

Principles, Policies and Practices of CEO Compensation in Australia: Is there a Relationship?

ABSTRACT

Against a background of much debate and controversy, CEO compensation continues to increase at twice the rate of average weekly income in Australia. This paper critically analyses the criteria upon which CEO compensation is established, and the policies which have facilitated the increasing divergence between CEO compensation and that of the rest of the workforce. Secondly, the paper investigates the relationship between CEO compensation and organisational performance across a diverse range of listed Australian companies over a 10 year period. The criteria used for comparing direct CEO compensation with organisational performance include stockmarket and accounting-based indicators. Together, these criteria provide a reliable appraisal of the sensitivity of the relationship over an extended period. The results from this study indicate there is a very weak relationship between CEO compensation and organisational performance.

INTRODUCTION

The issue of executive compensation has raised considerable interest and debate around the world (Gregg et al, 1993; Tosi & Gomez-Mejia, 1994; Williams & Crabb, 1995; Conyon et al, 1995; Miller, 1995; Finkelstein & Boyd, 1998). In Australia, the 'managed' micro-economic reform agenda has seen a move towards decentralisation of the wage bargaining system, which is increasingly being associated with compensation for productivity trade-offs through enterprise bargaining (Bennett, 1992; Cornish & Adams, 1993). This restructuring, combined with the public visibility of CEO compensation (Armstrong & Murlis, 1996), has highlighted the perceived inequities of the widening gap between executive compensation and employee compensation. This is increasingly being reflected in Australian data (ABS, Cat.No 6302.0; AIM, 1997). However, in an international context Australian CEO compensation is considered relatively modest (O'Neill & Iob, 1999). As figure 1 illustrates Australia lies mid-table on a world ranking of major western market economies. Ahead of Australia on this table are countries such as Argentina, Brazil, Mexico and Singapore.

[Insert Figure 1 here]

Research in the UK (Gregg et al, 1992; Conyon, 1995 et al) and the USA (Jenson & Murphy, 1990; Crystal, 1991; Pratt, 1996) suggests that there is little or no relationship between CEO compensation and organisational performance. In Australia, research in this field is limited (O'Neill, 1997; O'Neill & Iob, 1999). However, with increasing focus on organisational efficiency and performance, the compensation of senior executives is being given increased attention both in the academic and business literature (Carr, 1997; Evatt, 1997; O'Neill, 1997). The first section of this paper examines the principles and policies upon which CEO compensation is established and reviewed. The second section examines the relationship between CEO compensation and organisational performance through a study of a range of Australian organisations. A longitudinal study is undertaken to give perspective and depth to the trends developing across Australian industry and to allow for an understanding of the sensitivity of the relationship between CEO compensation and organisational performance over an extended period.

PRINCIPLES AND POLICIES IN DETERMINING CEO COMPENSATION

There are several major theories underpinning the development and justification of CEO compensation as separate or unique from other employees in the organisation. The neo-classical economic perspective views the role of the CEO in terms of the marginal contribution they make to the organisation, that is:

... the marginal revenue product of a CEO is the total profit under his/her stewardship, minus the profit level that would be achieved if the firm was at the helm of the best alternative executive, plus the amount that would be paid to hire the latter (Gomez-Mejia & Balkin, 1992:160).

However, as Jensen and Murphy (1990) note, the complexity of the relationships and the multiplicity of variables make this marginal revenue product in most cases impossible to isolate. In addition, Gomez-Mejia et al (1987) note that factors such as firm size rather than efficiency are more influential on CEO compensation, a link which has been identified in recent Australian research (O'Neill & Iob, 1999). The neo-classical perspective also fails to take into account the fact that in the modern corporation (except for a few examples) ownership and management are distinct and separate. The interests of the two groups are not therefore necessarily aligned to the same goals or agendas (in an economic context-profit maximisation). As Gomez-Mejia and Balkin (1992:162) observe, from a managerial perspective executives can become risk averse, to minimise the impact of potential poor performance upon their pay. They may also be inclined to focus on short-term gains over long-term development, to superficially enhance their stewardship.

In taking account of the diverging interests of owners and professional managers, the concept of Agency theory or the Principal-Agent model focuses on aligning the goals of these two groups more closely (Eisenhardt, 1989; Gomez-Mejia & Balkin, 1992). The basis of Agency theory is that executives are employed on behalf of the shareholders to manage the organisation, and therefore should act in their (shareholder) best interests and not self-interest (Milgrom & Roberts, 1992; Milkovich & Newman, 1996). In this context, the compensation package devised should be sufficient to negate the tendency towards self-interest and focus on increasing shareholder wealth (Hill et al, 1994; Conyon et al, 1995; Milkovich & Newman, 1996). Therefore, top management will be rewarded for measurable results that are deemed to be in the interests of the principal (Gomez-Mejia & Balkin, 1992). Jensen & Murphy (1990), suggest that linking compensation to stockmarket performance and thereby shareholders' rate of return can align the objectives of both more closely. However, research by Eisenhardt (1989); Crystal (1992); Conyon

& Gregg (1994) and Conyon (1995) indicates that the empirical evidence to support the Principal-Agent model is at best limited.

Why therefore do executive salaries continue to increase despite indifferent organisational performance and calls for wage restraint? In this context, arguments put forward for rewarding executives so generously focus on the individual characteristics of the incumbent. Human capital theory argues that because of the pivotal role in the success of the organisation in terms of performance, growth, prosperity and market positioning, the reward process is acknowledging the individual contribution of a CEO as a wealth creator, for loyalty to the organisation, and the demands of the job as well as their relative worth in the labour market (O'Neill, 1997; O'Neill & Iob, 1999). In this context their reward package reflects the need to attract and retain these key decision-makers (O'Neill, 1990; Henderson, 1995; Hill, 1994 et al). This is particularly seen as a key issue in an increasingly dynamic environment characterised by globalisation, competition and complexity (O'Neill & Clarke, 1990). As Gomez-Mejia & Balkin (1992), note in this context:

..... executives are generally highly educated and possess many years of work experience in responsible jobs requiring much personal sacrifice. Few people have the ability, stamina, or willingness to pay the associated personal price in terms of stress, family life, loss of privacy, and minimal leisure time. So their higher pay may be seen as a return on this capital investment (p.169).

In terms of future expectation, such rewards are also seen as an inducement to retain these employees and maintain high standards of commitment, effort and performance (Evatt, 1997). Whilst, there is intuitive link between knowledge, skills, ability and pay, Milkovich and Newman (1999) point out that while research does support this relationship, there is a limit. What this theory does help explain, however, is the relationship between organisational size (job complexity) and pay (Gomez-Mejia & Balkin, 1992; O'Neill and Iob, 1999).

