CEO COMPENSATION IN NEW ZEALAND

1997 – 2002

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This draft: December 2004

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Abstract

We use new data made available by the 1993 Companies Act to examine trends in CEO pay and related governance issues. Although these issues have received a great deal of coverage in the media, rigorous research is in short supply. This study is a first step in filling this gap.

Since 1 July 1997, when the mandatory disclosure of executive compensation required by the Act came into universal effect, real CEO cash compensation has grown at a median rate of 5.2% p.a. compared to 3% for shareholder returns. Unsurprisingly, this has pushed more CEOs into 'high-income' brackets: the proportion of firms paying the CEO more than $400,000 increased from 19% in 1997 to 41% in 2002.

The compensation committee obviously has an important role to play in the setting of CEO pay, and the composition of this committee may be crucial. Consistent with good governance principles, the proportion of firms reporting the use of a compensation committee to set and review CEO compensation increased from 47% in 1997 to 77% in 2002. However, while only 3.6% of these firms included the CEO on the committee in 1997, this rose to 12.6% by 2002. Consistent with the view that allowing CEOs to determine their own pay exacerbates agency problems, firms where the CEO is a member of the compensation committee pay more to CEOs and provide lower returns to shareholders.

CEOs also exert power through membership of the Board of Directors, particularly if they also fill the Chairman's role. Again consistent with good governance principles, the proportion of firms that have the CEO on the board decreased from 74% in 1997 to 65% in 2002. Less reassuringly, there was no change in the proportion of firms for which the CEO is also the Chairman of the board.

1. Introduction

The purpose of this paper is to investigate the nature and form of chief executive officer (CEO) compensation during the six-year period 1997 to 2002. The chapter is made up of six sections. Following the introduction, section two reviews the history and structure of executive compensation disclosure within New Zealand firms. In particular, I will focus on the change in disclosure requirements which came into effect from 1 July 1997.[1] The third section outlines the way in which the sample has been constructed. Section four examines trends in CEO compensation levels and relative measures of compensation with respect to worker and shareholder income. The fifth section investigates the effect of different governance structures on the level of CEO compensation. Finally the conclusion contains a list of stylised facts identified from the data analysis.

2. Compensation Disclosure for Publicly Listed Firms in NZ

2.1. Background

In New Zealand the new Companies Act came into universal effect from 1 July 1997. It was the date by which all public and private companies were deemed to be re-registered under the 1993 Act. One of the requirements of the new Companies Act was the mandatory disclosure in the firm's annual report of the number of employees receiving total compensation and other benefits in excess of $100,000. These amounts were required to be reported in $10,000 intervals. The exact amount paid to directors also had to be disclosed.

[1] The 11th hour clause of the 1993 Companies Act, section 211(1) (g).

Prior to 1997, it was not common for firms to publicly disclose compensation information as it was not part of the mandatory reporting process. The new disclosure requirement was controversial and followed a review undertaken by the New Zealand Law Commission at the request of the Minister of Justice. The Law Commission avoided recommending salary disclosure and argued that it was not contained in the first draft of the legislation on which public submissions were called. The rationale put forward by the Justice Minister for the disclosure was to encourage "greater openness" and the "desirability of shareholders being able to judge the management of the firm". These same sentiments also appear in the academic literature, for example, by Jensen and Murphy (1990). They argue (page 254) that "the benefits of the public disclosure of top-management compensation are obvious since this disclosure can help provide a safeguard against "looting" by management (in collusion with "captive" boards of directors)". However, while the reasons for disclosure may seem favourable Jensen and Murphy go on to note the associated, but often less appreciated, costs attached to disclosure. These include the effects on contracts with other employees, increased union demands, media criticism and ridicule by activist groups. They refer to these reactions as the "political process". They argue that it can discourage risk-averse board members from adopting efficient incentive contracts that link performance to compensation. Stakeholder outrage may embarrass directors and managers as well as causing them reputational damage. The net effect is a reduction in the effectiveness of executive employees and boards in managing the firm and the corresponding shareholder wealth. It suggests that CEOs seek to exert control over the compensation process in such a way as to camouflage rent extraction and encourage the adoption of inefficient compensation structures.

The concept of management control refers to the ability of the management of the firm to undertake discretionary behaviour, without fear of punitive action by shareholders, pursuing policies serving in their own self interests at the expense of the owners (Berle and Means (1959)). Shareholders interests serve as a constraint rather than as the dominant motivating factor in the decision making process. Given the assumption that every economic agent tries to maximise their own self-interest, there is no *a priori* reason to believe that CEOs who exercise control will necessarily adopt policies that maximise shareholder wealth. Like other human beings, CEOs tend to engage in activities that increase their own well-being. The lack of alignment between the interests of the shareholders and the CEO is referred to as an agency problem.

There are two approaches to the study of executive compensation. Under the optimal contracting view (OCV), the CEO's compensation package for large publicly traded firms is set by the board of directors and is designed to minimise agency costs by offering incentives for CEOs to maximise shareholder wealth. In contrast, the managerial power approach (MPA) suggests that the CEO can influence their compensation, camouflaging rent extraction leading to inefficient pay arrangements and suboptimal incentives which reduce shareholder wealth.

When this legislation was invoked, the salaries of politicians and public sector executives had been public information for some time. One argument in support of the increased disclosure is that the government wanted to allow the public to directly compare the compensation paid to politicians, public and private sector executives. The new legislation signalled two key changes. First, the new information brought a dramatic shift in the ability of stockholders to evaluate and monitor links between executive pay and performance. Second, the new requirements brought New Zealand reporting standards more in line with those already in place in Australia and the United States.

Opposition to the disclosure of executive compensation came from various business groups including the Business Roundtable, the Employers Federation and publicly listed firm Fletcher Challenge. While the disclosure of director compensation and benefits (also required in the 1993 Companies Act)[2] was seen as acceptable by these groups, since directors were viewed as elected representatives of shareholders, they argued that disclosure of executive compensation was an invasion of privacy. In particular, it would be easy to identify specific executives in the top salary bands. Opposition groups also argued that the blind disclosure of compensation details at arbitrary levels without any explanation of job performance requirements or employment conditions would not necessarily lead to increased accountability as suggested by the Minister of Justice. The Business Roundtable argued that due to the nature of the shareholder-management relationship, public disclosure would reduce the desire of boards to implement pay-performance related packages as the firm could be criticised for high salary figures if there was no explanation in the report regarding the detailed background of the salary package. Other views supporting the anti-disclosure stance believed that if compensation information was truly warranted by shareholders then it would be disclosed voluntarily without any intrusion by the law. [3]

[2] See section 211(1)(f).
[3] Richard A. Epstein, The Concealment, Use and Disclosure of Information, New Zealand Business Roundtable, August 1996.
Jan Corbett, Salary – Whose Business, Independent Business Weekly, 19 April, 1996.

Other reasons put forward against the mandatory disclosure requirement included the potential use of the information by predators wanting to recruit key CEOs. [4] Second, it could actually lead to an increase in the lower compensation levels rather than causing top salaries to fall as CEOs seek higher salaries based on disclosures by their peers. Accountants and lawyers could devise ways of providing benefits to CEOs that are not compensation and, therefore, less transparent. Lobbyists were not convinced that increased transparency and a need to bring public disclosure in line with government owned organisations were legitimate reasons for increasing disclosure.

It is not clear whether those supporting or opposing the change in compensation disclosure details were justified in their stances. On the one hand the lack of CEO compensation details prior to 1997 made it extremely difficult for shareholders to monitor the efficiency of both the form of compensation and the amount paid. In particular, shareholders had no way to compare firm performance relative to CEO compensation or to make comparisons between firms within the market. Conversely, those lobbying against the change argued that disclosure would result in weaker pay-performance sensitivity.

Following agency theory (Jensen and Meckling (1976)) one way to effectively monitor CEO compensation is by the measurement of pay-for-performance sensitivity. Under OCV CEO compensation in large, publicly traded companies is designed to minimise the agency costs that exist between the CEO, (the agent) and the shareholders, (the principals). The board seeks to maximise shareholder value. The compensation scheme is designed to serve this objective. Prior to disclosure it was

[4] Kevin Hart, Lobbyists maintain fight against pay disclosure, New Zealand Herald, 7 September, 1996.

assumed that this theory held in practice. Alternatively, under MPA compensation arrangements approved by boards often deviate from OCV because directors are "captured" or subject to influence by the CEO. This allows management to receive pay in excess of that level that would be optimal for shareholders. Rent extraction may be camouflaged by the use of inefficient compensation schemes that weaken incentives and further reduce shareholder wealth. Encumbent CEOs and captured directors who are extracting rents would be expected to lobby against disclosure due to the fear that the information will help reveal such inefficiencies. Business and other lobby groups are more likely to be OCV proponents. Conversely those in favour of disclosure are more likely to be MPA adherents.

