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EDITORIAL

Dear readers!

This issue of the journal is devoted to several issues of corporate governance.

Vincenzo Capizzi, Renato Giovannini, Valerio research the performance realized by secondary buyouts (SBOs), which are operations where a LBO is refinanced with a new ownership structure that includes a new set of private equity financiers and a new debt structure. By the analysis of a initial dataset of 164 transactions occurred in Italy during the period from 2000 to 2008, we find evidence of SBOs' rationales of corporate governance, with significant firms' performance improvements.

Feifei Li, Avanidhar Subrahmanyam provide a setting where due to a lack of sophistication, possibly arising from high opportunity costs of learning about accounting conventions and financial markets, nave (unsophisticated) investors are unable to decipher true executive compensation accurately. Expected compensation is therefore higher when such investors form a more significant clientele in the market for a firm's stock. Our model further suggests that increased information asymmetry between informed and uninformed traders may deter the entry of uninformed investors and keep executive compensation in check. Technologies that lower the cost of trading facilitate entry of relatively unsophisticated investors and raise expected compensation.

Mark Wickham and Tommy Wong undertake an analysis of the regional Tasmanian state government's approach to the management of dissenting stakeholder groups towards a controversial retail development. The paper provides a discussion of the manner in which their governance structure included the use of delay tactics, the abdication of responsibility, and the building of bureaucratic layers that effectively diluted the will of stakeholder groups to continue their dissenting activities.

Julio Cesar Donadone investigates the social articulations which result in internationalization and the naturalization of their managerial contents, specially the influence of management financial logistic – financing – and corporate governance. The main focus of this research project is to investigate how the agents, specially the ones related to consulting, bring new economic internationalization to Brazil and fulfill all the needs to achieve it. Hence, this study contributes towards understanding the Brazilian consulting market development process, its trends, strategies, and relationship with other organizations, its main changes over the last decades, and its particularities in the Brazilian Sector.

Hashanah Ismail reports on interviews with audit partners of listed companies on their perspectives of impact of corporate governance on the audit process. Based on responses received the study finds that audit risk framework is dynamic enough to incorporate expected changes in control environment brought about by greater consciousness on the part of directors on the need for good internal control. However there is still skepticism that good governance practice has filtered through clients' control environment as auditors believe dominant CEO's may still moderate the effectiveness of audit committees.

Seok Weon Lee examines how the dividend policy of banks is associated with the level of safety of the banks. As the proxy for the safety of the bank, we employ the asset size and leverage measures. Considering that the explicit protection system of deposit insurance backing up the banking industry is prevailing and implicit forbearance policy practiced by the banking regulators generally would not allow the failure of especially large banks, the banks with larger asset size, other things being equal, would be considered safer than smaller banks. Also, following the implications of finance literature, higher leverage is believed to represent higher riskiness and the firms in higher leverage positions would have greater risk-taking incentives to maximize potential upward gains from high profit. From the panel data of Korean banks during 1994-2005, we find that the banks in a safer position significantly pay more dividends. That is, the banks with larger asset size and lower leverage tend to pay more dividends. In the tests employing partitioned samples and interaction variables for risk characteristics, we find more transparent and consistent results.

Simona Franzoni aims to examine disclosure about listed companies' executive remuneration, investigating particularly the rules and recommendations adopted in industrialized countries (European countries: France; German; Italy; Spain; United Kingdom; and non-European countries: Canada; Japan; Russia; United States) and to verify if effective communication behaviours adopted in Italy and in foreign countries by listed public utility companies match cognitive and evaluation stakeholders' expectations and rules and existing specific recommendations. Disclosure of the remuneration is necessary to offer each stakeholder to understand if the amount of compensation paid and its composition is adequate to avoid potential excesses that could compromise the process of value generation by the enterprise. This is an important topic, considering also potential conflicts between form, structure and level of executive directors' remuneration (fixed and variable elements, stock options, total estimated value of non-cash benefits, remuneration paid to directors in connection with the termination of his activities during that financial year, etc.) and corporate performance optimization in the long term.