The final perspective is symbolic, which focuses on the unique position of the CEO in the organisation, in terms of role, responsibility and the political reality of managing the diverse and (potentially) conflicting interest of an organisation. In this context, it is argued that the principles and policies that govern CEO compensation should be aligned with pre-defined and agreed goals (Gomez-Mejia & Balkin, 1992). This perspective takes account of the way the CEO manages the divergent interest of the organisational stakeholders. In this context, it is argued that the assessment of CEO performance should relate to this 'internal score-card', and the use of financial or economic indicators alone would be

erroneous (Gomez-Mejia & Balkin, 1992; Steer and Ungson, 1987). However, the potential problem associated with this approach is the lack of transparency, in that the criteria may not be clear to organisational stakeholders and reinforce the lack of clear understanding of the conditions upon which CEO pay is based.

These theories attempt to explain, clarify and account for CEO compensation and why it should differ from others in the organisation in terms of assessment and valuation (O'Neill & Clarke, 1990; Gomez-Mejia & Balkin, 1992). The following section critiques some of the arguments put forward supporting the differentiation and levels of CEO compensation.

A CRITIQUE OF THE PRINCIPLES AND POLICIES DETERMINING EXECUTIVE COMPENSATION

The arguments developed in the previous section provide the key components in establishing and supporting the rewards of top executives. However, further analysis reveals that arguments supporting the differentiation and size of CEO compensation may be questionable and difficult to sustain. In terms of labour market pressure, the first question is—does a market really exist? Williams and Crabb (1995) argue that the market for CEOs is so small, with so few transactions that it hardly registers as a market at all. The UK-based Income Data Survey on Management Compensation (1992) highlighted the unusual nature of the executive labour market in that the market is a contrived one of social comparability. This point is supported by others (Bergmann et al, 1998; O'Reilly et al, 1992; 1993; Martocchio, 1998). The relatively small (and visible) nature of the senior executive market creates what Williams and Crabb (1995) describe as the 'domino effect', where any substantial individual improvement in compensation provides a benchmark for other executives. This can cause a chain reaction within the system, forcing compensation to rise and executive-workforce differentials to increase (Williams, 1994; Budman, 1997). As Bergmann et al (1998) point out, this continual upward spiral may not provide the organisation with any noticeable increase in performance or competitiveness.

Research by Williams (1994) and Williams and Crabb (1995) identified a turnover rate of between four and eight per cent for senior executives in the UK. The question is then—if these senior executives are so marketable why don't they move? More to the point, as Williams notes: "It is a matter of judgement whether a turnover of approximately five per cent is sufficient to create significant market pressure to raise levels of compensation by itself" (1994:93). However, it should be noted that the issue of opportunity cost may be

important in this context. As Gomez-Mejia and Balkin (1992:203) note, because of the difficulty of finding suitable replacements at this level of the organisation, compensations and benefits may be structured to include a tenure factor and penalise early termination of the relationship. These policies are often termed *golden handcuffs* and can also be used to prevent 'pirating' by other organisations. However, as noted, the relatively small size of the market, and the high profile of a successful CEO, may not prevent pirating. As O'Neill (1999a) points out: "Within this implicit market, executives who demonstrate a track record attract an individual premium based on their past record" (p.7). O'Neill (1999a) goes on to note that:

Added to this perspective on the executive labour market is the clear fact that the bar for success has been set higher as a result of the growing levels of competition (and related performance requirements) following from the rapid extension of the global markets and the ongoing deregulation of industries (p.7).

Within this context, the potential employer in attracting a CEO may be required to compensate them for lost income associated with a golden handcuffs clause. This has the result of further increasing CEO pay and distorting the performance relationship. Research indicating an inverse relationship between CEO pay and organisation performance may indicate this phenomenon (O'Neill and Iob, 1999).

The globalisation of business as a catalyst in necessitating organisations to provide large compensation packages to attract and retain top executives has also been challenged. As Williams (1994) points out, globalisation is only a factor for the largest international organisations (Williams, 1994). This point is supported by his research which indicates a heavy bias, in that recruitment does not flow across cultural boundaries. For example, in Australia the main external recruitment markets remain the UK and increasingly, the USA.

Whilst acknowledging that performance should be the central tenet in determining rewards, the trend for executives to justify their compensation by identifying with top performers in other fields (in particular the analogy with entrepreneurs and top performers in fields such as sport or entertainment) is problematic (Pratt, 1996; Williams, 1994). Senior executive salaries reward expertise in decision-making and commitment. Unlike entrepreneurs, these leaders seldom remain with an ailing organisation. In fact, the prominence of extremely generous 'golden-parachutes' and perquisites available to senior executives, combined with relative job security raises the issue of over-protectiveness (Hill et al, 1994; Williams, 1994; Pauline, 1997; Martocchio, 1998). The attempt to blur

the role of the CEO and entrepreneur is thus difficult to sustain. On this point Williams (1994) notes:

What is clearly wrong is for executives to lay claim to the rewards of the entrepreneur, while at the same time seeking the comforts of the role of employee. From an economic point of view (and from the moral point of view also) the size of the reward needs to be related to the size of the risk (p.67).

To negate the failure of compensation to reflect performance, increasing use is being made of compensation committees, particularly in US and UK-based organisations. Salary packages determined and governed by an independent compensation committee has been identified as a way to effectively negate the problems associated with determining fair and equitable packages (Conyon et al, 1995). As Williamson (1985) comments, this is seen as neutralising the problem of senior executives appearing to write their own contract with one hand and sign it with the other. The formalising of compensation committees has become an important process in the management of executive compensation in the USA (Martocchio, 1998) and more recently in the UK, after the Cadbury Committee (1992) recommendations. These recommendations have substantially influenced the recommendations of the Bosch Committee on Corporate Practices and Conduct (1995) in Australia. However, as Main and Johnson (1992) identify in their research, these non-executives are often senior executives of other companies and therefore have a vested interest in the process and outcomes. This proposition is supported by their research in the UK, which indicates that CEO compensation was actually higher when determined by a compensation committee. This problem is reflected in the US as Walters et al (1995) point out:

In many instances, the membership of a compensation committee is made up of other CEOs. The negotiation element of the fair bargain is in question, as bias may have been injected throughout the entire membership system. The reasonable compensation level conceived of as being determined by an arm's-length negotiation involving an informed buyer and an informed seller may be suspect (p.232).

The move towards leaner, flatter organisational structures emphasising a more participative work environment through team-building and joint effort (Mathews, 1994) has directed attention towards reward systems and structures which reflect, and are congruent with, this collaborative work culture (Cornish & Adams, 1993: Gross, 1997). As Lederer and Weinberg (1996) point out:

While senior management retains responsibility for making the company's key strategic decisions, the work takes place in the trenches—and so does the creation of shareholder value, which depends on growth instead of just cost-cutting (p.337).