3. Sample Construction

3.1. Data Disclosure

The new disclosure allows a descriptive analysis of CEO compensation level and structure. The data can also be used to draw relative comparisons between the level of compensation paid to CEOs versus average worker and shareholder income. The new information also enables compensation to be analysed relative to measures of firm governance and trends in real CEO compensation.

3.2 Data Collection

The sample consists of companies listed on NZX during the period 1996 to 2002. In each year firms were excluded from the sample if annual report information was missing, or they were only listed on the secondary board, or they delisted during the period, or they were managed by a firm employed to oversee the day-to-day operations of the business, or they operated as trusts or funds as these are managed by a group of executives and no individual CEO is appointed.[5] In each of these cases, there was either insufficient compensation data or other necessary data were unavailable.

Disclosures regarding total compensation including separate component payments used for compensation and equity incentives were taken from the reports. Compensation is defined as the cumulative value of salary, share grants, superannuation and bonus payments, retirement allowances, health insurance coverage, motor vehicle allowances and bonus payments where relevant for each respective corporate officer. Consulting fees are not counted as part of compensation. The value of CEO compensation is measured in one of two ways. In the event that the CEO is also a member of the board of directors, compensation details are taken directly from the information reported in the statutory disclosures section of the annual report. Otherwise, CEO compensation is calculated from the disclosures of payments made to employees in excess of $100,000. CEO compensation is calculated as the midpoint of the highest payment bandwidth. This information was disclosed voluntarily in 1996 by 34 firms.

The data were gathered mechanically from the individual annual reports of each firm listed on the New Zealand Stock Exchange (NZSX) during the seven year period 1996 to 2002. This data gathering process involved going through every firm's annual report for each year of the study, recording CEO compensation disclosures, statistics on ownership, governance and financial information from the income statement and the balance sheet. Firm annual reports and stock market data were obtained from the

[5] For example, in 2002 E-cademy Holdings Limited paid management fees of AUD36,000 to DPA Pty Ltd. and $60,000 to Baroda Hill company.

Datex database, the University of Otago Resource Library, the University of Otago Sharemarket database and the NZSX. Information was collated onto separate data sheets for each firm within each year and has been used to build a very detailed database on which much of this research is based. The final sample statistics for each calendar year are reported in Table I. A summary of the real level of CEO compensation is given in Figure I.

Table I
Number of Firms Sampled and Listed on the NZX, 1996 - 2002

	1996[1]	1997[2]	1998[3]	1999[4]	2000[5]	2001[6]	2002
Number of firms listed on the NZX	114	131	136	128	135	126	127
Number of firms in sample	34	83	88	73	74	76	79
Number of firms with insufficient data	14	28	23	28	33	29	25
Number of firms privately managed	3	7	11	11	12	7	10
Banks, trusts, funds and investment companies included in NZX listings	7	13	14	16	16	14	13
Number of firms for which there was no disclosure	56	0	0	0	0	0	0

[1]While companies were aware of the new disclosure requirements required under the changes to the Companies Act; firms were not legally required to undertake mandatory disclosure until July 1, 1997. In the 1996 sample of 90 firms, 34 made voluntary early disclosures that complied with the 1993 Companies Act, section 211(1)(g) which became mandatory after 1 July, 1997, and 24 reported compensation details for members of the board of directors only. There were 31 firms that did not disclose any compensation details.
[2]During 1997-1998 there were 2 takeovers, 3 firms were removed, 3 firms renamed and there were 10 new listings.
[3]During 1998-1999 there were 12 takeovers, 2 firms were removed, one merger, 10 firms renamed and there were 7 new listings.
[4] During 1999-2000 there were 3 takeovers, one merger, 3 companies moved their listings to overseas exchanges, 3 firms renamed and there were 12 new listings.
5 During 2000-2001 there were 7 takeovers, one merger, 5 firms were removed, 5 firms liquidated, 7 firms renamed and there were 9 new listings.
6. During 2001 – 2002 there were 3 takeovers, 4 firms were removed, 2 firms liquidated, 2 firms renamed and there were 10 new listings.

4. CEO Compensation

4.1 Trends in CEO Cash Compensation

Figure I is a graph of real CEO cash compensation measured in terms of 1997 dollars. Real compensation is calculated as the total of all cash components of the income package adjusted for changes in the consumer price index (CPI) relative to 1997 dollars. The compensation figures do not include the value of any option grants awarded as part of the compensation package.

Figure I

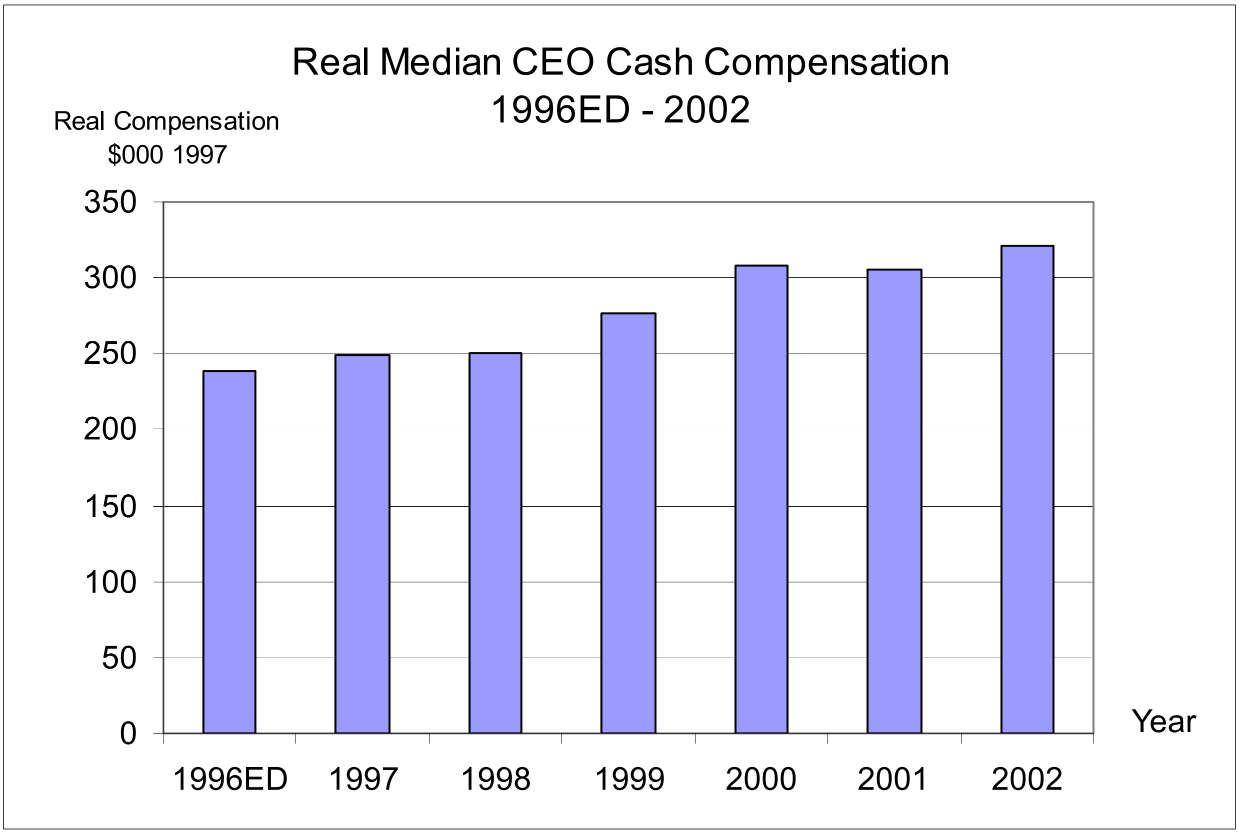


Figure I shows that real CEO compensation has increased during 1996ED to 2002. Each year since 1997, real CEO compensation has grown by a mean rate of 4.8% and a median rate of 5.2%. For the whole period, mean CEO compensation growth is 26.5% and median growth is 28.9%. This growth in CEO compensation is further emphasised by the increasing trend in the amount being paid to the CEO within each year and across the six-year time period is shown in Table II. The median and mean levels of total CEO compensation are reported in band widths for compensation above and below$400,000. While average payments to CEOs have increased across all the reported levels, the number of firms paying less than $300,000 has almost halved and the number of firms paying in excess of $400,000 has approximately doubled during 2001 and 2002 relative to 1997.

