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CEO personal reputation: does it affect remuneration during times of economic turbulence?

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Abstract

The primary focus of this study is to provide evidence on whether, during a period of economic turbulence, the personal reputation of CEOs holds up as a significant determinant of their remuneration, or whether the company's financial performance and governance structures are the more dominant determinants of CEOs' remuneration. Using secondary data sampled from Australian Top 200 listed companies over a 3 year period straddling the global financial crisis, this study models determinants of total CEO remuneration. The results reveal that CEOs' personal reputation does have a positive significant effect on total remuneration. Of the company financial performance influences on CEO remuneration, volatility of ROE and the net operating cash flow are found to have the most significant effects on total CEO remuneration, as expected during the period of economic turbulence studied. Governance structures of remuneration committee independence and the extent of substantial shareholdings were found to not have significant effect on total CEO remuneration.

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Keywords-Executive remuneration; personal reputation; financial performance; substantial shareholders; remuneration committee; corporate governance.

1. Introduction

The issue of executive, remuneration, especially that of the chief executive officer (CEO), has attracted intense interest from the public media and been given attention by policy makers like the Australian Stock Exchange (ASX) (Doucouliagos et al. 2007) in recent years. The global financial crisis (GFC) of 2008 only served to heighten concerns over corporate governance and executives' remuneration (Clarke 2010).

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Interestingly, AASB 124 'Related Party Disclosures' (ICAA 2006) adopts the term 'compensation' rather than 'remuneration' although it recognizes that both words refer to the same concept.

The objective of this study is to investigate whether CEO remuneration is adjusted in line with company financial performance and the strength of companies' governance structures during a period of financial crisis, or if a CEO's personal reputation is the overriding determinant of their remuneration.

The motivation for this study is threefold. Firstly, there is limited research on CEO personal reputation and the link with CEO remuneration. Prior studies have been conducted in the USA. Milbourn (2003) studied the link between CEO reputation and stock-based compensation while Francis et al. (2008) studied the relationship between CEO reputation and earnings quality. Secondly, excessive executive remuneration has attracted immense public attention due to the GFC, hence the period of this study from the year 2007 to 2009. In addition, authors such as Clarke (2010) question whether there is a crisis in the Anglo-American governance structure. Finally, there is a lack of evidence on how CEO remuneration is packaged. This study can provide improved evidence on CEO remuneration packaging because in the current regulatory environment companies are required to disclose key management personnel remuneration in greater detail. This data was not available prior to 2004 (Clarkson et al. 2006).

2. Literature review and development of hypotheses

Classical agency theory arguments have dominated the executive remuneration literature. Agency theory (Berle and Means 1932, Jensen and Meckling 1976) posits that CEO remuneration may be used as a mechanism to align management's interests with those of the shareholders and that this mechanism solves the issue of agency costs that arises due to the separation of management and ownership. Remuneration, according to Doucouliagos et al. (2007), is an important mechanism for soliciting effort, ensuring that executives act in accordance with owners' interests, and rewarding productivity. In general, the empirical evidence from international studies show that there is a significant positive correlation between executive remuneration overall and corporate performance where corporate performance is partly the observable result of CEO performance (Merhebi et al. 2006). In contrast, prior Australian studies find a negative or insignificant link between CEO remuneration and corporate performance with the exception of Merhebi et al. (2006). These findings support the agency theory contention as mentioned above that CEO remuneration is a solution to agency costs. A more recent study by the Productivity Commission (2009), however, finds no statistically significant relationship in most instances. This appears to support Bebchuk and Fried (2003) contention that CEO remuneration may pose an agency problem. Their view is that while managerial remuneration, such as CEO remuneration, is designed to alleviate agency costs; managerial remuneration is also part of the agency problem because managerial remuneration may be the result of managerial entrenchment or power, and can be characterized as rent-seeking behavior.