Reward systems in this context are central to facilitating and reinforcing these organisational values through the shared benefits of organisational success (Lawler, 1990; Paulin & Cook, 1992; Schuster & Zinghem, 1992; O'Neill, 1995; Bergmann et al, 1998). The maintenance of a two-tier compensation system when the effort or success is the result of many is therefore difficult to sustain (Hills et al, 1994; Armstrong & Murlis, 1996; Gross, 1997). Indeed, such policies can work against the organisation's strategies, goals and cultural values (Cornish & Adams, 1993) resulting in damage or breakdown in the organisation's internal environment (Jankelson, 1990). As Armstrong notes:

Teamwork matters in the new delayered organisation. The significant part that teamwork plays in achieving organisational success has directed attention to how employee reward systems can contribute to team effectiveness (1996:22).

As Brickford and Sorkin (1990) and Bergmann et al (1998) have noted, the impact of executive compensation on the organisation must be well thought-out. In the teamwork context, both moral and ethical considerations regarding the levels of CEO compensation need to be considered (Walters et al, 1995; Pratt, 1996). In this context, Martocchio (1998) also raises the issue of corporate downsizing:

Thousands of workers have been laid-off since 1990..... Top management typically advances several reasons that necessitate layoffs—global competition, reductions in product demand, technological advances that perform many jobs more efficiently than employees, mergers and acquisitions, and establishing lower labor costs. Virtually none of the executives of any of these companies involved lost their jobs (p. 360-61).

This perspective is reinforced by figures indicating that during the main period of corporate downsizing between 1990-1995 corporate profits in the USA increased on average 75 per cent and CEO compensation rose on average 92 per cent (Byrne, 1996).

As noted above, the issue of identifying and separating the contribution of the CEO is also difficult to assess. Whilst there are some obvious exceptions, Jensen and Murphy (1990) acknowledge the impossibility in most cases of isolating the marginal contribution to the organisation of a CEO. Despite these arguments, the primary motive for increases in CEO compensation is to reward improved organisational performance. In this context, organisations have been increasingly restructuring CEO pay to link it more closely to the business objectives (O'Neill, 1999a, 1999b). Increasingly the proportion of the total

annual reward is being made up of a variable component. As O'Neill (1999a) identifies in an Australian context, the variable aspect of CEO compensation (made of short and long-term incentives) has increased from 9.5 per cent to 49.6 per cent in the period from 1990 to 1998. However, paradoxically, this can have a reverse effect, as the strong growth in the stockmarket may result in pay that does not reflect the actual performance of the organisation. Secondly, where the market reacts adversely to lower than projected results, or the company or sector are out of favour, this also may not reflect the true performance of the organisation.

Thus (despite its flaws) the link between performance and rewards is the primary tenet of the CEO compensation system and the justification which organisations give for granting large increases in CEO compensation (Miller, 1995). It also accords with the principle of Agency theory, despite the lack of strong corroborating evidence (Tosi & Gomez-Mejia, 1994). Research in Australia by Cullen, Egan & Dell (1987, 1992) and PA Consulting (1994) indicates that company profitability is increasingly the most important factor in determining CEO compensation, despite the fact that in Australia, as O'Neill notes, "there is a lack of empirical research linking executive compensation and performance" (1997:1). However, O'Neill and Iob (1999) have identified in subsequent research that whilst factors such as age, tenure and company performance are influential on CEO pay, job size appears the primary determinant of remuneration. This outcome is supported by human capital theory. As they state:

Put simply, the findings suggest Australian organisations reward executives on the basis of job complexity, the larger and more complex the roles attracting higher levels of remuneration (O'Neill & Iob, 1999:72).

The focus of the empirical analysis section of this paper is to investigate whether there is a direct relationship between organisational performance and CEO compensation in Australia over an extended period of time. In undertaking this assessment, a cross-section of Australian organisations was analysed. The aim of this paper is to fill the gap in longitudinal research in Australia, in terms of empirically testing the relationship between organisational performance and CEO compensation.

In addition to the problems noted above, on the subject of assessing CEO pay and performance we also note the comments of Gomez-Mejia and Balkin (1992):

Executive pay has been thoroughly researched using empirical methods..... Despite this incredible amount of work, results are generally disappointing and mixed..... Unfortunately executive pay is a very treacherous research area.....

One problem with the use of databases is that researchers are constrained by information included in them, it is not always clear how comparable the reported data may be across firms over time (p.177)

The main sources of inconsistency include the data set, methodology, time frames, organisational measures of performance and the availability of information including organisational specific internally agreed objectives (Gomez-Mejia and Balkin, 1992). In this context, simple comparisons with financial or economic-based indicators may be inappropriate or not reflect the true components of the incumbent role. Compounding these issues is the fact that many elements determining CEO compensation are correlated. Therefore attempting to isolate and determine the impact of individual variables is highly problematic. With these points in mind, the following sections of the analysis examines and empirically tests the relationship between organisational performance and CEO pay in Australia to identify trend relationships over a 10 year time frame to assess whether over an extended period a relationship can be identified.

METHODOLOGY

This research takes a longitudinal perspective to assess the sensitivity of the relationship between compensation and organisational performance. A longitudinal study also assists in negating the problems associated with the timing of compensation and stockmarket or accounting information which may fall in different financial years. It also takes into account the nature of the business cycle, which has a significant influence on organisational performance indicators.

It is important to determine the parameters within which performance and compensation are defined. Through a longitudinal study, the relationship between CEO compensation and organisational performance across a diverse range of listed Australian companies over a 10 year period is examined. The criteria used for comparing direct CEO compensation with organisational performance include stockmarket and accounting-based indicators. There is considerable debate over criteria used to assess organisational performance (Conyon, 1995). Accounting-based performance indicators such as earning per share (EPS) provide information on the profit or return on each share. In addition, revenue and net profit indicate the relative prosperity of the organisation. Arguments put forward against accounting indicators suggest that they can be manipulated or managed, and can focus on short-term variations, rather than the key issues of wealth creation and market or industry standing (Jensen & Murphy, 1990; Williams, 1994).

Stockmarket measures of performance provide an indication of the wealth generation of the organisation. This is the chief objective of management under Agency theory, and as such, this approach tends to be the most favoured (Holmstrom, 1979; Jensen & Murphy, 1990; Williams, 1994). The key factors taken into account include total shareholder returns or shareholder wealth. Because of the differing focus and the problems associated with various measures, both approaches will be used in this empirical analysis. Together, these criteria provide a reliable appraisal of the sensitivity of the relationship over an extended period.