Table II
Total CEO Compensation Excluding Options
1997 – 2002

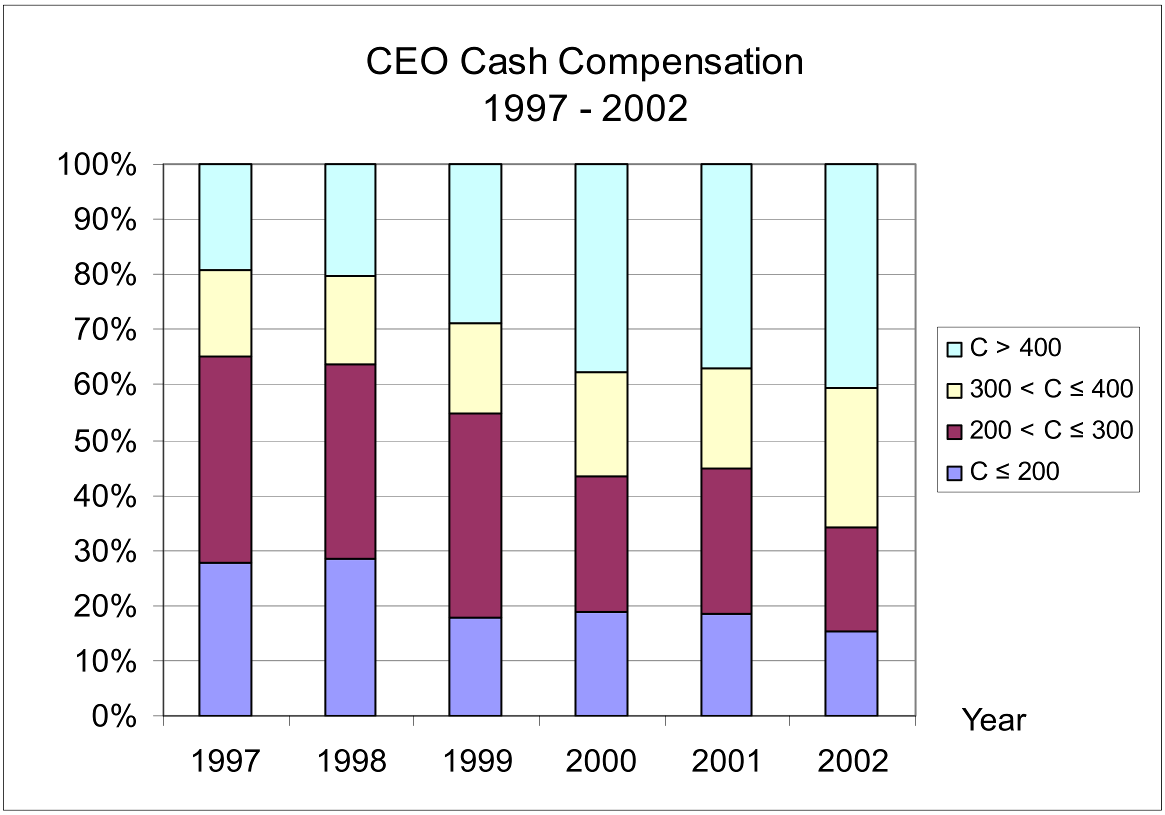
CEO Compensation ($000)	1997		1998		1999		2000		2001		2002	
	No. of CEOs	$000	No. of CEOs	$000	No. of CEOs	$000	No. of CEOs	$000	No. of CEOs	$000	No. of CEOs	$000
Comp ≤ 200	23	155 149	25	165 151	13	130 137	14	145 140	14	152 143	12	166 158
200 < Comp ≤ 300	31	237 244	31	246 245	27	251 251	18	250 250	20	268 257	15	250 250
300 < Comp ≤ 400	13	351 353	14	348 345	12	349 350	14	340 344	14	346 347	20	349 349
Comp > 400	16	574 709	18	515 776	21	595 732	28	509 670	28	565 686	32	551 731

Two numbers are reported for each year in the columns labelled $000.The first number is the median level of compensation within the stated band-width. The second number is the mean level of compensation paid to the CEO within the stated band-width. The total compensation paid to the CEO in each year is reported within $100,000 band widths for payments exceeding $200,000.

Figure II shows that during the period 1997 to 1999 the majority of CEOs were paid less than $300,000. In 1997, 65% of all firms paid CEOs at most $300,000. Similarly for 1998 and 1999 the proportion is 63% and 55% respectively In contrast, during the latter half of the study, for the years 2000 to 2002, the proportion of firms where the CEO earned less than $300,000 was considerably lower. In 2000 it was 43% and during 2001 and 2002 the proportion of CEOs earning less than $300,000 was 44% and 34% respectively. Figure II suggests that the shift to higher total CEO compensation began in 2000. In particular the growth in the proportion of CEOs earning more than $400,000 can be seen between the two periods 1997 to 1999 and 2000 to 2002. In 1997 19% of all firms paid CEOs more than $400,000. During

1998 and 1999 this had increased to 20% and 29% respectively. Throughout the last three years of the study these proportions were 38%, 37% and 41% respectively

Figure II

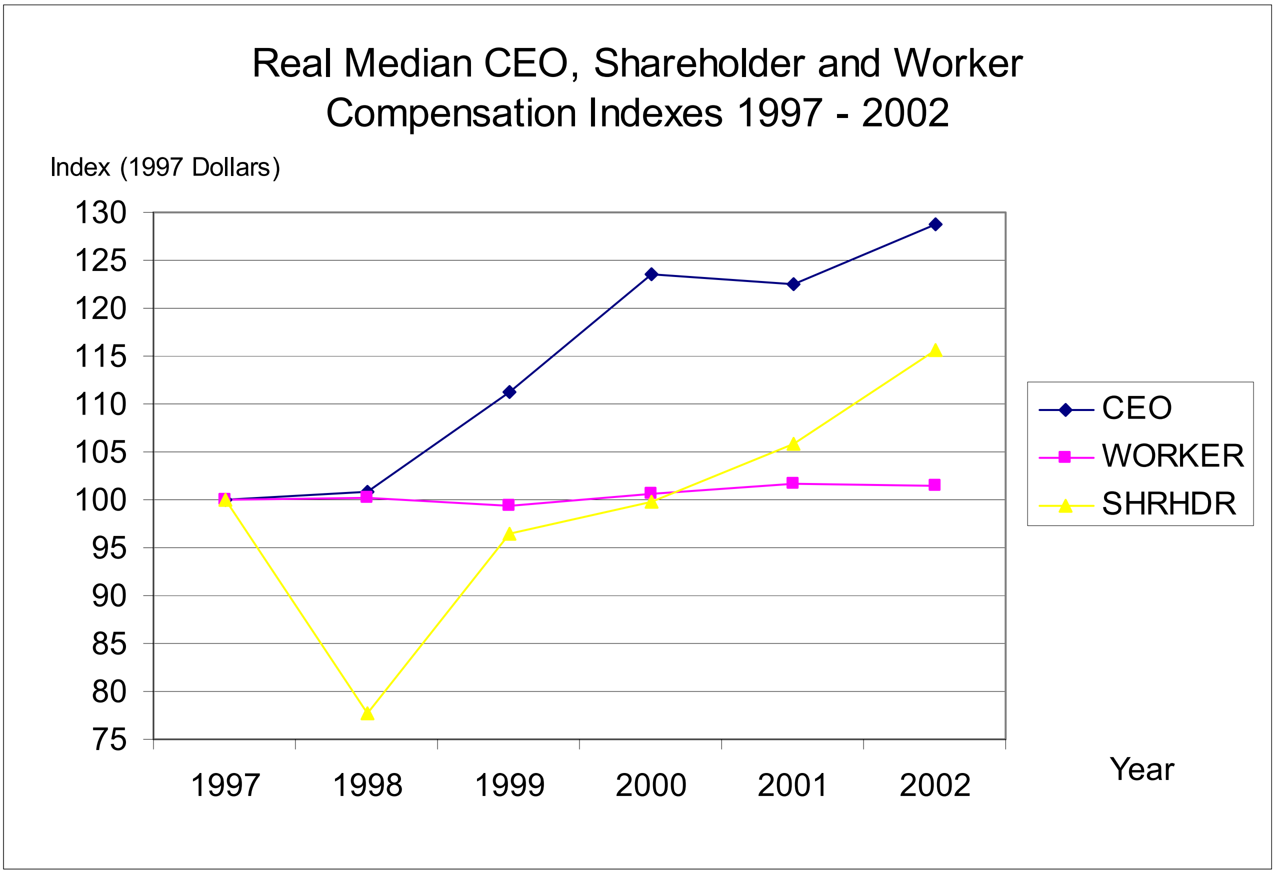


The total compensation paid to the CEO in each year is recorded within band widths for payments up to a maximum of $400,000. firms paying CEOs more than $400,000 per annum are treated as one group. The proportion of payments lying within these boundaries are shown on the graph.