We expect a positive relationship between CEO remuneration and company performance since the CEO should be appropriately rewarded if the company performs well (agency theory incentive that aligns CEO and shareholders' interests), and vice versa. Accounting and market based measures of company performance are used based on the argument that CEOs' performance is assessed and compensated on the basis of accounting measures. The counter argument is that accounting measures can be manipulated easily whereas it is more difficult to manipulate the market for an extended period of time (Merhebi et al. 2006). Return on equity (ROE) is used as an accounting measure of company performance (Merhebi et al. 2006). We also use the net operating cash flow as a measure since liquidity, especially cash, is crucial in times of financial crisis such as

the GFC. Market return to shareholders, that is dividend yield and capital gains whether realized or unrealized, is used as a market based measure (Productivity Commission 2009). Shareholders are interested in higher returns to their investments (Doucouliagos et al. 2007) which can be attributed to, among other factors, managerial effort. This leads to our first hypothesis as follows:

H1: there is a positive relationship between performance-based CEO remuneration and several measures of company performance.

However, company performance may to some extent be subject to economic cycles. Friske and Petersen (2001) acknowledge that companies struggle to design optimal employment contracts that compensate appropriately for performance in a volatile market. Accordingly, risk, generally speaking, is expected to have an influence on company performance (Core et al. 1999) and is measured by the standard deviation of the return on equity σ(ROE) over the last five years. Kini and Williams (2012) use both cash flow and stock return volatility as proxies for risk. We do not include the standard deviation of shareholders returns over the last five years in our regressions since there is a high correlation with the shareholders return variable which suggests multicollinearity. Pukthuanthong et al. (2004) argue that a company operating in a market that has higher financial volatility should be associated with increased remuneration due to risk sharing between management and shareholders. We take a different view. Our conjecture is that shareholders of big listed companies tend to be risk averse and would reward executives that achieve reduced volatility in the firm's ROE. Accordingly, our second hypothesis is as follows:

H2: there is an inverse relationship between the volatility of financial performance and CEO remuneration.

There is evidence that corporate governance mechanism such as the composition of the board of directors, the existence of a remuneration committee and the presence of outsiders who hold large blocks of shares, coupled with the design of executive remuneration contracts, mitigates agency problems (Pukthuanthong et al. 2004). Shleifer and Vishny (1997) define corporate governance as a set of mechanisms, both market-based and institutional, which induce the self-interested controllers of the company to make decisions regarding how the company would be operated which would maximize the value of the company to its owners, being the suppliers of its capital. Dalton et al. (1998) argue that the amount of CEO remuneration relates to the composition of the remuneration committee. Pukthuanthong et al. (2004) contend that outside directors are more concerned that the company's remuneration structure aligns with shareholders' interests so as to enhance their own reputation as effective board members. On the other hand, Lee (2009) is of the view that CEO remuneration does not appear to relate to board structure. She cites Kren and Kerr (1997) who suggest, from a theoretical perspective, that the benefit of outside directors' objectivity may come at the cost of an information deficit in regard to the CEO's true contribution to performance outcomes. The board would have to rely on other sources of information such as remuneration consultants, thereby weakening the outside directors' role in monitoring executive remuneration.

Our next hypothesis, which is on internal corporate governance, is as follows:

H3: there is an inverse relationship between the extent of independence of the remuneration committee and CEO remuneration.

The ASX (2003) recommend the establishment of a remuneration committee which comprises independent members as the majority to oversee the remuneration of company executives. Such board composition is linked with board monitoring activities, and hence we expect that the greater the ratio of independent directors, the greater the scrutiny on CEO remuneration (Doucouliagos et al. 2007). This implies downward pressure on CEO remuneration.

It is argued that ownership structure, in addition to board characteristics, plays an important part in corporate governance (Pukthuanthong et al. 2004). While managerial ownership influences the extent to which management and shareholders' interests coincide, a high ownership of shares by management may weaken board independence. In addition, good corporate governance may be affected by the extent of outside ownership (Pukthuanthong et al. 2004) since outside owners can be expected to monitor board performance and remuneration as well as company performance (Doucouliagos et al. 2007). Our fourth hypothesis is on ownership structure. We contend that outside owners would monitor company performance and expect CEO remuneration to reflect company performance (Doucouliagos et al. 2007). Therefore, we expect downward pressure to be exerted on CEO remuneration (Bebchuk and Fried 2005). We use the percentage of shares owned by substantial outside shareholders as a proxy. Substantial outside shareholders are shareholders who own blocks of the company's shares of at least 5 percent and who are not related to the CEO. We are of the view that the percentage of shares owned by substantial outside shareholders is an appropriate measure because this will indicate whether the substantial shareholders are majority shareholders and therefore have collective control of the company. This leads to our hypothesis.