With regard to CEO compensation, the package is often complex, long-term and variable when bonus entitlements, discretionary benefits and share options are taken into account. In this context, the focus for analysis is on base salary. Whilst acknowledging that this value has its own weaknesses, such as industry characteristics, the perceived value an individual CEO brings to the organisation (human capital theory) and the increasing focus on incentives for determining salary (Gomez-Mejia and Balkin, 1992; Milkovich and Newman, 1999), all of which can effect the survey data. However, as Williams (1994) points out:

Base Salary is important because:

1. it is the element of the total package which is much the easiest to compare with the market and
2. it is the platform or foundation upon which so much else rests: STI is usually calculated as a percentage of base salary, share options are usually granted as a declared multiple of base salary, pension contributions will be a specified percentage of it, and in the most common form of pension scheme the pension payable will be a proportion of the final salary. It therefore has a profound influence as a multiplier..... Finally, severance payments are often calculated as a multiplier of base salary (p.107–108).

As noted above, profitability has been identified as the most important factor in determining CEO compensation (Miller, 1995), a proposition which is supported by Australian research (Cullen, Egan & Dell, 1987, 1992; PA Consulting, 1994). Therefore, the assumption that direct compensation is sensitive to organisational performance supports taking this approach. However, as Gomez-Mejia and Balkin (1992:182), note “... empirical research on executive compensation is far from an exact science, and there is much room for personal interpretation”. In this context, the focus of the empirical study is to assess the nature of the relationship between CEO compensation and organisational performance over an extended period of time. The sample of firms analysed is based upon previous research in Australia by Heathcote, Pasqua and Dowling (1990). This study was used to provide a longitudinal comparative analysis of a data set. The original data set was analysed under considerably different conditions than those of

the 1990s. During the period of the original research (1988/89), the Australian labour market was still well regulated and the Prices and Incomes Accord¹ was influencing wage policy in a centralised fashion. Whilst acknowledging that the Accord was not specifically directed at senior management wage policy Heathcote et al (1990), note that through the Accord the government was keen to establish mechanisms to monitor senior management compensation to ensure it remained within specific boundaries. The results of the original data set found a statistically significant relationship between CEO pay and net profits ($r = 0.42$) and revenue ($r = 0.81$). In contrast the 1990s were characterised by increasing deregulation of the labour markets or what Davis and Lansbury (1999) describe as a move from a centralised system through coordinated to fragmented flexibility. This was characterised by increasing focus on individual bargaining and the effects of globalisation. In the context of senior management this can be seen in the increasing prominence of overseas CEOs in several major organisations. Some of the companies analysed in the Heathcote et al (1990) study were not available for this longitudinal study because of significant organisational changes and restructuring since the previous study.

The 24 publicly listed organisations in this analysis represent a cross-section of Australian industries (see Table 1). The data used in this study has been sourced from annual reports covering the period 1988–1997 inclusive. The companies cover a range of industrial sectors including: service and transport (4); resources and mining (7); retail (3); building and materials (4); manufacturing (3) and banking (3).

It is important to acknowledge that the diversity of these companies and the small size of the sample will impact upon the results. In this context, we recognise the limits of this study are recognised. As noted above, the focus of this analysis is comparative and longitudinal to assess the relationship of various company indicators to CEO compensation over time. In this context, the analyses examines the statistical strength and significance of the relationship between CEO compensation and organisational performance using stockmarket and accounting-based variables. Simple correlations are employed in two ways. Firstly, the strength and significance between CEO pay and organisational performance indicators within each year are examined. Secondly, the strength and significance of the relationship between changes in CEO pay and changes in organisational performance indicators between pairs of consecutive years is undertaken.

¹ The Prices and Incomes Accord was a an agreement between the Australian Council of Trade Unions and the Federal Labor Government in which wage restraint from the trade unions was off-set by social policy initiatives from the government.

In these two ways, cross sectional and longitudinal analyses are employed to examine the relationship between CEO compensation and organisational performance indicators

[Insert Table 1 here]

RESULTS

Because of the longitudinal nature of this study, two distinct time periods have been identified and provide a framework for this analysis. The first period 1988-1992 reflects a severe economic recession in Australia, and the second is the post-recession period 1993-1997. As would be expected from a general overview, CEO compensation remained relatively static during the period 1988-1992, as the economic effect of the recession gripped the Australian economy. However as Australia moved out of recession, the rate of growth in CEO compensation during the period 1993-1997 for the data set increased significantly in relation to average weekly earnings (AIM Salary Survey, 1997).

However, whilst this confirms the rise of CEO compensation in the second period, it is the key financial indicators that are significant in this analysis, as these track the relationship between organisational performance and CEO compensation.

With reference to accounting indicators, there was no significant relationship between these indicators and CEO compensation during the period 1988-1992. Whilst average CEO compensation increased steadily, earning per share declined significantly during this period and the relationship between CEO compensation and net profits was statistically insignificant (see Figure 2). Over an extended period of time there appears to be a time lag of approximately 12 months between CEO compensation and net profits, indicating that CEO compensation is relatively sensitive to profits changes, although again the relationship is not statistically significant.

In the post-recession period of 1993-1997, there is a marked positive increase in all three accounting indicators (Figure 2). It is worth noting that a basic time lag of approximately 12 months is detected in relation to net profits and EPS in relation to CEO compensation levels. Whilst this can initially be seen to show a relationship between these variables, it also illustrates the central weakness in using indicators that can be manipulated or adjusted in line with short-term variations or goals. This is confirmed by analysis, which indicates that after 1996-97 no statistically significant relationships between CEO compensation and these accounting indicators.

[Insert Figure 2 here]

Stockmarket indicators are considered the most appropriate or sensitive measure in terms of CEO performance as they reflect the wealth generation for shareholders (Jensen & Murphy, 1990). In the first period of this analysis (1988–1992) the relationship between CEO compensation and net assets was weak but positive ($r = 0.58$, $p < 0.05$), and for shareholder equity during the same period a stronger relationship ($r = 0.67$, $p < 0.05$) was identified (see Figure 3). During the period 1993-1997, as Australia moved out of recession, CEO compensation increased each year. The relationship between CEO compensation and stockmarket performance measures was clearly not linear. This is supported by statistical analysis of this period which indicates no statistically significant relationship between CEO compensation and stock-market indicators during this period.

[Insert Figure 3 here]

Further investigation of the data was undertaken to determine the significance of the relationship between consecutive years and CEO compensation. This was undertaken for both accounting and stockmarket-based indicators. This analysis presents the differences in percentages between the mean scores in the first of each consecutive year period. In other words, the differences reflect statistical change between corresponding years. Figure 4 presents the percentage changes in accounting-based indicators against CEO compensation. As identified earlier, a complex lag effect suggests that CEO compensation is sensitive to changes in net profit and EPS. When net profit and EPS decrease, reduction in CEO compensation occurs. This is best illustrated by the period 1992-1993. More recent years indicate that the relationship is increasingly more sensitive to these changes, with the lag breaking down after 1995-96.

[Insert Figure 4 here]

With reference to the stockmarket indicators (Figure 5), the results indicate that shareholder equity does have an effect on CEO compensation, whilst assets appear unrelated. The analysis identifies that negative change in shareholder equity over three successive periods results in a marked drop in CEO compensation. This is evident when examining the drop in CEO compensation in financial years 1992-1993 and 1995-1996.