The shift to higher CEO pay levels is also apparent from the 13% decrease in the proportion of firms paying less than $200,000 and the 18% drop in the proportion of firms paying between $200,000 and $300,000 for 2002 compared to 1997. In contrast, the proportion of firms paying between $300,000 and $400,000 increased by 9% while those paying more than $400,000 increased from 19% in 1997 to 41% in 2002. These findings demonstrate two important features of the data. First, the average level of CEO compensation has increased during 1997 to 2002. Second, there has been an increase in the proportion of firms paying higher amounts of compensation to CEOs for the period 1997 to 2002.

This increase in the level of CEO compensation has been referred to as the "ratcheting-up" effect on executive pay following public disclosure of executive compensation. This refers to the phenomena that as executives learn more about competitor pay levels through public disclosure, those who are underpaid will ask for pay increases. The pressure to pay more is also encouraged by boards using external consultant recommendations to support higher salaries in order to recruit, retain and motivate key staff.

Figure III



The level of real CEO compensation has also increased relative returns to shareholders and real worker income. Figure III shows that real CEO compensation has gained the most clearly exceeding the worker and shareholder indexes relative to a base level of 100 set in 1997. The index for shareholder returns lagged well behind the index for CEO compensation throughout 1997 to 2002 indicating that returns to shareholders did not match the gains in CEO compensation throughout the period. The real worker index changed minimally in comparison to both these indexes.

4.2 Relative Cash Compensation Levels

This section makes comparisons between the average level of CEO cash compensation, average annual worker income and average shareholder returns. Real average worker income is measured using inflation adjusted mean and median levels of weekly income reported by New Zealand Statistics for the period 1997 to 2002. The weekly income figures were converted into yearly incomes and used to calculate the ratio of average CEO compensation to average annual worker income. The mean and median compensation levels of income for CEOs and workers are reported in Table III.

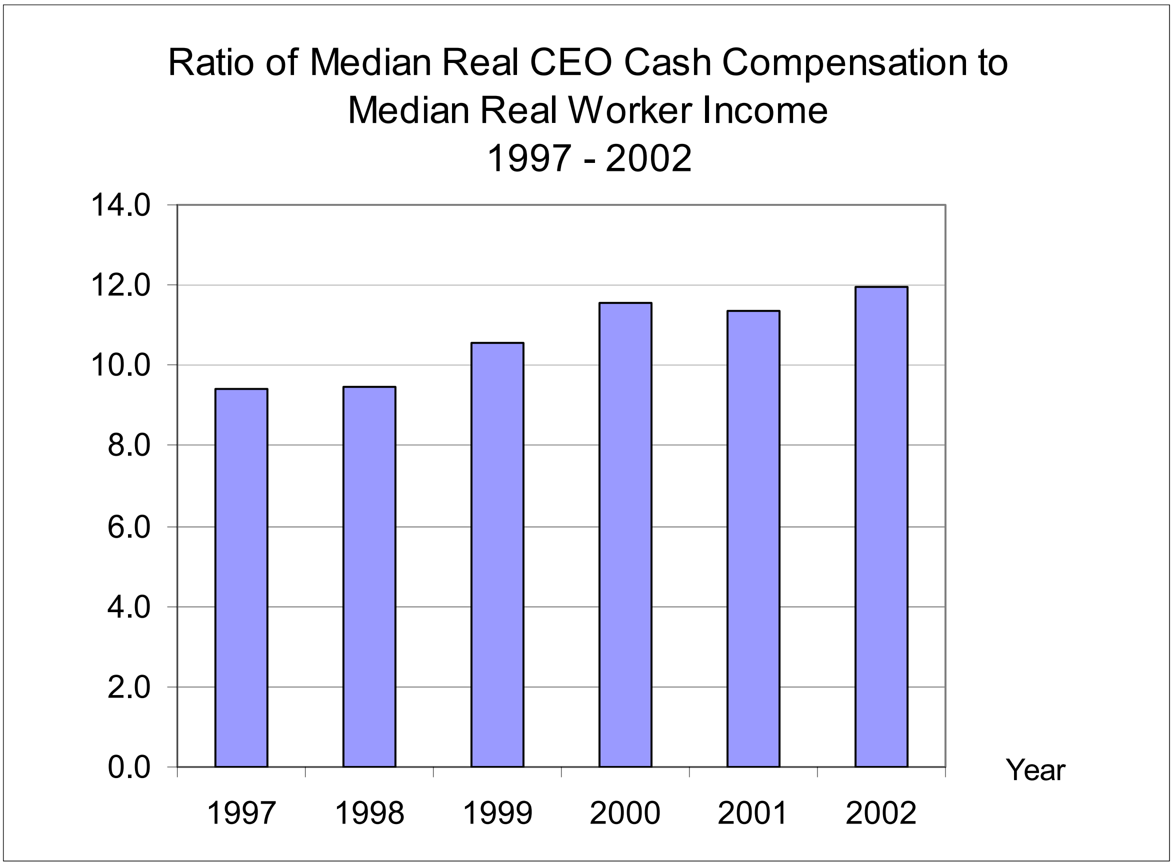
Table III
Real Corporate Officer and Annual Worker Income
1997 – 2002

	Real CEO Compensation ($000)		Real Annual Income per Worker[1] ($000)	
Year	Mean	Median	Mean	Median
1997	324	249	29.9	26.4
1998	338	251	30.0	26.5
1999	375	277	31.0	26.7
2000	386	308	30.6	27.0
2001	379	305	31.3	27.3
2002	410	321	31.5	27.3

[1]The annual income per worker data is taken from the Statistics New Zealand website and is calculated from the average reported weekly income during 1998 – 2002. The figures for 1997 are determined using the worker income index from the Reserve Bank of New Zealand.

The ratios of median real CEO compensation relative to median real worker income are shown in Figure IV. In 1997 CEOs earned approximately 9 times as much as an average worker. This ratio had increased to 12 times by 2002. The data in Figure IV show that the gap between real average CEO compensation and real average worker income has widened during 1997 to 2002.

Figure IV



As a way of directly comparing gains in CEO compensation relative to changes in shareholder value two portfolios were constructed based on the top 10 paid and the bottom 10 paid CEOs in the sample during 1997. The firms in each of these portfolios were tracked during the six-year period and the median real CEO compensation and median real shareholder return in each year was calculated for the respective portfolios. These values were then used to construct indexes starting with a base of 100 in 1997. The indexes shown in Figure V are used to compare changes in CEO compensation to changes in shareholder returns over the period 1997 to 2002.

