely examine the explanatory potential of economic theories – Clarke's (2004) reader is more appropriate – this section does pay closer attention to some of the more widely discussed and analysed theories applied in executive pay research. It is argued that a review of

such theories, particularly agency theory, is beneficial in the understanding of remuneration committee behaviour.

Seminal research

Two works that are both considered seminal in executive pay research and are often cited are Taussig and Barker's (1925) *American Corporations and Their Executives: A Statistical Enquiry* and Berle and Means' (1932) *The Modern Corporation and Private Property*. Published prior to and following the Depression, both works examined the changing nature of ownership and control in U.S. companies, with Berle and Means' (1932) book also having the growing concentration of U.S. industry as a major theme. Respectively, the publications contributed to two major avenues of executive pay enquiry towards the end of the twentieth century: the relationship between pay and performance and the contractual nature of owner-manager relationships.

The background to Taussig and Barker's (1925, p. 2) research into pre-First World War American corporations is encapsulated at the beginning of their article:

> Until the latter part of the [19th] . . . century the bulk of business was in the hands of individual proprietors or partnerships. At present, in the undertakings of importance, corporations have displaced almost completely the personally owned and personally conducted concerns. The central figure of the old days was the individual "undertaker"; today we have the incorporated employer, the impersonal enterprise, the corporate unit. This at all events is the situation in the United States. Business, grown larger and more complex, is no longer personal, it is institutional. Incorporated industry under salaried managers is the order of the day.

Among other issues, the researchers sought to determine if the executives were also large stockholders and if the executives' motives mirrored those of the proprietor form of organisation. In their investigation into the link between executive salaries and capital growth and annual earnings, Taussig and Barker (1925, pp. 20,22) found that:

> Executive salaries are subject to few and infrequent changes. What movement appears in the individual cases is almost entirely upward . . . Poor management leads to a change in personnel, not a decrease in salary . . . There is hardly a sign in any instance that salaries are adjusted upward year by year upon the basis of annual earnings, and none that they are adjusted downward. While earnings show the ebb and flow of changing business conditions, the salaries of managers remain unchanged.

Subsequent research conducted by Garen (1994) and Jensen and Murphy (1991) again found weak relationships between pay and performance.

Berle and Means' (1932) *The Modern Corporation* can be described as influential (see, for example, Gomez-Mejia & Wiseman, 1997) in the development of the principal-agent models of Fama (1980), Fama and Jensen (1983) and Jensen and Meckling (1976). The agency problem was articulated by Berle and Means (1932, p. 25) as:

> The separation of ownership from control produces a condition where the interests of the owner and the ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear.

While *The Modern Corporation* enjoyed considerable respect for several decades, due in no small part to its description of the power shift from owners to salaried executives (Bratton, 2001; Linden & Rotenier, 1994; and McCraw, 1990), it also attracted sustained criticism in

later years.[6] The fiftieth anniversary of *The Modern Corporation*'s publication, for example, 'was memorialized by a 261-page obituary published . . . in the guise of a fiftieth-anniversary symposium' (Bratton, 2001, p. 737).

The appeal of Berle and Means' (1932) arguments also proved to be their undoing. For example, the view that executives would become increasingly powerful at the expense of progressively atomised shareholders was countered with the growing influence of institutional investors (and, consequently, the concentration of ownership), more rigorous corporate governance practices and the market's potential to remove underperforming managers. In essence, the contention that American industry would fall under the control of a relatively small number of individuals was the reverse with the prominence of organisations such as CalPERS and TIAA-CREF in the 1980s and 1990s. Bratton (2001, p. 756) assessed these changes in his review of *The Modern Corporation*:

> Shareholder value now sits atop management agendas. Managers who create value build reputations and careers. Managers who do not are deemed failures. Managerialism, the contra-norm against which Berle and Means wrote and which guided corporate behavior through the 1980s, has not disappeared. But it no longer is respectable if untempered by reference to the shareholder interest. Outcomes change in the shareholders' favor as a result. Self-regulatory strategies become more plausible. When considered in comparison to the costs and perverse effects of regulation, they even start to look attractive.

Although the explanatory power of the agency model is now questioned and research into pay-performance relationships continues to be problematic, the avenues of inquiry were central to research into executive pay at the end of the twentieth century. Agency theory and pay-for-performance research are given closer attention.

Agency theory

Research by Jensen and Meckling (1976), Fama (1980) and Fama and Jensen (1983)[7] are often credited as making important contributions to the understanding of owner-manager relationships. In her analysis of agency theory, Eisenhardt (1989) lists a number of the applications it has had since the 1970s. Researchers in accounting, economics, finance, marketing, political science, organisational behaviour and sociology have tested agency theory, or variants of it. In the corporate setting, the theory has been used to explain compensation, acquisition or diversification strategies, board relationships, ownership and financing structures, vertical integration and innovation.

Jensen and Meckling's (1976) agency model is the one perhaps most often utilised in executive pay research. In its simplest form, the model presents a single *principal* who is both the owner and claimant of profits and who employs an *agent* to manage the principal's economic resources. Principal-agent research is concerned with a general theory of the principal-agent relationship. Extended to corporations, the principal could represent a public

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[6] See, for example, Bricker and Chandar (2000), Leech (1987), and Rutherford (1992).

[7] Eisenhardt describes these three articles as 'particularly influential' (1989, p. 59):

> Jensen and Meckling (1976) explored the ownership structure of the corporation, including how equity ownership by managers aligns managers' interests with those of owners. Fama (1980) discussed the role of efficient capital and labor markets as information mechanisms that are used to control the self-serving behavior of top executives. Fama and Jensen (1983) described the role of the board of directors as an information system that the stockholders within large corporations could use to monitor the opportunism of top executives.

company's shareholders that, in the interests of maximising their wealth, have employed a manager (or, for the purposes of this study, a chief executive) to fulfil their objectives.

Agency theory and executive pay

While agency theory has found applications in a variety of fields (for a brief list of studies into agency theory during the 1980s, see Eisenhardt, 1989), this present study is more concerned with understanding agent-principal relationships in the contexts of board and remuneration committee interactions, as well the relationships between the CEO, the board and the remuneration committee.