[Insert Figure 5 here]

DISCUSSION

An overview of the relationship between CEO compensation and organisational performance of these Australia companies indicates that the relationship is not statistically significant. The authors acknowledge the small sample size, and that the diverse nature of the organisations means the results cannot be transposed or generalised to all sectors of the Australian economy. As noted above, the focus of this sample is to examine trends in a cross-section of Australian organisations over a 10 year time span, to illustrate the dynamics of the relationship between CEO compensation and a variety of performance indicators over time. The accounting indicators show extreme variation in the relationship over the two distinct time periods identified in the longitudinal study, and therefore the limitations in determining a long-term relationship between CEO compensation and organisational performance. Over the initial time period (1988-1992) the trends in stockmarket indicators remain weak but positive. However, in the second period (1993-1997) the analysis indicates no significant statistical relationship. It appears therefore from this study that there is little relationship between CEO compensation and organisational performance.

This lack of relationship could be accounted for by a variety of explanations. Recent research in Australia (O'Neill and Job, 1999), and the US (Wineberg, 1995), identifies an inverse relationship between organisational performance and CEO compensation. The explanation given is that in response to poor performance the board must provide a significant premium to attract the calibre of person required to change the organisation's fortunes. It is also worth noting the effect of the increasing use of variable elements in the make up of CEO compensation (O'Neill, 1999b). This change in structure and design is seen as a way of increasing the sensitivity of the relationship between CEO compensation and organisational performance. However, this change in reward mix has corresponded with a period in which world stockmarkets have since the mid-1990s, been in a strong

and sustained growth. The increased emphasis on these variable factors in this environment could have the potential to distort the relationship. In addition whilst the internationalisation of markets has seen an influx of high profile CEOs from the US and UK, Australian organisations remain predominantly Australian run. However, in order to keep this talent, organisations may be forced into paying premiums over and above those associated with organisational performance indicators. A corollary to this is the issue of golden handcuff, that is organisations attempting to retain high quality CEO through increasingly structuring their rewards to include a substantial long-term incentive element (O'Neill, 1999b) to enhance organisation tenure. In this context, poor performing organisations may be paying a premium for quality staff, as they are required to buy out these lucrative long-term incentives, further affecting the pay and performance relationship.

Another factor, which may also have a distortive effect on CEO compensation, is the issue of disclosure. Since the early 1980s, pressure has mounted to make CEO compensation more transparent. In the late 1980s, disclosure regulations (schedule 7) required executive salaries commencing at \$85000, and in each successive \$ 10000 band be disclosed. Through the 1990s the pressure on disclosure has continued culminating in the 1998 Company Law Review Act, which focuses on the composition and relationship of executive pay to organisational performance. The paradox of this process may be that it invokes a 'domino effect' where CEO compensation becomes focused on comparative data as a source of benchmarking rather than company performance (Williams & Crabb, 1995; Bergmann et al, 1998).

CONCLUSION

Because of the variety of factors that affect and influence CEO compensation, the examination of trends which have emerged in this analysis may assist in more fully understanding this area of research in an Australian context. The lack of relationship between CEO pay and organisational performance over an extended period remains a contentious issue. In this respect more detailed longitudinal assessment of the data through more sensitive indicators may help to more clearly identify the dynamic relationship between CEO compensation and organisational performance. In addition the influence of disclosure, golden handcuff and poor performance upon CEO compensation (O'Neill and Job, 1999) are areas that have received little attention in the research. The potential of these issues to cause a 'domino effect' in such a small but highly visible market are important factors for consideration.

Whilst noting the small study sample—a fact which limits the conclusions that can be drawn from this study—the results serve as a useful indicator as to the sensitivity of the relationship between CEO compensation and organisational performance across Australian industry. The results indicate that Australian CEO compensation is following the trends set in the UK and USA, and that it is difficult to identify the relationship between the principles, policies and practices of CEO compensation. However, as noted above more detailed longitudinal research is required in order to more fully understand the dynamics of CEO compensation in Australia.

REFERENCES

- Australian Bureau of Statistics (ABS) (1997) *Average Weekly Earnings, State and Australia*, Cat.No. 6302.0. Canberra. AGPS.
- Australian Institute of Management (AIM) (1997) *Australian Institute of Management Annual Salary Survey*. Sydney.
- Armstrong, M. (1996) How Group Efforts Can Pay Dividends. *People Management*: 22–27. (January).
- Armstrong, M. & Murlis, H. (1996) *Reward Management: A Handbook of Compensation Strategy & Practice*, (3 ed.). London: Kogan Page Ltd.
- Bennett, M. (1992) Future Directions in Compensation Management. *Asia Pacific Journal of Human Resources*, 30(2): 75–86.
- Bergmann, T., Scarpello, V. & Hills, F. (1998) *Compensation Decision Making*, (3 ed). Fort Worth: Dryden Press.
- Bosch, H. (1995) *Corporate Practices and Conduct*. Sydney: The Australian Securities Commission.
- Brickford, L. & Sorokin, J. (1990) Long-Term Incentives for Management, Part 5: Selecting the Right Program, *Compensation and Benefits Review*, 22: 38–46. (March/April).
- Budman, M. (1997) Does it really pay to pay for performance ? *Across the Board* 34(3): 16–22. (March).
- Byrne, J. (1996) How high can CEO pay go ? *Business Week* 22: 100–106. April.
- Cadbury, A. (1992) *Committee on the Financial Aspects of Corporate Governance*. London. Gee Publishing Ltd.
- Carr, E. (1997) Executive Pay. *Australian Financial Review*. 11 October. Section B:1. Melbourne.
- Conyon, M. (1995) Directors' Pay in the Privatized Utilities. *British Journal of Industrial Relations*, 33(2): 159–171.
- Conyon, M. & Gregg. (1994) Pay at the top: a study of the sensitivity of top directors remuneration to company-specific shocks. *National Institute Economic Review*, 3: 83–92.
- Conyon, M., Gregg, P. & Machin, S. (1995) Taking Care of Business: Executive Compensation in the United Kingdom. *The Economic Journal*, 105: 704–714.
- Cornish, G. & Adams, G. (1993) Trends in Remuneration. The Concept of 'Total Quality Pay' *Asia Pacific Journal of Human Resources*, 31(2): 75–86.
- Crystal, G. (1992) *In Search of Excess: The Overcompensation of American Executives*. New York: Norton & Co.
- Cullen, Egan & Dell (1987). *Factors influencing Senior Executive Remuneration*. Sydney. (July).