Figure V

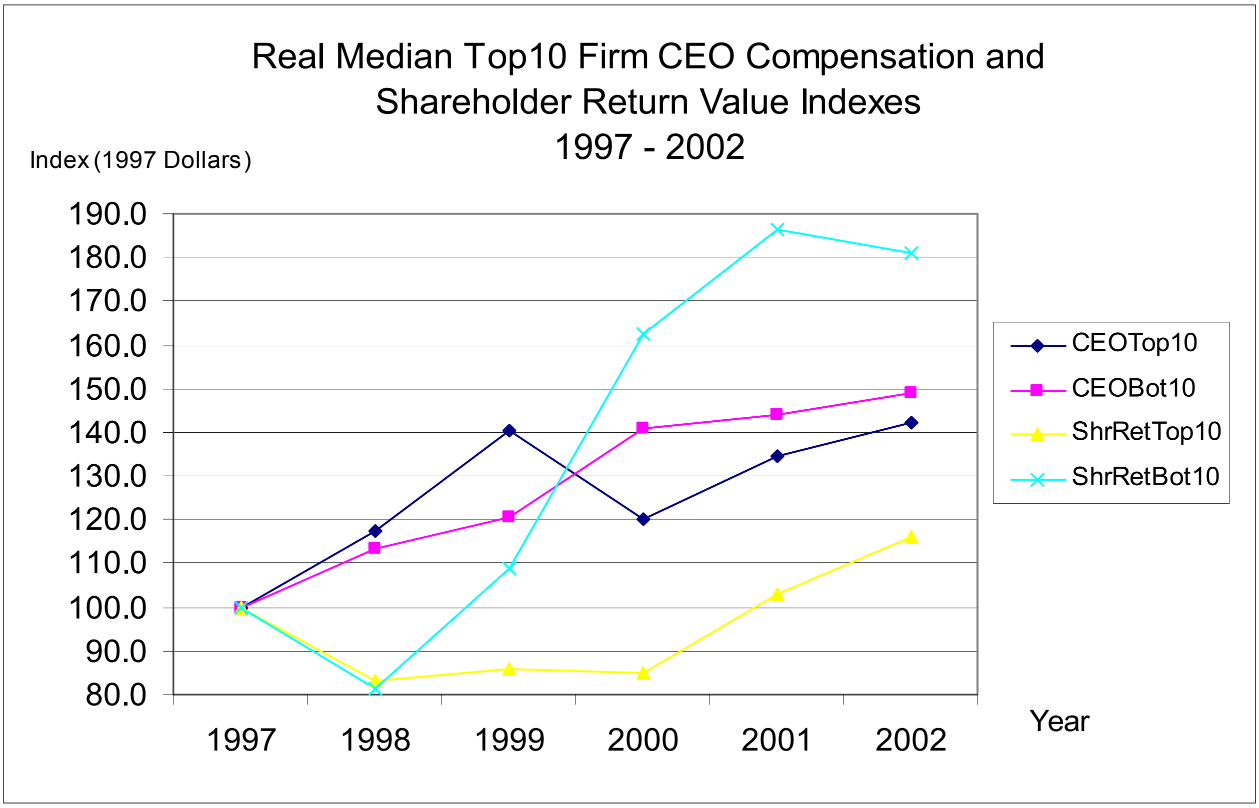


Figure V shows that by the end of 2002, the portfolio of 10 firms where the CEO was paid the least in 1997 had significantly higher shareholder returns compared to those earned by the 10 firms where the CEO was paid the highest in 1997. In comparison the actual compensation levels between the highest and lowest paid groups of CEOs did not differ too much at the end of 2002 indicating that on average the firms that had initially paid their CEOs less had increased their compensation levels and those firms paying CEOs more in 1997 had not continued to raise CEO compensation levels. This finding is consistent with the argument that disclosure would encourage a ratcheting up effect for lower paid CEOs.

5. The Compensation Setting Process

5.1. The Setting of CEO Compensation

The board or the compensation committee is responsible for designing pay packages that attract and retain key executives and offer incentives that motivate decisions to maximise shareholder wealth. As part of this process directors and compensation committee members may use the results of external compensation surveys and recommendations made by external compensation consultants as indicators of compensation levels. Typically, these surveys focus primarily on the size of the amount being paid and year-on-year increases.[6] Minimal emphasis is given to specific compensation objectives and their alignment to shareholder value and corporate performance.[7]Moreover as argued by Jensen and Murphy (2004) the use of consultants may be consistent with MPA if they also provide input for lower-level employee pay practices. The lucrative cross-selling of services in addition to CEO compensation information increases the conflict of interest for the consultant. In these situations the consultant may be less willing to argue against higher CEO compensation if the recommendation could hinder future contracting opportunities.

Following mandatory disclosure the inclusion of a separate compensation committee as part of the compensation setting process could be viewed as favourable, particularly if the CEO was excluded. In contrast, a compensation committee where the CEO is a member may result in a more beneficial executive pay structure. This is because the CEO may be able to exert more control over the content and conditions of

[6] Sarah Whitebloom, 1996, Caught in a vicious circle, *The National Business Review*, September 6, 52. "David Tankel, of consultant New Bridge Street, said, "It is not an exact science." The net effect, of course, is that large pay awards in one firm often lead to large pay rises for their competitors, according to a report published in the *Guardian* newspaper in the UK. It is a vicious circle that remuneration consultants argue they are not best placed to break. The theory goes that good executives would only go elsewhere if their particular employer sought to cut salaries against "market rates"…….. But within this framework, pay consultants are increasingly being employed to advise remuneration committees on executive salaries."

[7] Sarah Whitebloom, 1996, Caught in a vicious circle, The National Business Review, September 6, 52. "But one of the most crucial roles performed by consultants is the comparison with other companies' pay levels."

the compensation package. Conversely if the committee is independent of the CEO, compensation and incentives may be more closely aligned with shareholder interests. Table IV shows the number and proportion of firms that reported having a separate compensation committee and if the CEO is a member of the compensation committee. Table IV includes data for 1996 to allow comparisons to be made between pre- and post-disclosure periods.

Table IV
Compensation Committee Criteria by Number of Firms, 1996 - 2002

1996ED is the sample of firms during 1996 that voluntarily met the mandatory disclosure requirements prior to 1 July 1997.
1996DD is the sample of firms during 1996 that only disclosed director compensation details.
1996ND is the sample of firms during 1996 that did not comply with any of the mandatory disclosure requirements outlined under the new legislation.

Year	Number of Firms	Compensation Committee Criteria: No Compensation Committee		Separate Compensation Committee, CEO is not a member		Separate Compensation Committee, CEO is a member	
		No.	%	No.	%	No.	%
1996ED	34	22	64.7	12	35.3	0	0
1996DD	25	19	76.0	6	24.0	0	0
1996ND	31	20	64.5	10	32.3	1	3.2
1996	90	61	67.8	28	31.1	1	1.1
1997	83	44	53.0	36	43.4	3[1]	3.6
1998	88	38	43.2	43	48.8	7[1]	8.0
1999	73	22	30.1	40	54.8	11[1]	15.1
2000	74	20	27.0	42	56.8	12[1]	16.2
2001	76	21	27.6	41	54.0	14[1]	18.4
2002	79	18	22.8	51	64.6	10[1]	12.6

[1] In 1997-2002 Telecom had a separate compensation committee in place. While the CEO was not a formal member of this committee he/she was entitled to and did attend all (five out of seven in 2000) of the compensation committee meetings and has been included as being a member for this reason.

The proportion of firms reporting the use of a separate compensation committee is very similar for both the 1996 early disclosure sub-sample (1996ED) and the 1996 non-disclosure sub-sample (1996ND). This suggests that prior to the mandatory reporting date there was little difference between the importance given to the inclusion of a separate compensation committee for those firms that decided to undertake early disclosure versus those that did not.

From Table IV there has been an increase in the proportion of firms reporting the use of a compensation committee between 1996 and 2002. In 1996, the number of firms using a compensation committee made up 32.2% of the total sample. Immediately following the adoption of the new Companies Act, in 1997, 47.0%, of the firms in the sample reported the use of a compensation committee. This proportion increased to 56.8% in 1998.