Tosi and Gomez-Mejia (1989) believed that agency theory was generally approached in one of three ways. The first way is to use mathematical models to develop, test and support propositions (e.g. Fama & Jensen, 1983). The second method is to analyse shareholder concentration to draw conclusions about the level of monitoring or alignment of interests (e.g. Salancik & Pfeffer, 1980). The third technique is to draw inferences about agency effects from statistical relationships between pay and corporate performance measures (e.g. Antle & Smith, 1986). A fourth, direct, approach was added to this list by Tosi and Gomez-Mejia (1989) in which personnel involved in the executive pay process are surveyed.

Agency theory and pay-for-performance

The debate relating to the relationship between executive pay and firm performance has been a lengthy one, with little indication of resolution in the near future. Taussig and Barker's (1925) study, for example, found no significant relationship between pay and performance. This result has appeared frequently and consistently in hundreds of subsequent studies. Due perhaps to the reliance on economic arguments of efficiency, researchers are still finding that the results of their investigations into the link between pay and performance are inconclusive. Jensen and Murphy's (1990) study of a total of 10,400 years of CEO remuneration and performance data concluded that pay sensitivity for executives was approximately $3.25 for every $1,000 change in shareholder wealth. This was seen as '… small for an occupation in which executive pay is expected to play an important role' (Jensen & Murphy, 1990, p. 227).

Not satisfied with the findings of Jensen and Murphy's (1990) study, Garen's (1994) analysis of a simple principal-agent model (as described by agency theory) sought to test how far it could explain pay-performance sensitivity. Assuming that the CEO was a risk-averse agent and that shareholders were principals who held diversified portfolios leaving them subject only to the firm's systematic risk, Garen's (1994, p. 1180) results explained a small portion of the variance in sensitivity and found that the size of the CEO's firm continued to offer greater explanation.

While a majority of the studies focussed on the short-term relationship between CEO pay and firm performance, Boschen and Smith (1995) decided to investigate the long-term results of pay on performance by examining the link between cumulative pay and performance in 16 U.S. firms for the period 1948 to 1990. They found that long-term income effects were central to performance-based pay arrangements. That is, the future effects of good performance were found to be at least as important as the contemporaneous effects. This study forwarded three arguments. First, the cumulative response of pay to performance is roughly ten times that of the contemporaneous response. Second, one-time innovations in firm performance would raise pay over the next four-to-five years. Third, remuneration contracts have placed a greater emphasis on pay-for-performance over the four decades studied by the researchers.

Limitations of the studies

In spite of the continued trend by firms to align performance and pay, researchers and practitioners continue to be confounded by the weak or insignificant relationships between rewards and results. Researchers in recent years have continued to point to the most probable causes of divergence when discussing their results. Limitations in the study of pay-for-performance have included the researchers restricting themselves to samples of convenience such as lists of the top 500 companies like those published by *Fortune* magazine (Miller, 1995, p. 1382), or databases like COMPUSTAT. Concentrating on the largest firms excludes smaller firms – where firms may only be able to deal with the question of how much they can afford to pay, rather than how much the market demands – and limits the generalisability of the researcher's findings (Deckop, 1998). Other explanations offered by Gomez-Mejia (1994) for the disagreement between studies include different methods of data collection, different statistical analysis techniques, different time periods studied, the presence of different moderator variables, collinearity and different ways of operationalising constructs particular to a researcher's study (see, also, Gomez-Mejia & Balkin, 1992, pp. 177-178).

Criticisms of agency theory

Until the early 1990s, a relatively unchanged agency model was applied to the pay setting process. The principles of this model are simple. Fundamentally, it assumes that there is a separation of ownership and control. *Agents* (managers) are given incentives to maintain the interests of the *principals* (shareholders). To ensure that the shareholders' interests are aligned with those of the agent, the agent incurs *monitoring costs*. Monitoring costs (for example, the withholding of performance-related payments in periods of minimal or negative share price growth) are higher when the interests of the agent and the principal are not aligned. To reduce monitoring costs, the agent will incur *bonding costs*. This may include the cost of producing periodic financial reports for principals.

Agency theory was popular with accounting and microeconomic researchers in the 1970s and the 1980s. However, the failure of the model to describe the relationship between pay and performance meant that it would have limited application by itself in later years. Garen (1994, p. 1198), for example, decided that 'the overall explanatory power of the empirical model for pay-for-performance [was] quite low … [and remained] a puzzle in the analysis of executive compensation'.

Agency theory has been criticised for its limitations (see Beatty & Zajac, 1994; Eisenhardt, 1989; Jensen & Murphy, 1990; and Wiseman & Gomez-Mejia, 1998). Two of the criticisms are described in this review. First, it assumes that all actors make rational decisions. While this is convenient for economic models, psychology and behavioural theorists would suggest otherwise. Second, an assumption is made that there is no information asymmetry – all actors have full and free access to information to make well-informed decisions. Again, this is unrealistic and, at best, difficult. It is impossible for managers to know what returns shareholders seek. Conversely, shareholders will often be unaware of what managers are doing. In order to increase share prices in the short term, managers may defer spending on research and development projects or capital investment projects to other years. This has a positive effect in the short term (i.e. profits are high, share prices rise, shareholder wealth increases, managers receive higher pay), but will have negative effects for the firm and shareholders in the long term. Executive decisions, made in an environment characterised by bounded rationality and information asymmetries, will directly impact on the size and composition of reward packages recommended by board remuneration committees.

Perrow (1986, p. 224), who questioned the applicability of agency theory and related economic theories such as adverse selection and moral hazard, also forwarded his concerns with agency theory:

> Agency theory, unlike transaction-costs analysis, does not have a clear problem to which it offers a solution. It appears to reflect a concern with applying the most stark assumptions of economics – maximizing utilities, where net utilities are rewards (money) minus effort – to explain contracts and thus organizations. If such a minimalist assumption can cut through all the concepts, studies, and volumes of theory that organizational analysts have piled up, it will, as some of its proponents claim, "revolutionize" organizational theory. Its ambitions are large, but the theory is hardly subject to empirical test since it rarely tries to explain actual events or make predictions.