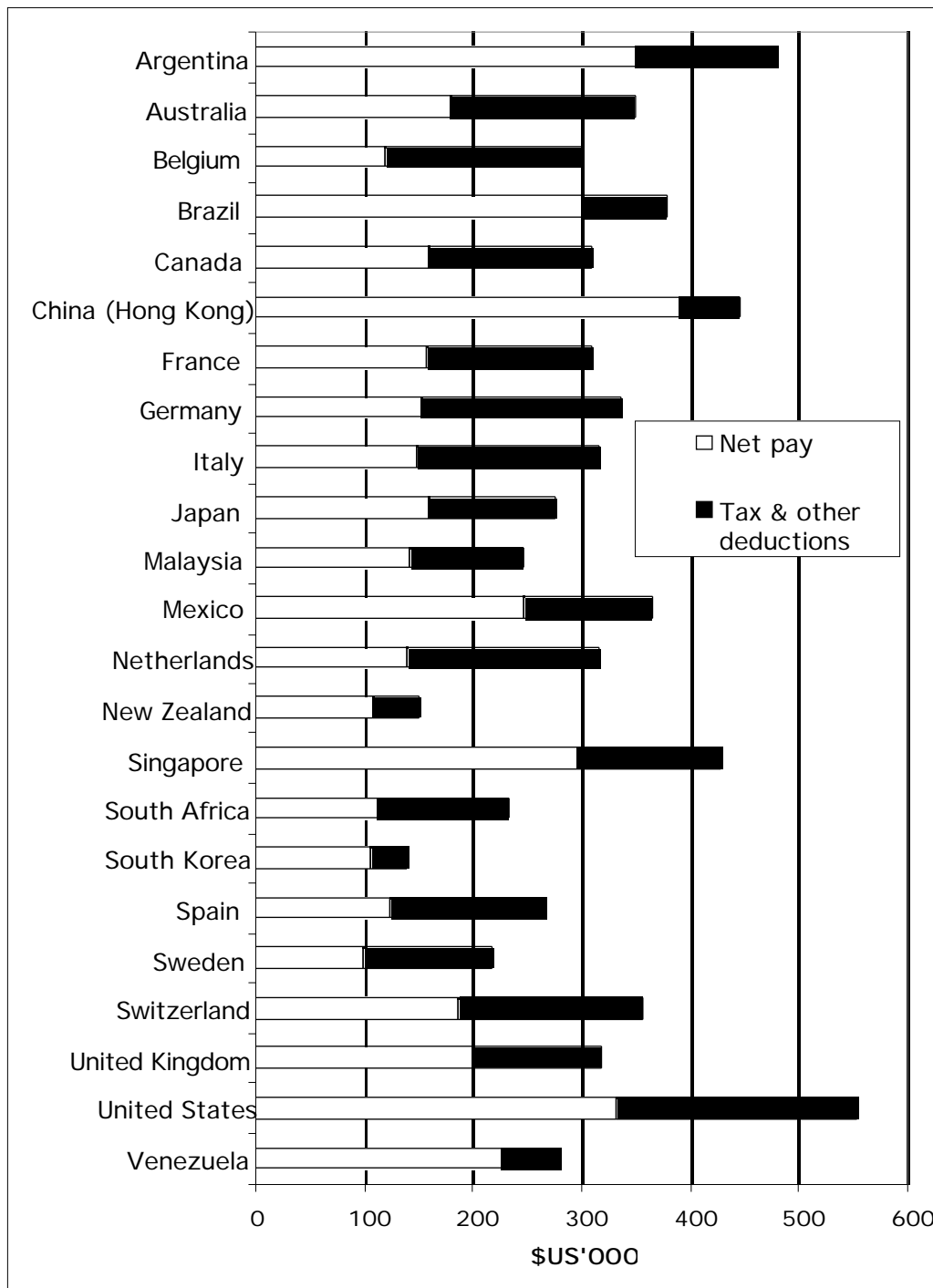
- Cullen, Egan & Dell (1992). *Factors influencing Senior Executive Remuneration*. Sydney. (July).
- Davis, E. & Lansbury, R. (1998) Employment Relations in Australia. In G. Bamber, & R. Lansbury. (eds), *International and Comparative Employment Relations*, (pp.110–143). Sydney: Allen & Unwin.
- Eisenhardt, K. M. (1989) Agency Theory: An Assessment and Review. *Academy of Management Review*, 14(1): 57–74.
- Finkelstein, S. & Boyd, B. K. (1998) How much does the CEO matter? The role of managerial discretion in the setting of CEO. *Academy of Management Journal*, 41(2): 179–199.
- Gomez-Mejia, L. & Balkin, D. (1992) *Compensation, Organizational Strategy, and Firms' Performance*. Cincinnati: Southwestern College Publishing.
- Gomez-Mejia, L., Tosi, H, & Hinkin, T. (1987) Managerial control, performance, and executive compensation. *Academy of Management Journal*. 30: 51–70.
- Gregg, P., Machin, S. & Szymanski, S. (1992) The Disappearing Relationship Between Directors' Pay and Corporate Performance. *British Journal of Industrial Relations*. 31: 19.
- Gross, S. E. (1997) When Jobs Become Team Roles, What Do You Pay For? *Compensation & Benefits Review*, 29(1): 48–51.
- Heathcote, B.D., Pasqua, N. & Dowling, P. J. (1990) An Analysis of the Current Regulations Covering The Disclosure of Salaries and Payments by Australian Companies. *Asia Pacific Journal of Human Resource Management*, 28(4): 88–105.
- Henderson, R. I. (1994) *Compensation Management: Rewarding Performance* (6th ed). Sydney: Prentice Hall.
- Hills, F., Bergmann, T.J. & Scarpello, V.G. (1994) *Compensation Decision Making* (2nd ed). New York: The Dryden Press.
- Holmstrom, B. (1979) Moral Hazard and Observability. *Bell Journal of Economics*, 10: 74–91.
- IDS—Incomes Data Survey on Management Pay Review. (1992) *Income Data Service*. London. (February).
- Jankelson, M. (1990) Remuneration Trends and Issues: Looking Forward, Looking Back. *Asia Pacific Journal of Human Resource Management*, 28(2): 27–43.
- Jensen, M. C. & Murphy, K. J. (1990) Performance Pay and Top Management Incentives. *Journal of Political Economy*, 98: 225–264.
- Lawler, E.E. (1990). *Strategic Pay*. San Francisco: Jossey-Bass.
- Main, G. & Johnston, J. (1992) Deciding on Top Pay by Committee. *Personnel Review*, 32–35. (July).