H4: there is an inverse relationship between the percentage of shares owned by substantial shareholders and CEO remuneration.

Behavioral research on the personal reputation of key management personnel in organizations is a counter perspective to the rational-economic perspective of agency theory. From an economics perspective, reputations are viewed as signals or traits that are used by companies to gain a competitive advantage (Riel and Fombrun 2007). Under signaling theory, reputations are information signals to observers that are meant to increase their trust and confidence in the company's products and or services. For example, obtaining higher education is an attempt by workers to signal their talents to employers (Spence 1973). CEOs with strong reputations can command higher remuneration packages relative to their peers (Ranft et al. 2006). In addition, CEOs with strong reputations are expected to yield better performance from the company (Ranft et al. 2006). A CEO's reputation is built not just on financial performance but also on qualities such as honesty and credibility (Gaines-Ross 2003), and having a track record of achievements such as the experience in leading a large and complex business as well as behaving with integrity which includes making effective, rather than politically expedient, decisions (Wackerle 2001). According to Gaines-Ross (2003), reputation is usually either enhanced or undermined within a year or two. Huse (2005) states that measures of the board's competency include the directors' knowledge and skills as well as their intellectual, social and relational capabilities. Milbourn (2003) adopts proxies for CEO reputation such as the CEO's tenure, the number of business-related articles which contained the CEO's name (Francis et al. 2008), and industry-adjusted company performance during the CEO's tenure. Lafond (2008), however, criticizes the use of press coverage as a proxy for CEO reputation because of the possibility that there may be bias in the press coverage. Based on the literature, we contend that a CEO's personal reputation would be proxied by the CEO's qualifications, professional memberships, tenure with the company and prior experience. A CEO would signal his or her capabilities, determination and sense of ethics and professionalism to the job market via his or her qualifications and professional membership(s). In addition, a CEO would build his or her reputation over the years and that would be proxied by the CEO's prior experience and tenure.

H5: a CEO with a relatively stronger reputation will receive a higher remuneration.

It is hypothesized that there would be a positive relationship between the CEO's remuneration and the CEO's personal reputation since the company would make an objective determination of the level of remuneration that should be given to a CEO which would commensurate with the CEO's qualities, or reputational capital.

3. Regulatory framework in Australia

In Australia, company accounting practices are regulated by the Corporations Act 2001 and accounting standards as issued by the AASB (AASB 2009, Lee 2009). The current regulatory regime in Australia makes it easier to collect data because listed companies are required to disclose more information as required by accounting standard AASB 124 and section 300 (10) of the Corporations Act 2001 which requires that the annual directors report disclose each director's qualifications, experience and special responsibilities.

Furthermore, companies which list on the ASX need to ensure that their internal governance rules comply with the requirements of the ASX Listing Rules (Hanrahan et al. 2007). The ASX Listing Rules require that listed companies adopt the recommended corporate governance practices and structures as detailed in the Principles of Good Corporate Governance and Best Practice Recommendations.

4. Conceptual model and measurement of variables

A linear model of the relationship between the various measures of remuneration and the variables that are hypothesized to be related to remuneration is given as follows:

$$CEOREM_{i,t} = \alpha + \beta_1 CEOREPUT_{i,t} + \beta_2 INDEPENDRC_{i,t} + \beta_3 SUBSTOWN_{i,t} + \beta_4 FINPERF_{i,t} + \beta_5 VOLATILITY_{i,t} + \beta_6 COSIZE_{i,t} + \varepsilon_{i,t}$$

where: CEOREM = a measure of the CEO's total remuneration; CEOREPUT = CEO personal reputation as measured by the reputation index; INDEPENDRC = the ratio of independent board members to total board members on the remuneration committee; SUBSTOWN = a measure of outsiders who own at least 5% of shares; FINPERF = the accounting based and market based measures of the company performance; VOLATILITY = the standard deviation of ROE over the last five years; COSIZE = total assets; and ε = error term.