Fundamentally, it seems, agency theory dovetails neatly into capitalist and bureaucratic structures where self-serving behaviours may be expected to be more prevalent. However, the theory develops problems when it assumes that such behaviour is also inherently human and ignores neutral and other-regarding behaviours in functional organisations (Perrow, 1986). Professor Charles O'Reilly (Stanford University, 2002) has also been critical of 'elegant' economic models (such as tournament theory, described below) utilised in formulating executive reward packages.

Another perceived shortcoming of traditional accounting research was its tendency to conduct experiments in laboratory settings. Behavioural accounting research focussed on incorporating factors from the accountants' natural habitat so that their results would have more relevance to the business world and were more descriptive (Watts, 1995, p. 326). The early research followed psychology models and focussed on the effect of decision-makers' cognitive abilities and deficiencies on decision performance. The difference between the traditional laboratory-based approach and the emerging, more iterative methods of studying decision making was surprising. As Libby (1983, p. 79) noted, accountants and students (the typical subjects) were 'incredibly stupid' in an experimental room, but in their natural settings, accountants were able to perform complex tasks and students proved to be 'troublesomely cunning. A new approach to studying pay had become available.

Tournament theories

Tournament theory may act as a complementary or alternative theory to the principal-agent model. Drawing primarily from the work of Lazear and Rosen (1981) and Rosen (1986), Lambert, Larcker, and Weigelt (1993) offer a robust description of the theory. Tournament theory suggests that agents compete against one another for higher positions in the tournament hierarchy in a series of sequential elimination tournaments. In relation to executive pay research, executives will compete against one another at respective organisational levels. In relative terms, high-performance executives will be promoted to the next level, where the next round of competition begins. The more competitors there are for a higher position, the higher the prize is likely to be. The process of identifying and promoting relatively high performers is repeated at all but the top level, thereby allowing organisations to identify the best talent for the higher levels.

Executives who do not advance within the organisation will find their prospects for promotion adversely affected. Conversely, winning a tournament improves the executive's career advancement potential, as there is the opportunity to progress further in the tournaments and earn higher pay. However, as executives move into higher levels, the opportunity to be rewarded more options decreases. In agency theory terms, principals have to provide a

substitute for lost option value in order to obtain at least the same level of performance as the level from which the executive was promoted. To compensate for the diminishing value of options (and to continue attracting high performance competitors), higher salaries may be offered. The awarding of higher salaries prompts tournament theory to predict that remuneration is an increasing function of organisational level. At the final level, where there are no more prizes to be attained, CEOs require other incentives to remain motivated. Tournament theory predicts that there will be an extraordinarily large pay differential between the CEO and managers at the previous level (Eriksson, 1999; Lambert, Larcker, & Weigelt, 1991).

Where O'Reilly et al. (1988) found that tournament theory could not satisfactorily explain the pay differences between CEOs and vice presidents, Lambert et al. (1993) found that pay differentials were an increasing function of an organisation's hierarchy and that the differentials between contiguous levels increased for CEOs moving up the hierarchy.[8]

Subsequent studies by Conyon, Peck, and Sadler (2001), Eriksson (1999) and Walls (1999) found support for tournament theory's primary contention of a convex relationship between pay and organisational levels. However, evidence indicating larger prizes when there was a greater number of competitors for a position appears to be less than conclusive. While Main, O'Reilly, and Wade (1993) and Eriksson (1999) found a positive relationship between the size of the prize and the number of competitors, Bognanno (2001) in his study could not find such a relationship. The findings by Conyon et al. (2001) may have generally agreed with those of Main et al. (1993), but the increase in the CEO's pay by 3.5 per cent (compared to the median pay of the rest of the executive team) with the addition of each executive was not considered compelling evidence in the explanation of pay differentials between organisational levels. Alternative theories applied in the study of executive pay are discussed below.

Alternative theoretical constructs applied in the explanation of CEO pay

Rational economic man theories

Fundamental to the explanation of human behaviour in economic entities was the construct commonly referred to as the 'rational economic man' (also known as *homo economicus*). Common assumptions of rational economic behaviour include a desire to maximise utilities or gains, an aversion to risk or risk-seeking behaviour and a 'perfect' knowledge of market activity, i.e. a knowledge of all choices available to allow for optimal decision-making. While this may have been useful in the development of theoretical models and provided plausible explanations for and simplifications of complex economic phenomena, researchers continued to question the value of using the rational economic man model. Although the inherent assumptions of the model were few in number, they could also act as significant limitations on a theory's explanatory power. The rational man postulate could not find broad acceptance amongst social scientists. According to Zinam (1979, pp. 170-171):

> 'Economic man' behavior and maximization are plausible and applicable only under very strictly defined special conditions of predominantly free competitive markets operating in an economy which is an approximation to laissez-faire. Even under these conditions the motivation of entrepreneurs, as revealed in the works of Sombart, Max Weber, Schumpeter and some others

[8] Lambert et al. (1993) also found similar or analogous conclusions in Bognanno (1993), Bull, Schotter, and Weigelt (1987), Cappelli and Cascio (1991), Ehrenberg and Bognanno (1990a), Ehrenberg and Bognanno (1990b), Leonard (1990), Rosenbaum (1979) and Weigelt, Dukerich, & Scotter (1989).

> "include the desire for power, prestige, independence and security as well as the desire to maximize gain and utility".

Despite the prevalence of normative approaches to understanding and regulating economic behaviour, psychologists and sociologists continued to devise and employ more 'anti-rational' or 'holistic' embodiments of actors. Human behaviour would often deviate from the systematic pursuit of utility maximisation, as was argued in Kahneman and Tversky (1979). Williams and Findlay (1981) also refer to a number of studies that adopted less rigid models prior to the 1980s.

Recent support for moving away from 'an overdependence on idealized models of hyper-rationality' (Roth, 1996, p. para 3) has come from Kahneman and Tversky (2000), Kay (2000), Roth (1996) and Tversky and Kahneman (1986). Amos Tversky and Daniel Kahneman, in particular, were prolific proponents of cognitive psychology-based models for economic phenomena. While research in this area may have been of interest, it was not paid closer attention until the 1990s. Indeed, Nobel Prizes in economics have been awarded to theorists who studied *behavioural* economics.[9]

Kahneman and Tversky (2000) identified a number of human characteristics which demonstrated that people were less than entirely rational and were therefore more likely to make sub-optimal decisions. A summary of those characteristics is presented in Table 1. The possible manifestations of these behaviours in a remuneration committee are also included.