- Lederer, J. K. & Weinberg, C. R. (1996) CEO compensation: Share the wealth. *Chief Executive*, 116: 30–47.
- Main, G. (1993) Pay in the Boardroom: Practices and Procedures. *Personnel Review*, 22: 3–14.
- Martocchio, J. (1998) *Strategic Compensation: A Human Resource Management Approach*. New Jersey: Prentice Hall.
- Mathews, J. (1994) *Catching the Wave: Workplace Reform in Australia*. Sydney: Allen & Unwin.
- Milgrom, P. & Roberts, J. (1992) *Economics, Organization and Management*. Englewood Cliffs, NJ: Prentice-Hall.
- Milkovich, G. T. & Newman, J. M. (1996) *Compensation* (5th ed). Chicago: Irwin.
- Milkovich, G. T. & Newman, J. M. (1999) *Compensation* (6th ed). Chicago: Irwin.
- Miller, D. J. (1995) CEO Salary Increases may be rational after all: referents and contracts in CEO Pay. *Academy of Management Journal*. 38(5): 1361–1385.
- O'Neill, G. L. (1990) *Corporate Compensation in the 1990s: Strategies for Decision Makers* (eds). Melbourne: Longman Professional.
- O'Neill, G. L. & Clarke, R. R. (1990) Executive Remuneration in the 1990s: Major Issues and Trends. In *Corporate Compensation in the 1990s: Strategies for Decision Makers* (ed). Melbourne: Longman Professional.
- O'Neill, G. L. (1997) Linking Pay to Performance: Conflicting Views and Conflicting Evidence. *Asia Pacific Journal of Human Resources*, 33(2): 20–35.
- O'Neill, G. L. (1999a) Executive Remuneration in Australia: An Overview of Trends & Issues – A White Paper. NSW: AHRI/Hay Group
- O'Neill, G. L. (1990b) Issues in the design and structure of executive remuneration. In G.L. O'Neill & R. Kramar (eds), *Australian Human Resource Management: Current Issues in Management Practice*, NSW:Business & Professional Publishing Pty Limited.
- O'Neill, G. L. & Iob, M. Z. (1999) Determinants of Executive Remuneration in Australian Organisations: An Exploratory Study. *Asia Pacific Journal of Human Resources*, 37(1): 65–75.
- O'Reilly, G., Main, G. & Crystal, G. (1992) Compensation as tournament and social comparison. *SEC Release* No 33–6962. (October).
- O'Reilly, G., Main, G. & Crystal, G. (1993) *Compensation as tournament and social comparison*. *SEC Release* No 34–33229. (November).
- PA Consulting Group. (1994) *Perspectives on Top Management Rewards*. Sydney: PA Consulting Services.
- Paulin, G. & Cook, F. (1992) What Should Be Done About Executive Compensation. *ACA Journal* 1: 20–35. (Autumn).

- Paulin, G. (1997) Executive Compensation and Changes in Control: A Search for Fairness. *Compensation & Benefits Review*, 29(2): 30–40.
- Pratt, N. C. (1996) CEOs reap unprecedented riches while employees' pay stagnates. *Compensation & Benefits Review*, 28(5): 20–24.
- Schuster, J. R. & Zingheim, P. K. (1992) *The New Pay*. New York: Lexington Books.
- Steers, R & Ungson, G.R. (1987) Strategic issues in executive compensation. In D.B. Balkin & L.R. Gomez (eds), *New Perspectives on Compensation*. Englewood Cliffs, NJ: Prentice-Hall.
- Tosi, H. L. (jr). & Gomez-Mejia, L. R. (1994) CEO Compensation Monitoring and Firm Performance. *Academy of Management Journal*, 37(4): 1002–1116.
- Towers Perrin. (1997) Pay Rates Around the World cited in *The Australian Financial Review*. 19 May.
- Walters, B., Hardin, T. & Schick, J. (1995) Top executive compensation: Equity or excess? Implications for regaining American competitiveness. *Journal of Business Ethics*, 14(3): 227–234.
- Williams, A. (1994) *Just Rewards? The Truth About Top Executive Pay*. London: Kogan Page.
- Williams, A. & Crabb, S. (1995) Quelling the storm over top salaries. *People Management*: 22–25. (March).
- Williamson, O. (1985) *The Economic Institutions of Capitalism*. New York: Free Press.

Figure 1 Comparative CEO Pay Rates*

* includes basic compensation, variable bonus, compulsory company contributions, voluntary company



contributions, perquisites and long-term incentives.

Source: Towers Perrin: Pay rates around the world 1997

Table 1 Organisations Analysed in this Study

<i>Company</i>	<i>ASX Code</i>	<i>Industry</i>
Aberfoyle Ltd	ABF	Resources & Mining
ANZ Banking Group Ltd	ANZ	Banking
Ashton Mining Ltd	ASH	Resources & Mining
The Broken Hill Proprietary Ltd	BHP	Resources & Mining
Brambles Industries Limited	BIL	Service & Transport
Boral Ltd	BOR	Building & Materials
BTR Nylex	BTR	Manufacturing
Coca-Cola Amatil Ltd	CCL	Retail
Coles Myer Ltd	CML	Retail
CSR Limited	CSR	Building & Materials
Finemores Limited	FMH	Service & Transport
Hills Industries Ltd	HIL	Manufacturing
National Australia Bank Limited	NAB	Banking
Magellan Petroleum	MGP	Resources & Mining
Mayne Nickless	MAY	Service & Transport
OPSM Industries Ltd	OPS	Manufacturing
Pioneer Industries Ltd	PNI	Building & Materials
Santos Ltd	STO	Resources & Mining
TNT Ltd	TNT	Service & Transport
TMA Tubemakers Ltd	TMA	Manufacturing
Wattyl Limited	WTL	Building & Materials
Western Mining Corporation	WMC	Resources & Mining
Westpac Banking Corporation	WBC	Banking
Woodside Petroleum	WPL	Resources & Mining