FINPERFORM represents the following (alternative) variables: ROE = Return on Equity; ROE t-1 = ROE lag one year; CASHFLOW = Net operating cash flow; CASHFLOW t-1 = Net operating cash flow lag one year; MKTRETURN = Market or shareholders return; and MKTRETURN t-1 = Market return lag one year; Subscript i denotes the company while subscript t denotes the year and t-1 denotes the previous year.

One-year lags are taken into consideration since the CEO's remuneration might have been based on the prior year's and/or the current year's performance (Doucouliagos et al 2007). Where a new CEO was appointed during the year, the person who served as CEO for more than six months in that year would be deemed to be the CEO for the year (Milbourn 2003). We transform the dependent variable to its natural log since the skewed nature of the CEO remuneration indicates that the logarithmic model is more appropriate to mitigate the effect of extreme values (Merhebi et al. 2006, Pallant 2007). Consistent with previous studies such as Merhebi et al. (2006), termination payments are excluded from remuneration since such costs should be amortized over the total period of the employment. Cross-sectional linear multiple regression analyses are conducted on the pooled data covering the years 2007 to 2009. CEO reputation index is constructed as follow: CEO's qualifications: 1 = diploma level or lower 2 = bachelor's degree, 3 = post graduate qualifications. CEO's professional memberships: 1 = none, 2 = membership of one professional body, 3 = membership of more than one professional bodies. CEO's tenure with the company in the particular position: 1 = not more than one year, 2 = not more than three years, 3 = more than 3 years. CEO's prior experience: 1 = had prior managerial working experience but not as a director / CEO of any company, 2 = had prior working experience

as a director / CEO of a non-listed company, 3 = was a director or CEO, or both, of a listed company (listed either on the ASX or overseas). All score bands are from 1 to 3 to allow for aggregation. The reputation index is then constructed by a simple arithmetic aggregation of the CEO scores for qualifications, professional memberships, tenure and prior experience. Any weighting would just be arbitrary.

5. Sample

A list of the top 200 companies by market capitalization as at 30 June 2009 as listed on the ASX is obtained from Aspect-Huntley's FinAnalysis database. Only companies which have a balance date of 30 June are selected to ensure consistency in the time period used for this study. Companies which usually do not have CEOs or executive-style management such as superannuation funds, trusts and mutual funds are excluded (Merhebi et al. 2006). In addition, a company with missing data, namely non-compliance in regard to the disclosure of its CEO remuneration, is excluded. The sample is then extended to companies from this list which also appeared in the Top 200 in the two years prior, that is, in 2007 and 2008. This ensures consistency since the same companies are studied over the three year period. This brings the final list of companies down to 83 which gives a total of 249 cases for the 3 years sampled. This sample size is determined to be adequate for the purpose of this study based on the formula given by Tabachnick and Fidell (2007).

Data in regard to CEO experience, professional memberships and qualifications, remuneration, the remuneration committee, accounting ratios and other financial and governance data are obtained from the FinAnalysis, DatAnalysis and Connect4 databases as well as from the annual reports themselves which can be found on the ASX website or the DatAnalysis database. ROE and dividend per share (DPS) are as defined in the FinAnalysis database. Data, particularly in regard to remuneration, are also obtained from other (related) reports referred to within the annual reports such as Proxy Statements. While different companies may have varying terminology for their top executive such as managing director, the term CEO is used throughout this study for simplicity. Likewise with the term remuneration committee even though certain companies may have used other terms such as the human resources or personnel committee although the duties and responsibilities are similar.

Recent studies have indicated a strong association between CEO remuneration and company size in Australia (Productivity Commission 2009). Like Doucouliagos et al. (2007), we deem total assets to be an appropriate measure of company size. In addition, we included dummy variables to capture events such as a change of CEO where 1 equals a change in CEO for the year and 0 otherwise. We also control for CEO ownership of shares which is expected to have a negative effect on CEO remuneration (Doucouliagos et al. 2007). This is consistent with agency theory where the agent's interests are more in line with the owners, the principal. Therefore, it follows that CEOs who are substantial shareholders are more interested in the company performance rather than seek rent extraction. In addition, we include a variable to control for the state of the national economy. A proxy for this is the Australian Bureau of Statistics (ABS) (2011) national economy growth rate that is the Gross Domestic Product (GDP) growth rate which would also reflect the unemployment rate. Furthermore, an analysis of the companies by industry is conducted. Dummy variables are used for the ten industry sectors which are categorized according to the Global Industry Classification Standard (GICS). Where remuneration was expressed in foreign currencies, those amounts are converted to Australian dollars based on the exchange rate applicable for the year which is available on the Reserve Bank of Australia (RBA) (2011) website. In addition, all monetary data are adjusted for inflation using the Consumer Price Index (CPI) as published on the ABS (2011) website.