Roth (1996), although supporting a broader approach to economic actors, also discussed compromises between rational economic man and the models arising from psychology. He evaluates models known as 'risk neutral economic man', 'expected utility maximizing man', 'almost rational economic man', 'psychological man' and 'neurobiological man' as useful approximations in the study of economic phenomena.

In his study of executive pay (and, by implication, remuneration committee decisions), Platt (1987) evaluated neoclassical economic and concept formation perspectives of executive pay. The neoclassic model asserts that a CEO's pay has a positive relationship to the company's financial performance. Concept formation allows employees, after a number of experiences, to develop strategies to increase their earnings without a corresponding increase in productivity (see Cahill & Hovland, 1960; Hovland & Weiss, 1953). Extended to the remuneration committee, as the CEO acquires a better understanding of and possibly more control over the board, the CEO may be able to keep the board from considering or looking for other candidates for the executive role. The board's demand for the CEO's skills is therefore affected by the CEO's ability to influence the board's demand. Remuneration packages may therefore not reflect CEO performance. In his study, Platt (1987) found that executive remuneration appeared to be related to both productivity measures and measures of concept formation.

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[9] The 2001 Nobel Prize in Economic Sciences was awarded to George A. Akerlof, A. Michael Spence and Joseph E. Stiglitz. The 2002 Nobel Prize in Economic Sciences was awarded to Daniel Kahneman and Vernon L. Smith.

Table 1
Human characteristics countering the rational economic man model

Characteristic	Example
Fear of regret	Benefits are passed up even if there is a small risk of failure
Prone to cognitive dissonance	Holding a belief contrary to all available evidence
Anchoring	Influence by an outside suggestion
Status quo bias	Bigger gambles are taken to maintain current status than enhance it
Compartmentalisation	Decisions may be made without considering a wide range of issues
Over-confident	People overestimate the likelihood that they are correct
Representative heuristic	Events are treated as representative of some familiar template or pattern
Availability heuristic	Excessive focus on one event or issue, particularly if it is recent or obvious
Magical thinking	Attributing one's actions to something that had nothing to do with them
Quasi-magical thinking	Behaving as if under the belief that one can influence events, even if this is known not to be true
Hindsight bias	Overestimating the extent to which an event could have been predicted
Memory bias	People convince themselves that they predicted events when they actually did not
Emotional	People can be spiteful and passionate

Note. Adapted from Kahneman and Tversky (2000) and *The Economist* (1999)

Alternate management- and psychology-based theories which offer the potential to provide researchers with a better understanding of remuneration committee processes given an increasingly competitive and complex market for executive talent[10] and tighter regulation of corporate activity are considered in the following pages.

Social capital theories[11]

In the study of executive pay, the use of theories such as agency theory typically ignore issues of politics and power (Barkema & Pennings, 1998). Barkema and Pennings (1998) discuss two kinds of power in management: overt and covert power. Overt power may be defined by the level of equity an executive has in a company. Covert power (or surreptitious influence) is characterised by an executive's social networks and tenure.[12] Social capital, a theory which has had wide usage in ethnographic studies, may assist in explaining the nature of CEO and remuneration committee interaction and how it affects CEO pay.

The definitions of social capital by Bourdieu (1985) and Coleman (1988) are the most widely used. Bourdieu (1985, p. 248) defined social capital as ‘the aggregate of the actual or potential resources which are linked to possession of a durable network of more or less institutionalized relationships of mutual acquaintance or recognition’. This conceptualisation is often at odds with Coleman’s (1988, p. S98) definition, which characterised social capital by its function as ‘a variety of entities with two elements in common: they all consist of some aspect of social

[10] Clements, da Silva Rosa, and Lieu’s (2004) findings suggest that the perception that the pressures often associated with the global competition for talent may be exaggerated.

[11] An introduction to the social capital literature and some of its criticisms can be found in Jeanette Pope’s (2000) paper.

[12] Carroll and Teo (1996) pay closer attention to social networks.

structures and they facilitate certain action of actors – whether persons or corporate actors - within the structure'.[13] Further, Coleman's work typically describes social capital as comprising three elements: accumulated obligations, information and norms. A fundamental difference between the definitions can be attributed to how social processes develop. Bordieu saw social processes being constrained by structures such as the corporation, while Coleman believed that they are created by the free will of individuals. Indeed, Pope (2000, p. para 5) added that the second conception of social capital was:

> … a form of contract made between individuals and unconstrained by underlying economic factors. Social capital here has an 'economic rationalist' flavour where individuals freely choose to build networks to further their self-interest.

One broad application of social capital is in its explanation of stratification, particularly in access to employment, mobility through occupational ladders and entrepreneurial success (Portes, 1998). In the context of board relationships, Kilduff and Krackhardt (1994, p. 89) noted that:

> The "pricing" of individuals in this [internal labour] market is a cognitive process that unfolds within a social context. An individual's performance is often difficult to assess, so people look for signals of quality (Spence, 1973). Does the person hold a high position in the organization? Is the person a friend of a prominent leader? In this cognitive assessment process, both individual attributes and social ties may contribute to the determination of performance reputation.

Citing weak links between pay and performance, the failure of the agency theory model and the promise of social comparison theory, Belliveau et al.'s (1996, p. 1569) study of CEO-remuneration committee dyads in 61 firms tested the effects of social capital on CEO pay. In this study, social capital was conceptualised in terms of both social similarity between a CEO and the remuneration committee chair and the absolute and relative status of the CEO and the committee chair. As the setting of CEO packages was high in task ambiguity and CEO-board relationships are often close in U.S. companies (Lorsch & MacIver, 1989; Main, O'Reilly, & Wade, 1995), social similarity – a form of social capital – may affect CEO pay by enhancing the relationship between a CEO and the remuneration committee's chair.[14] Further, CEOs with a higher social status were more able to use their status to influence remuneration committee members. Two supporting arguments were used. First, in the absence of clear measures of CEO performance, committees may view the CEO's status as an important cue in designing the package. Status was thought to have a greater effect on CEO pay than social similarity (Ibarra & Andrews, 1993). The second argument took a resource dependence theory perspective: a CEO's social capital may be seen as a unique resource and would therefore serve as a criterion for setting pay.