As a result of the disclosure requirements it is quite possible that firms viewed the adoption of a compensation committee as a means of signalling to shareholders that compensation was being set ethically. It is reasonable to anticipate that more firms would adopt committees over time if this was the case. The increase in the proportion of firms using separate compensation committees continued throughout the last four years of the study moving from 69.9% in 1999 to 77.2% in 2002. Initially the inclusion of a compensation committee appears to be consistent with OCV, aligning the incentives of management and shareholders. However, if (independent) directors are reluctant to challenge decisions about CEO pay and perquisites, being influenced instead by notions of reciprocity and authority, then the use of a compensation committee may be consistent with MPA.[8]

There is also an increase in the proportion of firms where the CEO is a member of the compensation committee. In 1998, the first full year for which the disclosure rulings would have been in effect, the proportion of firms including the CEO as a member of the committee is 8.0%. This is a rise from 3.6% in 1997. The increase has been

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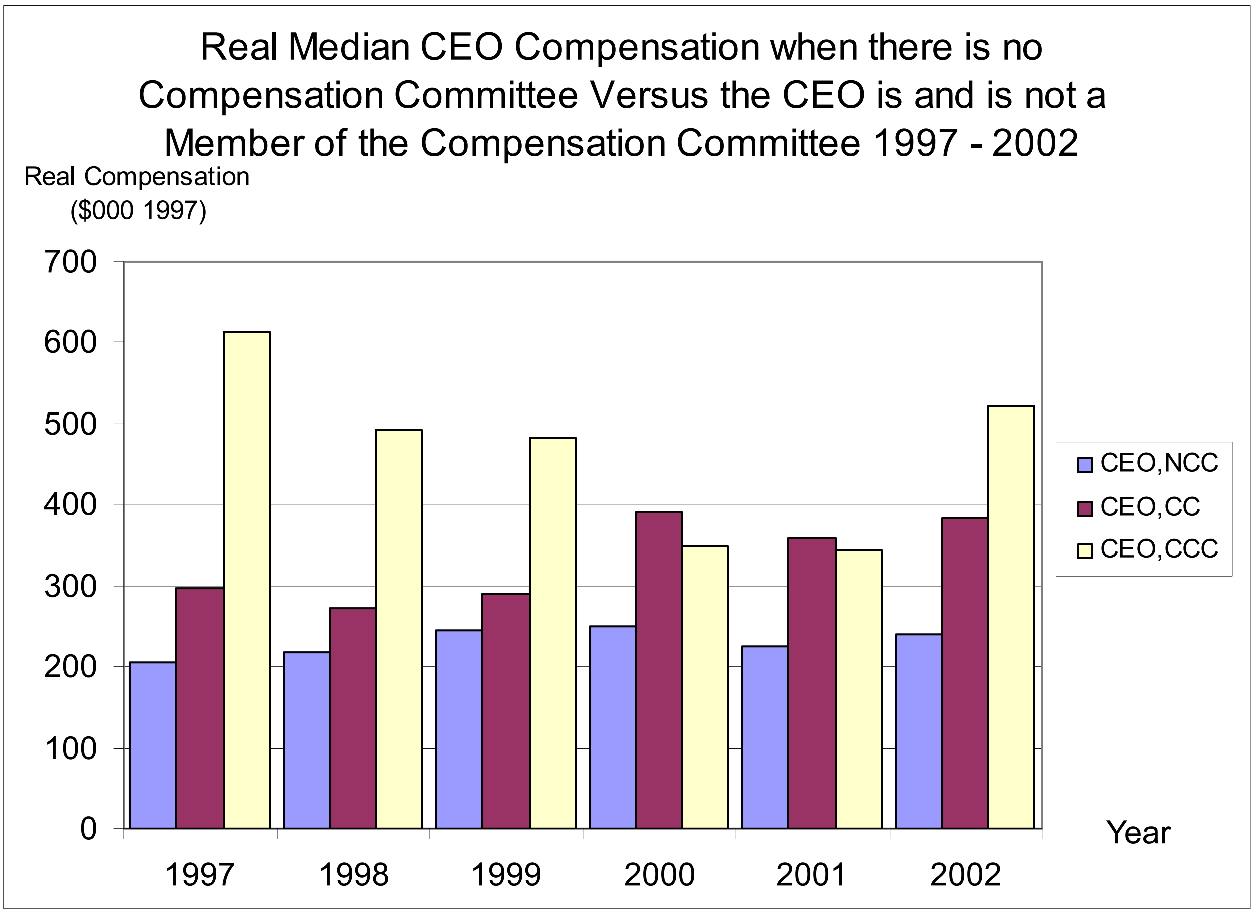
[8] Brian G. M. Main et al., 1995, The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives, 11, *Industrial and Corporate Change*, 293, 302-303.They find that compensation committee chairmen who are appointed after the CEO takes office tend to reciprocate by awarding higher CEO compensation. They also find a significant association between the compensation level of outsiders who serve on the compensation committee and CEO pay.

maintained and grown slightly going from 15.1% in 1999 to 18.4% in 2001 before falling to 12.6% in 2002. Bebchuk, Fried and Walker (2002) examine the influence of the CEO and management on the pay-setting process. They refer to the “pervasive influence of management, particularly the CEO” as a key problem in the function of the compensation committee. In particular, they express concern about the ability of the CEO to use his or her power and influence to optimise pay decisions based on self-interest. A CEO who is also a member of the compensation committee is assumed to have more control in the setting of both compensation and performance incentives. This leads to a conflict of interest caused by the need to make a decision that affects personal well-being while also needing to act in the best interest of the shareholders. In these cases if the CEO behaves opportunistically agency theory predicts that compensation will be higher and more performance insensitive. Under MPA, the inclusion of the CEO on the compensation committee suggests that the CEO is able to extract rents.

Figure VI shows the difference in real median CEO compensation for firms that do not report the use of a compensation committee (NCC), firms that use a compensation committee and the CEO is not a member (CC) and firms that use a compensation committee and the CEO is a member (CCC). The data show two interesting results. First, firms which report the use of a separate compensation committee reward the CEO on average higher levels of compensation compared to those that do not. Second, firms where the CEO is a member of the compensation committee tend to pay the CEO higher levels of compensation compared to firms where the CEO is not on the compensation committee and there is no compensation committee.

Figure VI



These findings suggest one of three possible outcomes. First that the use of a compensation committee may result in higher pay packages. These results are consistent with the issue of "social dynamics" suggested by Bebchuk et al. (2002). They note that the social dynamics of the board (and the compensation committee) have an important effect on the "desire to object" to executive compensation programs. The suggestion is that committee members feel pressure to "placate" one another at the expense of the shareholder.[9] This may be exacerbated by the inclusion o f the CEO on the compensation committee. If this is the case compensation committee members may feel even less able to fairly evaluate and object to CEO and non-CEO executive employee compensation packages.

[9] Eisenberg, Melvin A.,1999, The compensation of Chief Executive Officers and Directors of Publicly Held Corporations, SE39 ALI-ABA 103, 117-118.

Second, the tendency for compensation to be higher for those firms that use a compensation committee may be explained by the need for CEOs to 'camouflage' or legitimise rent extraction. The more concern or 'outrage' that shareholders raise regarding a compensation arrangement the more reluctant directors will be to propose or approve it. However plans put forward by a compensation committee, in consultation with an external consultant may be viewed as legitimate by shareholders. Hence while it may seem that the increased use of compensation committees is a way to optimise incentives, consistent with OCV, it may be a way for CEOs to justify the adoption of inefficient compensation schemes. This is especially true when the CEO is also a member of the compensation committee, since the CEO able to influence the decision and also use the committee as a vehicle to approve and promote shareholder acceptance of the package.

Finally, the association between higher real median CEO compensation and firms that use a compensation committee (which could include the CEO) may be due to an endogeneity problem. It is possible that the sorts of firms that choose compensation committees are typically the firms that choose to pay higher compensation.

5.2 The Dual Role CEO

The CEO is able to exert a lot more influence on the board of directors if he or she is also the chairman of the board. In addressing weaknesses in the structure of the CEO evaluation and pay-setting process Jensen, Murphy and Wruck (2004) make the following recommendation: "The board should be chaired by a person who is not the CEO, was not the CEO, and will not be the CEO". They argue that the responsibility of the Chairman "is to run the process that evaluates, compensates, hires and fires the

CEO and top management team”.[10] For this reason the CEO cannot also serve as the Chairman of the board. Jensen et al. (2004) argue that this conflict of interest has been a contributing factor in the failure of firm governance systems.

Table V
Board Independence Criteria by Number of Firms, 1996 – 2002

Year	Number of Firms	Number of Firms and Governance Criteria					
		CEO is not on the Board of Directors		CEO is on the Board of Directors		CEO is Chairman of the Board of Directors	
		No.	%	No.	%	No.	%
1996ED	34	4	11.8	28	82.3	2	5.9
1996DD	25	7	28.0	17	68.0	1	4.0
1996ND	31	6	19.4	24	77.4	1	3.2
1996	90	17	18.9	69	76.7	4	4.4
1997	83	17	20.5	61	73.5	5	6.0
1998	88	19	21.6	62	70.4	7	8.0
1999	73	14	19.2	53	72.6	6	8.2
2000	74	16	21.6	47	63.5	11	14.9
2001	76	18	23.7	51	67.1	7	9.2
2002	79	23	29.1	51	64.6	5	6.3

Table V reports the prevalence of firms where the independence of the compensation committee may be at risk due to conflicts of interests arising from dual roles. These include cases where the CEO is not on the board of directors, the CEO is on the board of directors but is not Chairman, and when the CEO is also the Chairman of the board. In each of these cases it is possible that the CEO may be able to exert influence over those involved in the compensation setting process, effectively weakening the firms’ governance systems. Bebchuk, Fried and Walker (2002) argue that the influence of the CEO over the “arm’s length” pay-setting process can be large and may come through associations with directors, the dynamics of the board and the reputational concerns of the directors on the committee. If this is the case, then consistent with MPA, CEOs will be able to extract excess compensation.