6. Results and analysis

The descriptive statistics for CEO remuneration and the independent variables are listed in Table 1 below.

Table 1: Descriptive statistics of CEO remuneration and key independent variables

Variable	N	Mean	SD	Variable	N	Mean	SD
TOTAL ($'m)	249	3.267	3.548	$CASHFLOW_t$ ($'m)	249	655	2,268
CEOREPUT	249	9.0	1.726	$CASHFLOW_{t-1}$ ($'m)	249	622	2,051
INDEPENDRC	245	0.934	0.164	$MKTRETURN_t$ ($/share)	249	49.065	57.942
ROE_t	249	0.166	0.230	$MKTRETURN_{t-1}$ ($/share)	249	51.316	63.583
ROE_{t-1}	249	0.174	0.228	SUBSTOWN (unit)	207	2.88	1.461
VOLATILITY	249	0.090	0.119	SUBSTOWN (%)	207	29.24	16.006
COSIZE ($'m)	249	13,300	52,420	CEO-OWN (%)	223	3.25	8.50

Notes: N = Number of observations; SD = Standard deviation; SUBSTOWN (unit) = the number of outside substantial shareholders; SUBSTOWN (%) = Percent of shares owned by outside substantial shareholders; CEO-OWN (%) = percentage of shares owned by the CEO; $'m = $ million; all monetary data are expressed in real terms.)

We conduct a one-way between groups analysis of variance (ANOVA) with post-hoc tests on CEO total remuneration less termination payments with each year in the study representing one group. Our results indicate that there is no statistically significant difference between the years and hence it is appropriate to run regressions on the pooled data over the three years.

We run regressions for CEO total remuneration. Only the results which are based on our hypotheses are shown in Table 2. The results in Table 2 in relation to CEO total remuneration are rather similar when regressions are run for both company performance measures for the current year and when lagged one year. The adjusted R square compares favorably with the literature where other authors such as Merhebi et al. (2006) have reported 0.180. This is because there are numerous factors which may affect CEO remuneration such as the particular country's regulatory environment and business practices (Lee 2009). The regression results show that there is a statistically significant and positive relationship between CEO total remuneration and CEO personal reputation.

We find that, in general, the ratio of independent directors to the total number of members on the remuneration committee does not have any significant influence on CEO remuneration. Our results suggest that the influence of substantial shareholders is not significant for CEO total remuneration. This is understandable because the ability of shareholders to dictate CEO remuneration is curtailed since there is no regulatory requirement in Australia that compels companies to accept the majority shareholders decision in regard to CEO remuneration. Our results in regard to company performance measures are mixed. There is no significant association between CEO total remuneration and ROE whether for the current year or lagged. There is a significant and positive relationship between CEO total remuneration and net operating cash flow, either for the current year and or lagged one year. This implies that liquidity and the company's ability to pay are important considerations in influencing CEO remuneration.

Table 2: Regression results (selected only): determinants of CEO remuneration

	TOTAL (regressed against current FINPERF)	TOTAL (regressed against lagged FINPERF)
Intercept		
	(7.613)	(7.674)
CEOREPUT	0.110**	0.114**
	(2.000)	(2.090)
INDEPENDRC	0.084	0.081
	(1.541)	(1.481)
SUBSTOWN	-0.014	-0.027
	(-0.249)	(-0.485)
ROE_t	0.038	
	0.656)	
ROE_{t-1}		0.021
		(0.373)
$CASHFLOW_t$	0.132**	
	(2.300)	
$CASHFLOW_{t-1}$		0.154***
		(2.682)
$MKTRETURN_t$	0.023	
	(0.392)	
$MKTRETURN_{t-1}$		-0.022
		(-0.369)
VOLATILITY	-0.140**	-0.136**
	(-2.409)	(-2.373)
COSIZE	0.418***	0.415***
	(6.602)	(6.495)
Adjusted R^2	0.333	0.336