Although these two arguments were not supported, Belliveau et al. (1996) found that when the remuneration committees chair's status was higher than the CEOs, the CEO's pay would be lower. Also, when the CEO's status is higher than that of the committee's chair, the CEO's pay is expected to be higher. This result suggests that social comparison theory, discussed shortly, may have some application in understanding the effect of CEO-remuneration

[13] Loury's (1977) work influenced Coleman's (1988) in his more refined analysis of the role of social capital in the creation of human capital (Portes, 1998).

[14] This may be particularly evident when the CEO is instrumental in the screening and hiring of new executives and directors (Barkema & Pennings, 1998, p. 984). See Finkelstein and Hambrick (1996) and Hambrick and Finkelstein (1995) for discussions on sociopolitical factors in management and corporate boards.

committee relationships on executive pay. The results of this current study ultimately invalidated economic and resource dependence theory arguments (Belliveau et al., 1996, pp. 1586-1587).

Human capital theories

Social capital and human capital are closely related. According to Coleman (1988), social capital helps produce human capital.[15] Human capital variables are comprised of factors such as education, work experience and tenure in the company (Hogan & McPheters, 1980).

Like social capital, human capital theories have some alignment with resource dependence theories, as inimitable human capital qualities are thought to be more highly valued in organisations. Carpenter, Sanders, and Gregersen (2001) found that a resource-based perspective was evident in their study of expatriate CEO pay in multinational firms. The human capital variable of international assignment experience allowed CEOs to appropriate a share of firm performance for themselves in the form of higher total pay (Carpenter et al., 2001, p. 505).

Gerhart and Milkovich (1990) investigated the effects of human capital investment on managerial pay for about 14000 top- and middle-level managers in 219 companies. They found that base pay and pay mix were related to one's human capital investment and job responsibility. A manager's job and human capital attributes could explain statistically significant amounts of variance in base pay and long-term incentive eligibility (Gerhart & Milkovich, 1990, p. 675). Belliveau et al. (1996, p. 1585), however, found no evidence for a human capital explanation of CEO pay.

Additional comments on human and social capital theories

Related to the human and social capital and demographic variables of CEOs is the level of power they possess, their influence on the remuneration setting process and the composition of remuneration committees. It is argued that CEO power and pay level are positively correlated. In addition, CEOs who are also directors of the company and who occupy a position on the remuneration committee are more likely to have larger salary packages. In their study of *Fortune 500* companies whose primary businesses were either printing and publishing, chemicals or computers, Finkelstein and D'Aveni (1994) investigated the relationship between CEO duality and board vigilance. CEO duality occurred when the same person held the titles of CEO and board member in a corporation. Vigilant boards were assumed to favour a separation of the two titles as a CEO-board member could dominate both the agenda and content of board meetings (1994, p. 1082). This perspective was consistent with agency theory, but was not supported by the results of the study.

Extending on recent research which investigated social (O'Reilly et al., 1988; Westphal & Zajac, 1997), political (Lambert et al., 1993; Zajac & Westphal, 1995) and strategic (Rajagopalan & Finkelstein, 1992) influences on the remuneration process, Finkelstein and Boyd (1998) studied the role managerial discretion played in forming a manager's pay. Their study of 600 randomly selected firms from *Fortune*'s 1987 *Top 1000* found that in companies where CEO discretion was high (e.g. deregulated firms, high capital investment, product differentiation and innovation, demand instability), CEO pay was also higher. Also, the relationship between CEO discretion and CEO compensation was heightened in firms with

[15] Friedman and Krackhardt (1997) and Portes (1998), for example, adopt this perspective.

high performance. This finding suggests that compensation committees are willing to grant higher rewards to managers who can successfully manage risk. However, the study did not address the question of how board and remuneration committee membership and monitoring processes affected pay (Finkelstein & Boyd, 1998, p. 194).

Social comparison theories

Social comparison processes (Festinger, 1954) involve social actors and decision makers constantly relying on a wide range of social comparisons to secure equity in the setting of their expected rewards. People have a need to evaluate their opinions and abilities. In the absence of objective criteria, social criteria are used. They will prefer to make comparisons with others who are perceived as similar: opinions might be evaluated in closed social circles, or ingroups and abilities might be measured against those who are thought to possess similar attributes. Further, people are motivated to make the comparisons when they believe the opinion or the ability is important and when the referent group is important to the individual. While there is a general tendency for people to compare themselves with others who are perceived to possess similar opinions and attributes (or abilities) (Goodman, 1974), there is also a tendency to select referents with slightly higher abilities for comparison. The comparisons may be motivated by self-improvement motives (upward comparisons) or self-enhancement motives (downward comparisons). Individuals also engage in comparisons in 'an attempt to reduce personal uncertainty and conserve or improve self-esteem' (Conner, 2003, p. 134).

In the context of remuneration committees, Ezzamel and Watson (1998, p. 223) argued that non-executive directors selected to serve on remuneration committees were chosen because of their similarity to those involved in the selection process.[16] Similarities between executive and non-executive directors in terms of earnings levels would ensure that committee members would tend to base their judgements regarding an appropriate executive reward package on their own earnings (Tversky & Kahneman, 1974).

O'Reilly et al. (1988) believed that almost all empirical investigations of CEO remuneration centred on economic determinants. While their study of *Fortune 500* firms did not discount research finding that factors such as firm size, industry, sales and profits impacted on CEO pay, they included human capital variables. Hence, one of the main determinants of a CEO's package could also be extended to the board or committee's perception of his or her social capital. O'Reilly et al. (1988) described CEO pay packages to be the result of a social comparison process, modelled on Festinger's (1954) social comparison theory. Indeed, in their study of conventional economic determinants of pay, board and remuneration committee composition, (O'Reilly et al., 1988) found that CEO pay was positively related to the pay levels of the remuneration committee's members.