Figure 2 CEO Pay : Accounting Based Indicators

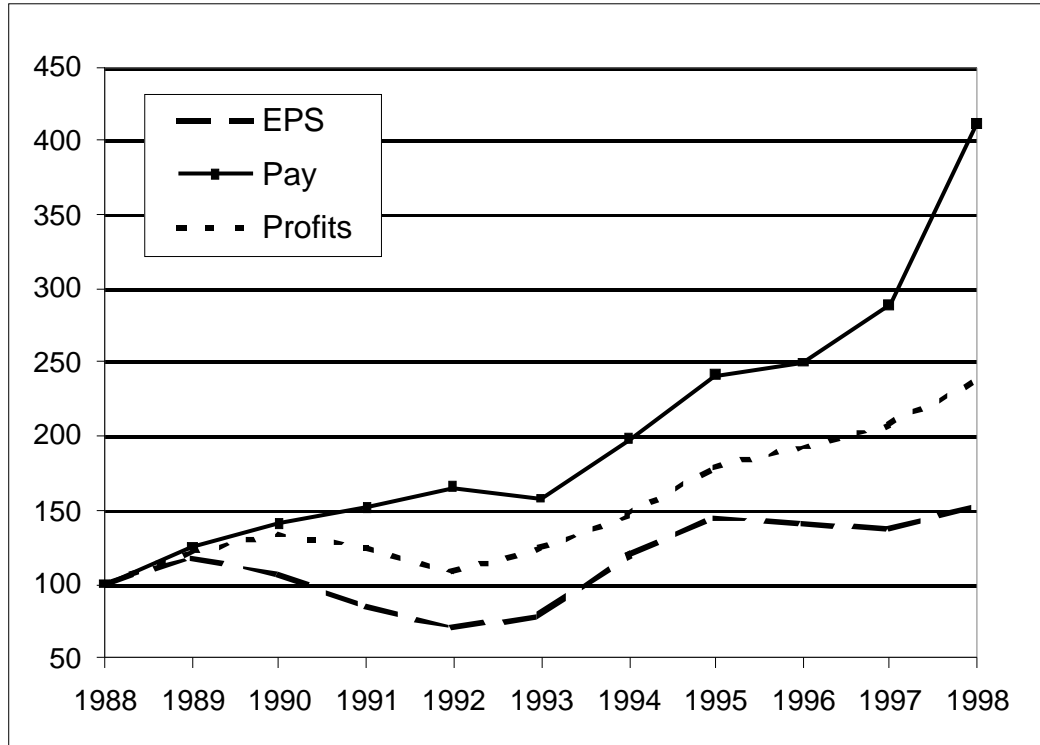
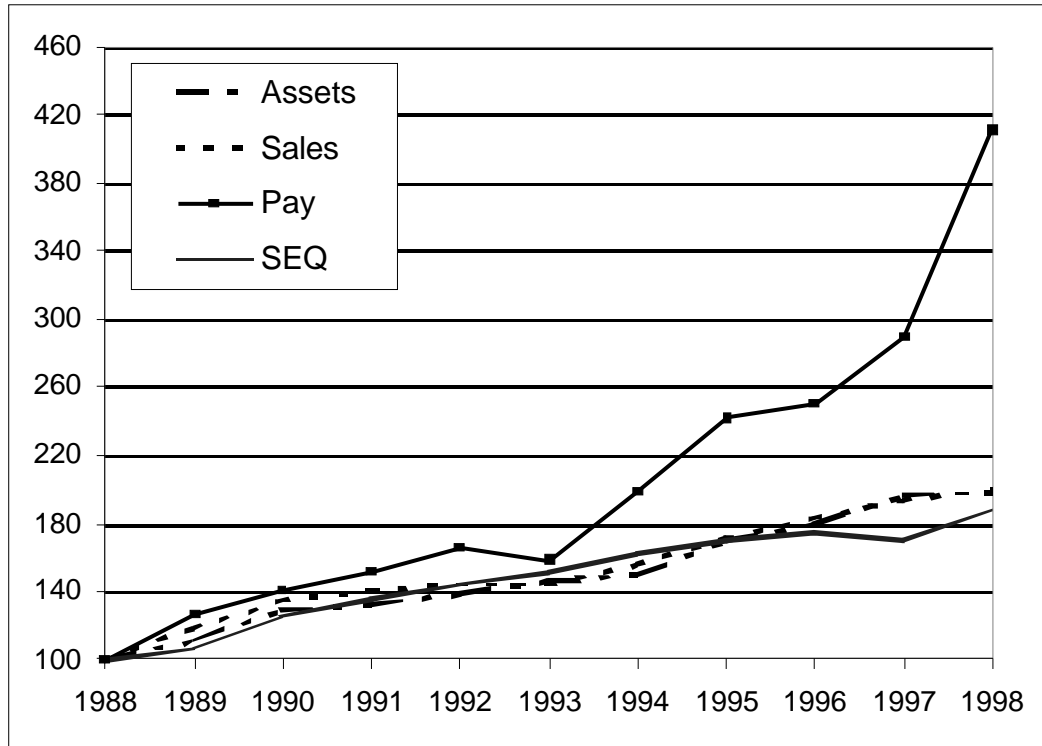
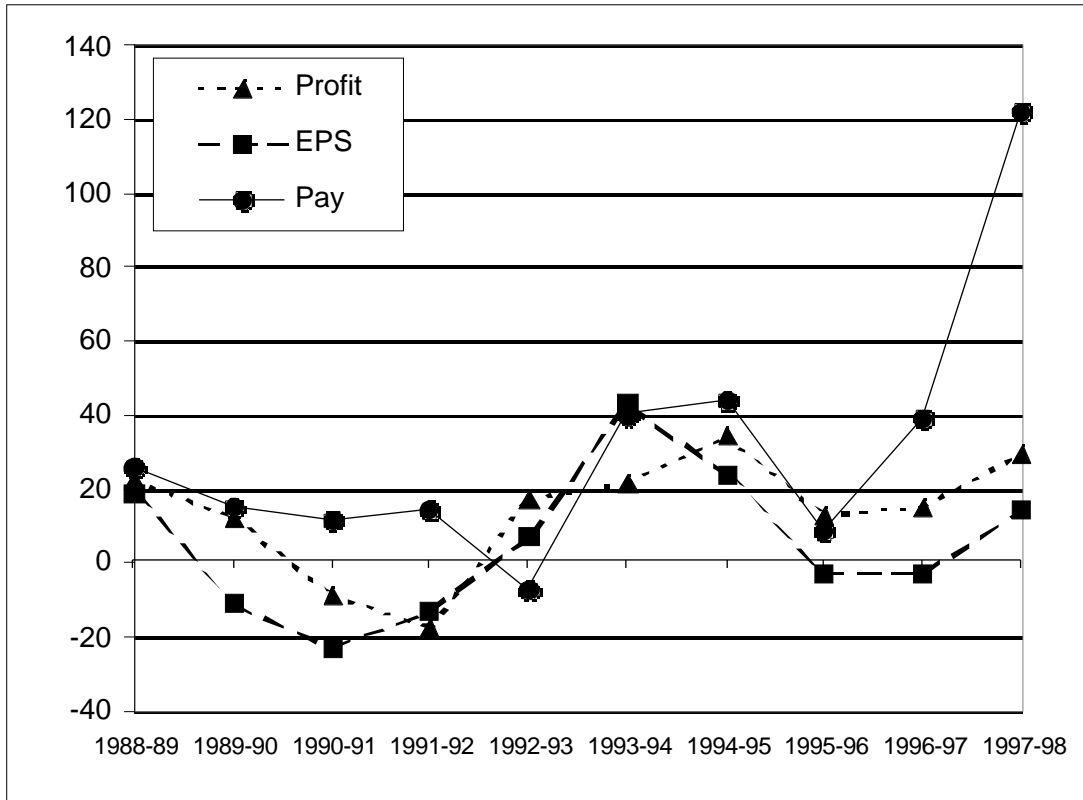


Figure 3 CEO Pay: Stockmarket Based Indicators



**Figure 4 CEO Pay and Accounting Based Indicators:
Differences in Percentages for Pairs of Years**



**Figure 5 CEO Pay and Stock Market Based:
Differences in Percentage for Pairs of Years**