Notes: *, **, *** denotes statistically significant at the 10%, 5% and 1% levels respectively. Each cell reports the coefficients from different regressions, with t-statistics in parentheses. Refer to Table II for abbreviations

There appears to be no significant relationship between shareholders returns, be it for the current year or lagged one year, with CEO remuneration. In regard to risk, our results show a significantly negative relationship between CEO remuneration and VOLATILITY (i.e., σ(ROE)). Our results imply that companies may be risk averse and do not like volatility in reported earnings and therefore penalize CEOs for any increase in the variability of ROE.

We run regressions to test for industry effect and note that none of the industry sectors have any statistically significant influence with the exception of the financial as well as the Information Technology industries which have a significantly negative effect on CEO remuneration. The downward pressure on CEO remuneration in the financial industry may be a reaction to the adverse publicity that banks were getting from the GFC. Bebchuk et al. (2005) contend that the more outrage expected to be provoked at remuneration arrangements, the more unlikely directors will be to approve CEO remuneration increases due to the potential social costs to the firm. The significantly negative effect on CEO remuneration in the information technology industry may be due to intense competition in the market where such functions can be outsourced overseas where labor is relatively cheap. Any further analysis by industry is beyond the scope of this paper.

Our initial regression results do not show any statistically significant relationship between CEO total remuneration and any changes in CEO during the year, as well as with the percentage of company shares owned by CEOs, and GDP. Our analysis of the data shows that the average shareholdings for CEOs is less than five percent and therefore is deemed to be non-substantial. Accordingly, we omit these three control

variables from further analysis. From our results, we observe that company size has a significantly positive effect on total CEO remuneration.

7. Conclusion

Our study provides more insight into the factors that may affect CEO remuneration in more recent years. Our results show that there is a positive association between CEO total remuneration and CEO personal reputation. This shows that personal reputation is a strong rationale for the amount of remuneration that is awarded to that CEO. The results relating to the ratio of independent directors on the remuneration committee show that having more independent directors does not appear to have any constraining effect on CEO remuneration. We do not find any significant relationship between the composition of the remuneration committee and CEO remuneration. This may not necessarily be due to the composition of the remuneration committee, but the determination of director independency as debated by authors such as Bebchuk et al. (2005). This finding contributes to the debate on whether there are flaws in the Anglo-Saxon model of corporate governance especially given that this study is based on more recent data. Our results also show that the effectiveness of outside shareholders in monitoring CEO remuneration is somewhat limited. This may be due partly to the regulatory environment which does not give the owners of the company, the shareholders, binding authority in the determination of CEO remuneration. The argument is that the board of directors knows better than the shareholders on how to manage the company. However, our results in regard to remuneration committee composition indicate that this may not necessarily be true due to the board capture theory (Doucouliagos et al. 2007) and arguments from authors such as Bebchuk et al. (2005) that directors tend to ratchet CEO remuneration above the industry average on the justification that this is prevailing practice rather than seeking the best deal for their shareholders. We use the net operating cash flow as one of the measures and find that there is a significantly positive relationship between CEO remuneration and company performance. Our results show that volatility in financial performance is a major determinant of CEO remuneration and rightly so. And, consistent with prior literature, we find that company size has a significantly positive effect on CEO remuneration.

There are limitations to this study in terms of its empirical modeling and variable measurement. Firstly, the empirical schema does not comprehensively include all possible independent variables related to corporate governance mechanisms such as CEO duality. Secondly, the data collected to measure some variables do not cover all possible constructs of the variables being measured. For example, the personal reputations of the directors on the remuneration committee are not used as an independent variable. However, using a large number of explanatory variables may be of concern due to multicollinearity (Pukthuanthong et al. 2004). Our future study will consider analyzing the determinants of the various components of CEO remuneration, such as fixed, performance-based and share-based remuneration. In addition, we may study the pay elasticity of CEO remuneration with independent variables such as the annual change in company performance. In addition, the sample size may be increased to say the ASX Top 300 and or the study period extended to the financial year 2010 to determine if there are any lagged effects from the GFC.

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