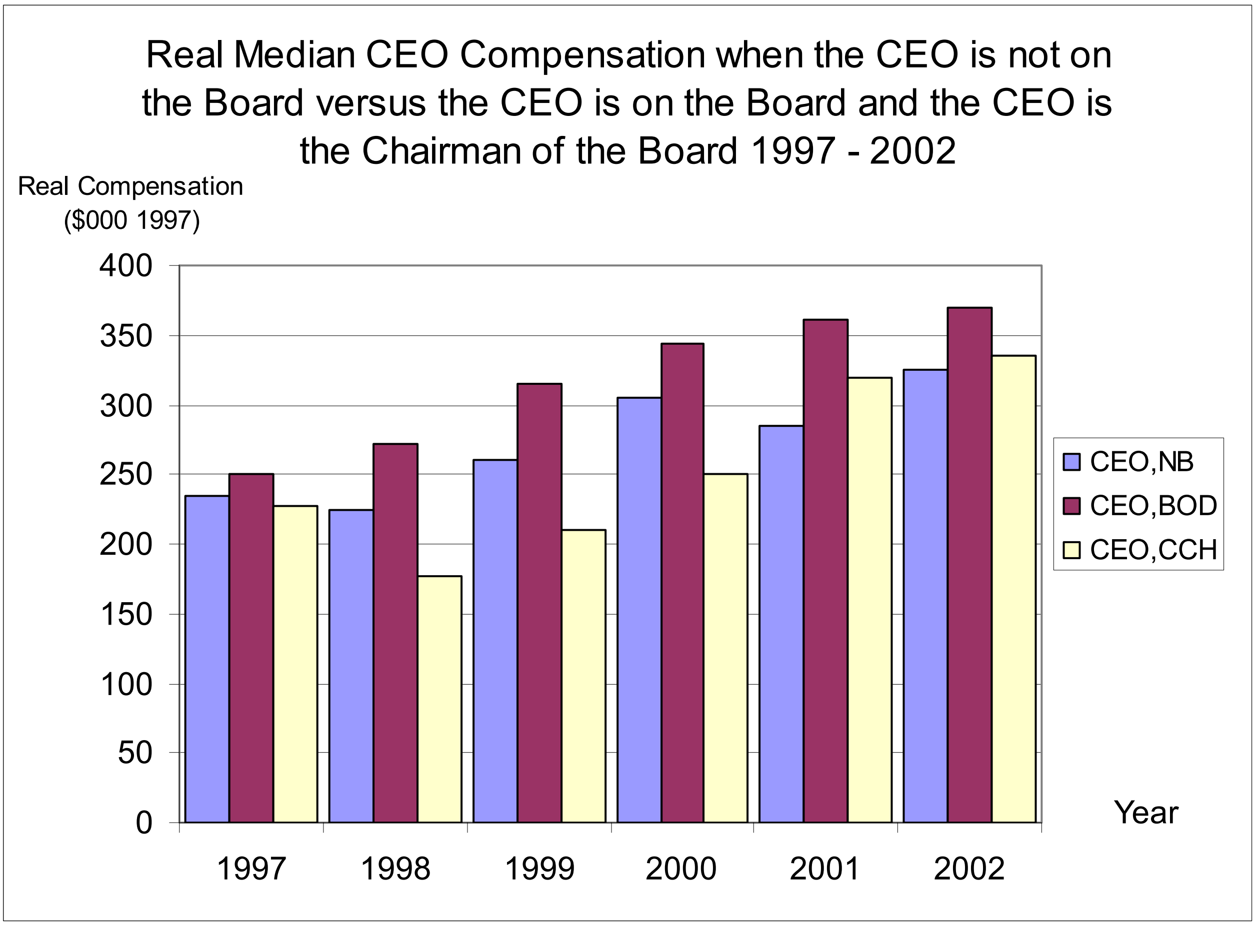
[10] See recommendation R-14, page 54, of “Remuneration: Where we’ve been, how we got to here, what are the problems, and how to fix them.” Finance Working Paper No. 44/2004, July 2004.

From Table V between 1997 and 2002 the proportion of firms where the CEO serves on the board of directors but is not Chairman of the board has decreased by around 10%. This has been partially offset by an increase in the proportion of firms where the CEO is not on the board. The number of cases where the CEO is also the Chairman of the board increased during 1997 to 2000 before declining in the last two years of the study. In order to examine the difference in CEO compensation levels due to the inclusion of the CEO on the board of directors and the impact of the CEO who also serves as Chairman of the board the average compensation levels for each of these scenarios over the six years of data were calculated. The results are shown in Figure VII. The designation NB represents those firms where the CEO is not on the board of directors. BOD denotes those firms where the CEO is on the board and CCH stands for those firms where the CEO is also the Chairman of the board.

Figure VII shows the difference between the compensation levels for the three categories of CEO board involvement over the six-year period, 1997 to 2002. During every year of the study median real CEO compensation is highest for firms where the CEO is a member of the board. In comparison CEO compensation for firms where the CEO is not on the board is higher than for firms where the CEO is also the Chairman during 1997 to 2000. In the last two years CEO Chairman compensation is higher although the difference in the compensation levels between these two groups is small for 2002.

The increasing trend in the level of CEO compensation for those firms where the CEO is also a member of the board of directors is consistent with MPA since the inclusion of the CEO on the board may make it more difficult to monitor CEO performance due

Figure VII



to the influence that the CEO has on other board members. If this is the case then the CEO may be able to extract rents resulting in a departure from optimal contracting. This would be consistent with higher compensation levels compared to CEOs who do not serve on the board. Finally, firms where the CEO serves as the Chairman have lower real median CEO compensation levels. These findings are contrary to the MPA argument which suggests that the greater influence exerted by the CEO on the board through the joint role as both CEO and board Chairman should enable the extraction of rents and consequently lead to higher levels of compensation compared to firms where the CEO does not serve as the Chairman.

5.3 Board Dynamics and the Composition of the Compensation Committee

Under OCV the primary responsibility of the directors is to monitor the CEO's performance. In extreme circumstances this may require firing a CEO and employing a suitable replacement for the position. Otherwise, the directors are expected to support the CEO. The Chairman of the board plays a pivotal role in setting the tone and conduct of meetings and business is expected to be conducted in a polite and courteous manner respecting both the CEO and the Chair. While the inclusion of independent directors in a compensation committee may lessen the influence of the CEO on executive compensation the social dynamics of the board and the role of the Chairman within the group of directors may lead to decisions based on these intra-company relationships. If this is the case then CEO compensation may be more a product of the social dynamics of the board rather than an incentive to maximise shareholder wealth. In order to further investigate these possible interactions on corporate officer compensation summary statistics regarding the involvement of the Chairman and the CEO on the compensation committee are given in Table VI.