On the basis of methodologically inconsistent studies, O'Reilly et al.'s (1988) application of social comparison theory may provide a better model for explaining executive pay. Unlike market forces, social comparison theory is concerned with the formal and informal processes employed by committee members when setting executive pay. As CEO performance is sometimes difficult to quantify and is often ambiguous, committee members engage in social comparison. The CEO's salary package, therefore, is likely to reflect the salary levels of remuneration committee members (see, also, Daily et al., 1998; Westphal & Zajac, 1997).

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[16] CEOs may be particularly instrumental in the appointment of new executives and directors (Barkema & Pennings, 1998, p. 984; Finkelstein & Hambrick, 1996; and Hambrick & Finkelstein, 1995).

As stated earlier, the composition of the committee is thought to affect the size and composition of the CEO's pay package. One would expect that if the committee is comprised of members beholden to or dependent on the CEO, the salary package would be larger. This hypothesis was not supported by Daily et al.'s (1998) study of the relationship between the composition of remuneration committees and CEO pay levels, as shown earlier. Subsequently, the literature indicates some support for agency theory and a need to further test the validity of social comparison theory.

Social comparison theory and executive remuneration committees

The utility of social comparison theory

Social comparison theory could be viewed as a reaction to some of the typically structured and somewhat limited models of human behaviour. In discussing the narrow perspectives adopted by some researchers in the field of social network analysis, Knoke and Kuklinski (1982, p. 9) remarked, 'In the atomistic perspectives typically assumed by economics and psychology, individual actors are depicted as making choices and acting with regard to the behavior of other actors'. Cason and Mui (1997) also pointed out that most studies of economic decisions assumed (erroneously) that a single individual made the decisions, while Kilduff (1990, p. 271) described the separation of decision-makers from the field of social influences that surrounded them as a 'splendid isolation'. The limitations of the rational economic man model were outlined earlier.

While there is a large and diverse body of literature in group behaviour and group decision-making, much of it is beyond the scope of the present study.[17] Instead, in this study, remuneration committee processes are viewed primarily through the lens of social comparison theory as part of the decision-making literature. Mumford (1983) believed that social comparison had important applications in novel environments and Kilduff (1990) thought that the theory had applications when individuals faced important and ambiguous decisions, while Finkelstein and Boyd (1998) found that managerial discretion had a positive relationship on CEO pay. In the context of making a decision after the processing of complex and voluminous data, social comparison theory may help explain the size and composition of CEO reward packages in Australian companies.

Task uncertainty and complexity, such as that experienced by a remuneration committee, will prompt members of a group to seek others to assist in finding solutions to problems presented to the group. Sociometric data from the 1930s, 1940s and 1950s led Festinger (1954, p. 136) to conclude that people associated with a group tend to be members of the same socio-economic class:

> The segmentation into groups which are relatively alike with respect to abilities also gives rise to status in a society. And it seems clear that when such status distinctions are firmly maintained, it is not only members of the higher status who maintain them. It is also important to the members of the lower status to maintain them for it is in this way that they can relatively ignore the differences and compare themselves with their own group. Comparisons with members of a

[17] Buunk and Mussweiler (2001, p. 467) described a 'renaissance' in social comparison theory and its application to a number of fields. Recently, for example, Sweeney and McFarlin (2004) examined the application of the theory in a study of pay satisfaction across nations.

different status group, either higher or lower, may sometimes be made on a phantasy level, but very rarely in reality.

Byrne, Clore, and Worchel (1965) hypothesised that attraction to another was a positive function of similarity of economic status. While they found that attraction responses in their study were most positive towards a stranger of similar economic status, they also found that low-economic level subjects responded more positively to a high-economic stranger than predicted. This result is consistent with the upward comparisons and was replicated in the CEO-remuneration committee interactions studied by Belliveau et al. (1996).

Social comparison theory applied in governance and remuneration research

Charles O'Reilly (Stanford University, 2002), a critic of the indiscreet use of economic models in executive pay research, described reasons for why social dynamics within the remuneration committee (not labour market forces) had significant influences on CEO pay. In the committee, there is a strong element of peer-group comparison when determining CEO reward packages. A director on the remuneration committee of one company may be a CEO in another company.[18]

Over two decades ago, Koenig and Gogel (1981) and Koenig, Gogel, and Sonquist (1979) noted that the character of U.S. corporate boards was undergoing change. Specifically, they described the growing prevalence and influence of outside directors being appointed to boards. The 'class hegemony' model described in Koenig and Gogel (1981, p. 40) visualised the directorate network as one 'through which affect, evaluation, knowledge, opinion, influence and power are constantly passing among directors'. In other words, there is an incentive to ensure that executive pay remains 'high'. Nicholson, Alexander, and Kiel (2004) conceptualise this issue from a social capital perspective. Director 'interlock' occurred between two (or more) organisations where a director on a focus firm sat on the board of a different firm (Boyd, 1990). Nicholson et al.'s (2004, p. 59) depiction of an intercorporate network is presented below in Figure 1.

Figure 1 shows a simplified example of the connections among 12 directors. The interlockers (directors 1, 3, 7, and 10) each have six direct contacts, three of from each of the two boards on which they sit. The five other directors in the network can be reached in two steps (i.e. through the direct contacts of the interlockers).

Latent and conscious feelings of reciprocity may be present on boards. Molm's (2003, pp. 3,4) examination of exchange theories described a reciprocal exchange as one where 'actors' contributions to the exchange are separately performed and nonnegotiated . . . that is, A's behaviour individually produces rewards for B, and vice versa'. As alluded to earlier, directors in U.S. companies often owe their appointment to the CEO and may feel indebted to the CEO despite their apparent independence. As the CEO often recommends potential directors who share similar experiences and other personal characteristics, positive social comparisons may be more likely.[19]

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[18] Board interlocks are also referred to by Caswell (1984), Galaskiewicz, Wasserman, Raushenbach, Bielfeld, and Mullaney (1985), Gaunt (2000), Investor Relations Business (1999), Mac Canna, Brennan, and O'Higgins (1998), Murasawa (1998) and Sheridan (1993).

[19] Mumford (1983, pp. 878-879) describes the utility of social comparison theory in peer evaluations.

