

# **CEO Compensation and Corporate Governance: Empirical Evidence from Australia**

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**Investigators: Richard Heaney, Larry Li and Vicar Valencia (RMIT University)**

## **Project objectives**

Dramatic increases in CEO compensation, coupled with a series of corporate failures and managerial misconduct, have reinvigorated the attention to governance structures that promote corporate efficiency. In this project, we empirically identify the mechanisms of corporate governance that influence the level and design of CEO compensation. Using a unique hand-collected dataset of executive remuneration of the top 100 Australian companies from 1990 to 2008, we examine the change in CEO pay and test whether the compensation scheme is determined by the quality of a firm's governance structure.

A fundamental concern that perennially emerges in the corporate literature is the governance and control of CEO (Chief Executive Officer) compensation. Examples abound indicating overpaid CEOs, unaccountable to the stockholders and with considerable latitude to set and structure their own pay. For instance, over the decade from 1995 to 2005, CEO compensation in both the US and UK has more than doubled, with an annual growth rate of 9% (Brenner and Schwalbach, 2009). Australia has reflected the same pattern, with an appreciable rise in CEO pay of, on average, US\$ 708,000 in 2005, from US\$ 377,000 in 1995, at an annual rate of increase of 7%. Results from

research explaining this increase are mixed and are mainly based on CEOs in the US. Our project aims to examine the evolution, cause and consequence of rising CEO compensation in Australia. We seek to advance our understanding of the rise in pay and empirically identify the corporate governance mechanisms associated with this phenomenon. Our research will shed light on the still unresolved and underexplored question whether CEOs are paid for their performance or, through weak governance structure, their ability to set their own pay. In our analysis, we aim to investigate whether there is a consequent need for regulation of managerial pay or whether such calls for reform and intervention may actually undermine CEO productivity and corporate performance.

Our objective is to examine whether Australian CEOs are paid for their performance by comparing the distribution of executive remuneration with the stock returns generated. We hypothesise that CEOs are paid for their performance if highly-paid CEOs generate above-average stock returns and lower-paid CEOs generate below-average stock returns relative to the market and relative to their industry.

### **Ultimate relevance to the finance industry**

This project is relevant to the finance industry because it involves empirical investigation the link between CEO compensation and the mechanisms of corporate governance in Australian firms. Our research findings will help provide an important industry and public policy perspective on executive remuneration in Australia, highlighting the role of and what impact the board of directors and remuneration committees may have on the appropriate design and structure of CEO compensation schemes. These questions are of particularly interest to the finance industry because of the impact that CEO performance can have on firm performance.

This project is motivated by differing views and evidence on CEO compensation. Executive pay is considered as an incentive scheme to mitigate the agency problem, along the lines espoused by Hall and Lieberman (1998) and Kaplan and Rauh (2008). By incentivising the CEO to perform better, through the provision of an adequate compensation package, the company performs better, consistent with shareholder value maximisation. Yet, Bebchuk et.al. (2001) and Bertrand and Mullainathan (2001) argue the CEOs may actually set their own pay. The implication is that CEOs gain control of the board, or compensation committee and, given limited external monitoring, effectively capture the compensation decision.

These findings, however, are based largely on US data. To date, there have been relatively few studies that focus on the compensation of Australian CEOs. These include Merkebi, et.al. (2006) who find a positive link between CEO pay and firm size and performance, and Izan, et.al. (1998), reporting, in contrast, no association between pay and performance. A limitation of these studies is that they do not examine the governance structures that can potentially influence the level and design of the compensation package. We posit that the quality of a firm's corporate governance can influence CEO pay.

This project will empirically evaluate the impact of ownership structure (e.g., concentrated ownership and, possibly, the presence of institutional shareholdings), board and compensation committee characteristics (e.g., board/compensation committee size and independence), and the profile of the CEO (e.g., whether the CEO is Board Chair as well) on executive pay in Australia. We contribute to the literature by providing empirical evidence on the extent to which these factors contribute to the rise in CEO pay and on which components of the compensation scheme (e.g., base salary or equity incentive) they primarily affect. In a broader context, our research findings will provide a normative perspective on the appropriate design and implementation of CEO

compensation, in particular, and guidelines that prevent the distortion of CEO incentives and enhance corporate efficiency, in general.

### **Opportunities for private sector involvement**

Given the scope and nature of our research project, and the policy issues it addresses, we welcome the opportunity to gain feedback from practitioners and other researchers in the field, and we would certainly welcome collaborative industry support.

Private sector support involvement would be valued in each stage of the research, from extension of the literature review through data collection and final write up of papers dealing issues raised in this research.

We welcome the opportunity to present our findings to the private sector for discussion and feedback. There are a number of issues that will need to be resolved as the research task unfolds and the private sector involvement through comment and criticism would be most welcome.

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