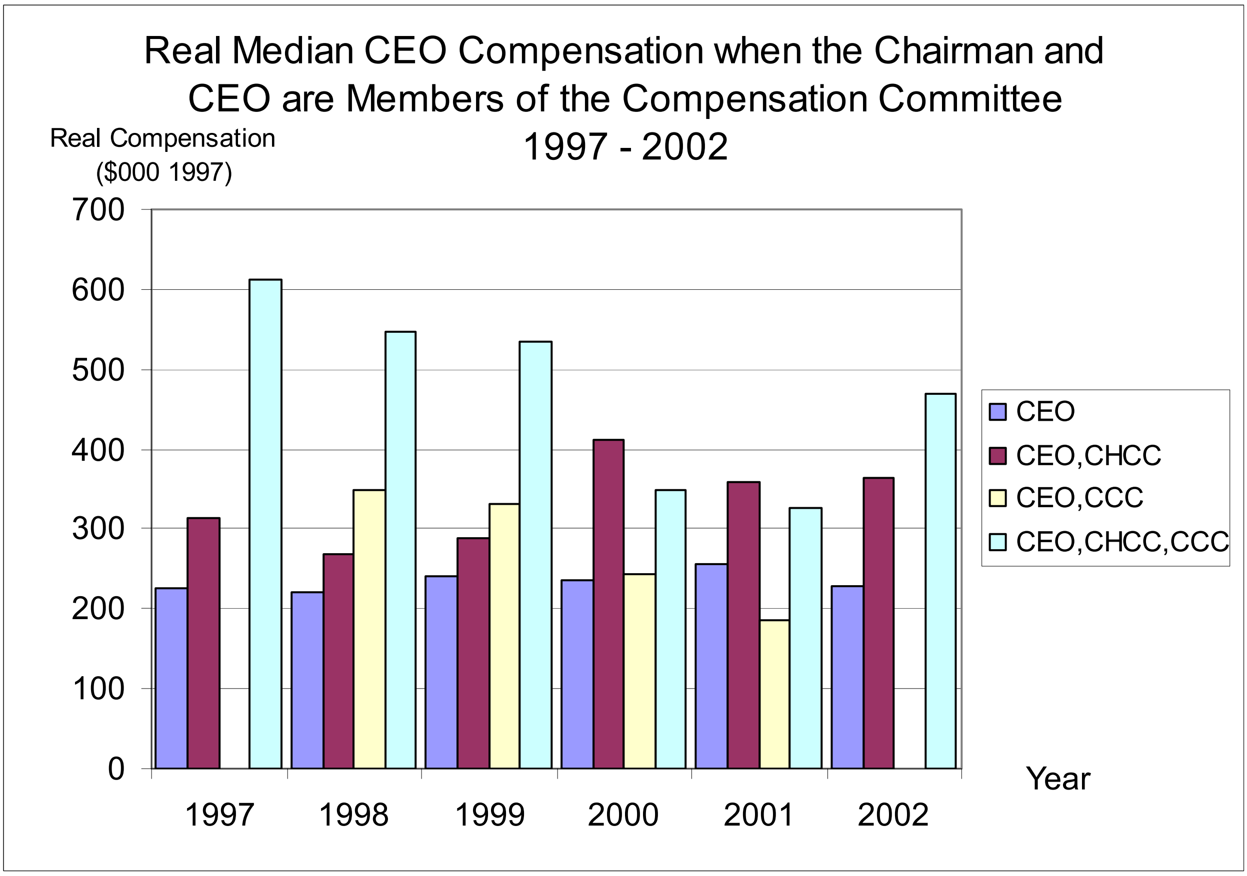
Table VI
Compensation Committee Composition by Number of Firms
1996 – 2002

Year	Number of Firms	Number of Firms and Compensation Committee Composition							
		Chairman and CEO are not on the Compensation Committee		Chairman only is on the Compensation Committee		CEO only is on the Compensation Committee		CEO and Chairman are on the Compensation Committee	
		No.	%	No.	No.	No.	No.	No.	%
1996ED	12	0	0	12	100	0	0	0	0
1996DD	6	1	16.7	5	83.3	0	0	0	0
1996ND	11	2	18.2	8	72.7	0	0	1	9.1
1996	29	3	10.3	25	86.2	0	0	1	3.5
1997	39	6	15.4	30	76.9	0	0	3	7.7
1998	50	5	10.0	38	76.0	1	2.0	6	12.0
1999	51	5	9.8	35	68.6	2	3.9	9	17.6
2000	54	7	12.9	35	64.8	1	1.9	11	20.4
2001	55	7	12.7	34	61.8	1	1.8	13	23.6
2002	61	11	18.0	40	65.6	0	0	10	16.4

The data in Table VI show the number and proportion of firms that include the Chairman or CEO relative to the total number of firms that have a separate compensation committee for each respective year. The results show that there has been a slight increase in the proportion of firms for which both the Chairman and the CEO are not on the compensation committee. However there are proportionately fewer firms with only the Chairman or only the CEO on the committee in 2002 compared to 1997. This fall is offset by an increase in the proportion of firms which have both the CEO and the Chairman as members of the compensation committee. The proportion rose from 7.7% in 1997 to 23.6% in 2001 before dropping back to 16.4% in 2002. Chairman only participation in the committee dropped from 76.9% in 1997 to 65.6% in 2002. Hence in each year of the study, at least two-thirds of the firms have the chairman but not the CEO as a member of the compensation committee. Overall these figures show that a large proportion of firms had either the CEO or the Chairman of the board involved in the compensation setting process during 1997 – 2002. Median CEO compensation levels based on the criteria reported in Table VI are shown in Figure VIII.

The designation CHCC refers to those firms where only the Chairman is on the committee. CCC denotes firms where only the CEO is on the compensation committee. During 1997 and 2002 there were no firms where both the Chairman and the CEO were on the compensation committee. The use of both abbreviations together indicates CEO compensation for firms where the Chairman and the CEO are joint members of the compensation committee. During 1997 to 1999 and 2002 firms in which the compensation committee included both the CEO and the Chairman paid the highest level of CEO compensation. This changed during 2000 to 2001 when firms where only the Chairman was on the compensation committee had the highest level of CEO compensation. Firms that did not have either the CEO or the Chairman as part of the compensation committee had the lowest level of compensation throughout the six year period.

Figure VIII



Consistent with MPA these results suggest that the inclusion of both the Chairman and the CEO on the compensation committee may influence compensation levels in favour of the CEO relative to those firms that do not have a compensation committee. The closer the network of decision makers within the firm the less willing non-executive directors may be to confront the CEO regarding compensation decisions. If this is the case the pay-setting process will go unchallenged and may be largely influenced by both the CEO and the Chairman. In this event the CEO a will be able to create opportunities to extract compensation which is sub-optimal for shareholders.

6. Conclusion

The purpose of this chapter has been to describe and examine CEO compensation for New Zealand publicly listed firms during the period 1997 to 2002. The research has highlighted some key facts about CEO compensation. These results have been compiled into a list of stylised facts which summarise the findings from this analysis.

1. Real CEO compensation increased during 1997 to 2002 with growth in CEO compensation exceeding inflation, growth in stockholder wealth, and growth in worker earnings.
2. Real average CEO compensation was approximately 12 times greater than real average worker income during 1998 to 2002. The mean (median) CEO income increased from 10.9 (9.5) to 12.6 (11.3) times the median annual income for a New Zealand worker during 1998 – 2002.
3. Firms that employ the use of separate compensation committees tend to have higher levels of CEO compensation. In 1997 median CEO compensation was 50% higher for firms with a separate compensation committee. By 2002 the difference had increased to 55%.
4. CEO compensation is higher for firms when the CEO is also a member of the compensation committee.
5. CEO compensation is highest when both the CEO and the Chairman are members of the compensation committee.
6. CEO compensation is higher when the CEO is on the board of directors.

7. Median CEO compensation is lower for those firms where the CEO is also the Chairman of the board of directors and there is no compensation committee.
8. Firms where the Chairman is also a member of the compensation committee have a higher median CEO compensation level compared to those firms where there is no compensation committee.
9. A portfolio of firms made up of the 10 lowest paid CEOs in 1997 produced higher average shareholder returns than a corresponding portfolio of firms made up of the 10 highest paid CEOs in 1997 over the six-year period 1997 to 2002.
10. Firms that had a compensation committee and did not include the CEO on the committee produced higher median shareholder returns than firms missing one of these characteristics.
11. Firms where the CEO did not serve on the board had higher median shareholder returns than firms where the CEO was a board member.
12. Firms that only include the chairman on the compensation committee had higher median shareholder returns.
13. There has been an increase in the proportion of firms paying higher levels of CEO compensation.
14. The proportion of firms reporting the use of a separate compensation committee to set, review and evaluate CEO compensation has more than doubled (32% in 1996ED, 77% in 2002) over the period of the study.
15. The proportion of firms where the CEO is a member of the compensation committee has increased from 3.6% in 1997 to 12.6% in 2002 and was as high as 18.4% in 2001.

16. The proportion of firms for which the CEO is on the board of directors and is also a member of the compensation committee has doubled since 1997.
17. There was a reduction in the proportion of CEOs on the board of directors, but the proportion of CEOs who also served as Chairman of the board stayed the same.
18. For at least two thirds of firms in the sample the Chairman of the board of directors is also a member of the compensation committee.

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