The social status of the actors also impacts on CEO pay. Consistent with Belliveau et al. (1996), CEOs of a higher social status than the remuneration committee's chair would be more highly paid, all other things being equal. Boards (and, by extension, board committees) have often been criticised as rubber stamps for executive initiatives (see, for example, Oliver, 2000; and Ward, 1997). In his interviews with executives, Mace (1971, pp. 26-27) was told that,

> The board rarely, if ever, rejects out of hand a proposal by the president, but their existence in the management scheme of things influences the president and helps his decisions within the bounds of conscionable conduct.

It may follow, then, that 'rubber stamp behaviour' is to be expected when boards are viewed through social comparison lenses. More broadly, this may be what Belliveau et al. (1996) describe as the 'number of psychological and political processes that shape individual and group decisions everywhere'.

Focal social comparison studies

The sections immediately following focus on studies by O'Reilly, Main, and Crystal (1988), Main, O'Reilly, and Wade (1995) and Ezzamel and Watson (2002). These three studies have paid particular attention to the relationship between the CEO's reward package, the remuneration committee and social comparison theory and serve as significant theoretical drivers in the present discussion.

O'Reilly, Main, and Crystal (1988): *Compensation as tournament*

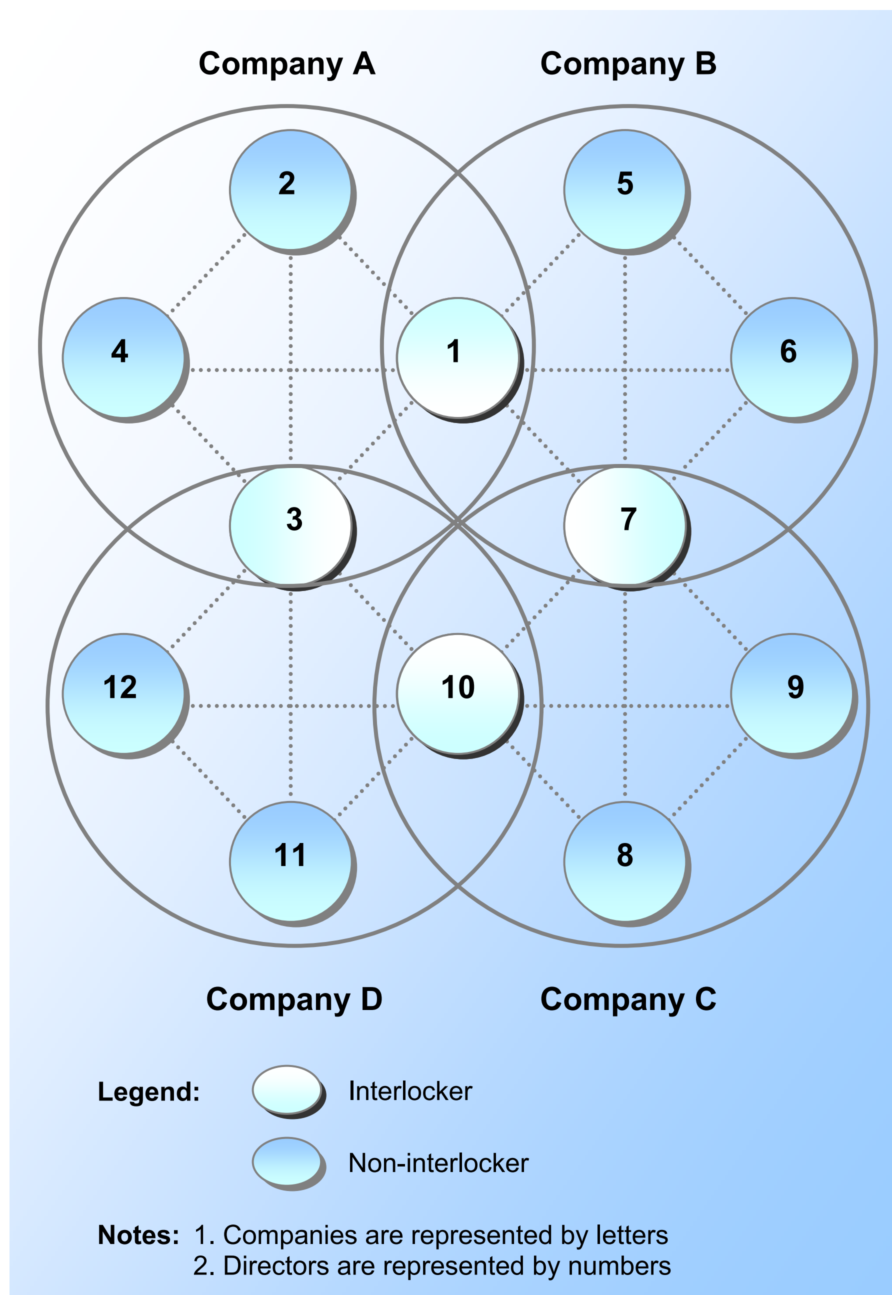
Three perspectives for understanding CEO pay were examined in O'Reilly, Main, and Crystal's (1988) article: *neoclassical explanations* that have used common economic determinants; CEO pay levels being the results of *tournaments* (Lazear & Rosen, 1981); and *social comparison* as a fitting social psychological explanation for CEO pay. While mixed or no support was found for the respective hypotheses of the first two perspectives, the social comparison argument is of most interest to the present submission.

O'Reilly et al. (1988) believed that it was possible that noneconomic factors may have been at play in the determination of executive salaries. Examples of studies examining how the power or form of organisational control could affect the level and structure of executive pay, or how the use of wage surveys and shared compensation consultants could also affect salaries were cited. O'Reilly et al. (1988) reasoned that since most of the outside directors were likely to be or to have been CEOs in other companies, then a social comparison process may be taking place. The CEO's pay could be at least partially attributed to the pay earned by the remuneration committee's members. CEO pay was likely to be positively related to the pay levels of committee members.

Studying a sample of 105 firms (drawn from *Business Week*'s 1985 survey of executive compensation) representing nine industries, the researchers found that approximately 65 per cent of remuneration committee members were current or retired CEOs. O'Reilly et al. (1988, p. 269) also found that the

> . . . presence of highly remunerated outside board members is related to high CEO salaries in a statistically significant manner. And these results hold even when there are controls for the fundamental economic characteristics of the corporation such as size, profitability and industry.

These results, it must be conceded, did not prove that the appointment of a highly-paid executive as an outside board member would lead to a rise in the pay for that firm's CEO.



Adapted from Nicholson, Alexander, and Kiel (2004, p. 59)

Figure 1
The personal intercorporate network

Main, O'Reilly, and Wade (1995): *Economic and psychological perspectives*

Main, O'Reilly, and Wade's (1995) study discussed economic, institutional and psychological factors that may affect how the board of directors determine executive rewards. In discussing governance in modern corporations, Main et al. (1995, p. 304) presented an argument against '. . . the theoretical ideal of [the board as] a group of vigilant, informed and impartial principles objectively monitoring the performance of top management so as to serve the shareholders' interests'. Two explanations were suggested for this contention: first, the legal roles and responsibilities ascribed to boards are not as clear as the theory suggests; and

second, board members are often selected by CEOs. The members are often reluctant to question the formal and informal authority of the CEO, especially if the CEO also serves as the board's chair.[20] In order to understand how the CEO influences board members or, indeed, how board members influence each other, Main et al. (1995) viewed the board of directors as a social group subject to the norms of reciprocity, authority and similarity and liking.

Perquisites are one form of rewards or serving on the board of a major company. These perks represent an obligation that the norm of *reciprocity* suggests needs to be repaid. Main et al. (1995, p. 308) suggest that the repayments may take the forms of favourable assessments of the CEO's plans and actions, lessened criticism of poor performance and a greater readiness to increase CEO pay. Also, a CEO or a chairman may use their *authority* to control meeting agendas, filter information and actively manage the directors in addition to shaping the board. The use of authority (accepted as legitimate by board members) can affect how directors interpret issues and make decisions. Finally, it is more difficult to disagree with people who we care about and whose opinions of us are relevant (*similarity and liking*). Gilson and Kraakman (1991) point out that despite the legal definitions for 'independence', there are no requirements for directors to be socially independent. It is likely that board members will therefore look to others to determine what is correct behaviour on the board, particularly if they are recent appointments.

Drawing from the same population as O'Reilly et al. (1988), Main et al.'s (1995) studies suggested that social influence had a significant influence on the pay setting process. Further, the findings suggested that efficient corporate governance models driven by theories such as agency theory and transaction cost economics would be difficult to obtain as long as the CEO exercised social influence over directors. While findings such as these do not necessarily negate agency theory, they do raise the question of whether or not contracts are being devised in the interests of the principals of the firm (a recurring theme of theories such as agency theory).

Ezzamel and Watson (2002): *Pay comparability and UK boards*

Pay comparisons in large, publicly-listed U.K. companies were examined through social comparison and equity theory lenses by Ezzamel and Watson (2002). Rather than adhering to agency theory's focus on the alignment of interests, factors such as corporate governance, the maintenance of executive pay comparability, team cohesion, competitive employment opportunities and signalling to external stakeholders the high quality of the firm's executive were thought to be important considerations in the pay setting process (Ezzamel & Watson, 2002, p. 209). As well as alignment with the external executive market, the remuneration committee was thought to also attempt to maintain a level of comparability with the pay of other board members (see, also, Ezzamel & Watson, 1998).

Ezzamel and Watson's (2002) study of 199 *Times 1000* companies suggested that external labour market and board pay comparisons were important in explaining both CEO and directors' pay rewards. Two reasons are offered as to why the complex executive pay-setting process is unlikely to mirror the incentive alignment concerns integral to models such as those in agency theory.[21] First, remuneration committees appear to seek to strike a balance between

[20] CEO duality is studied in Conyon and Peck (1998) and Finkelstein and D'Aveni (1994).

[21] It should be noted that studies such as Bitler, Moskowitz, and Vissing-Jørgensen (2001), Bitler, Moskowitz, & Vissing-Jørgensen (2004), and Shaw, Gupta, & Delery (2000) do not dismiss the explanatory power of agency theory. They are more likely to question its narrow conceptualisation of board-CEO relationships, and often

maintaining equity between directors and ensuring that external market considerations (particularly for the CEO) were not ignored. Second, equity was found to be multidimensional in the context of CEO and director pay. *Lateral equity* meant that executive and director pay had to conform to the 'going rate' of the market. *Vertical equity* related to the magnitude of the pay and its percentage changes over time that reflected hierarchical, symbolic and political differences between executives (Ezzamel & Watson, 2002, p. 228).

A better understanding?

The studies by O'Reilly et al. (1988), Main et al. (1995) and Ezzamel and Watson (2002) were discussed in greater detail because they represent unique attempts to understand and perhaps re-conceptualise (at least in part) remuneration committee behaviour. Common to these three studies is the serious evaluation of the utility of social comparison theory. To their credit, the studies also do not consider social comparison theory in isolation: O'Reilly et al. (1988) also tested tournament theory; Main et al. (1995) referred to agency and transaction cost perspectives; and Ezzamel and Watson (2002) added to their previous work examining the application of equity theory. In all cases social comparison offers at the very least novel, if not promising or conclusive, explanations for executive pay. Traditional economic theories have not been discounted by these and other researchers, who have paved the way for an alternative theoretical paradigm for executive pay and executive pay-setting processes.

Despite the potential offered by social comparison theory, it should be noted that it is untested in the context of executive pay and governance in publicly-listed Australian companies. Further, the theory may not have the same fit it has demonstrated with studies from the U.S. and, to a lesser extent, the U.K. This can be attributed to the different corporate governance structures and business climate in Australia. As stated earlier throughout this submission, the roles of CEO and chairman are more likely to be one and the same in the U.S. than in Australia. With the separation of ownership and control (a fundamental assumption in some economic theories) relatively lacking, social comparison processes are likely to play a more prominent role.

Given recent heightened public interest in corporate activity, increased levels of share ownership and shareholder activism, tighter regulation and increased global activity which necessitates sound and transparent governance structures, social comparisons can play an appreciable role in explaining pay issues in Australian boardrooms.

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advocate the interpretation of agency theory alongside '… the more psychological approaches [which] begin with the premise that the compensation-setting process relies on the deliberations of a small group of people of a firm's compensation committee' (Belliveau et al., 1996, p. 1570).

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