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Simona Franzoni

SECONDARY BUYOUTS, PRIVATE EQUITY AND FIRMS' CORPORATE GOVERNANCE

Vincenzo Capizzi*, Renato Giovannini**, Valerio Pesic*

Abstract

During last years numerous studies have focused attention on determinants of leverage buyouts (LBOs), finding strong evidence about the capability of those operations to improve firms' productivity and operating performance. Nonetheless, there is a lack of research concerning the performance realized by secondary buyouts (SBOs), which are operations where a LBO is refinanced with a new ownership structure that includes a new set of private equity financiers and a new debt structure. By the analysis of a initial dataset of 164 transactions occurred in Italy during the period from 2000 to 2008, we find evidence of SBOs' rationales of corporate governance, with significant firms' performance improvements.

Keywords: Leverage, Corporate Governance, Value of Firm, Shareholder, Venture Capital, LBO

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1. Introduction

Financial research literature has increasingly focused attention on leveraged buyouts (LBOs) and has found extensive evidence that the transactions improve productivity and operating performance (Jensen, 1993; Thompson and Wright, 1995; Cumming, Siegel, Wright, 2007). As Cumming, Siegel and Wright (2007) noted, little research examined the value increases of buyout targets and returns realized from secondary buyouts (SBOs). These are particularly interesting transactions affecting corporate control due to the involvement of private equity investors as both buyers and sellers. (For this reason, they are also called sponsor-to-sponsor transactions.) Typically, an SBO is an LBO of a company that has previously undergone an LBO; for purposes of this research, SBOs also include all tertiary and successive buyouts.

Our aim is to analyze SBOs, which have been made possible in recent years due to favorable conditions such as available liquidity in debt markets and a significant increase in private equity investors seeking control of corporations. SBOs are a recent phenomenon; consequently, there is little empirical research and literature on the topic. This study aims to determine whether SBOs are simply speculative transactions or flow from more substantive rationales of corporate governance.

2. LBOs and Secondary Leveraged Buyouts: the Influence on Firms' Corporate Governance

By analyzing the SBOs that occurred in the Italian market from 2000 to 2008, this research presents evidence regarding the nature of such deals. We study data from SBOs transacted in Italy because the geographical criteria has been retained more appropriate to shortlist a dataset of transactions (Volpin, 2002; Melis, 2000). This paper makes three original contributions. First, it gathers the available literature regarding SBOs, which is very fragmented implementing it with an evidence from these particular deals. Second, the research is based on a detailed dataset (a set of 164 Italian buyouts from the period 2000-2008), generated from accurate research of the Italian market for corporate control. The dataset is unique and original because private equity in Italy generally has limited information disclosure due to legal, fiscal and privacy restrictions. Third, this paper is the first empirical work focused entirely on SBOs that includes both the buy side and the sell side. It examines whether SBOs are just speculative ventures for investors or transactions that can lead to value increases and gains in productivity and operating performance for the subject companies.

Recent studies of LBOs based on shareholder returns data (Kaplan, 1989; Lehn and Poulsen, 1989;

Marais et al., 1989) and company returns (Smith 1990; Smart and Waldfogel, 1994; Wright at al., 1996) strongly suggest that LBOs generate significant financial returns for investors. Therefore, it is relevant to analyze how private equity investors use SBOs and what happens to acquired companies.

In an SBO, an initial LBO is refinanced with a new ownership structure that includes a new set of private equity financiers and a new debt structure. In general, an LBO allows investors to buy a company with minimal equity commitment but with significant debt which the bought-out company assumes. The company must improve performance simply to service its increased debt obligations (Burriugh, 1990; Cumming, Fleming, Schwienbacher, 2006; Cuny, Talmor, 2007). According to most relevant literature (Jensen, 1986; 1989), LBOs generally result in improved corporate governance mechanisms (such as operating efficiency, governance of debt structure, strongest ownership of equity and the presence of active investors) that reduce agency costs and increase firm value (Bierman, 2003; Cumming, 2006; Bernile, Cumming, Lyandres, 2007). Nonetheless, the burden of additional principal and interest payments limits how much management can improve a company's operating efficiency and increase its profits.

An SBO then effects its own changes to the company, which prompts questions about how such transactions affect company performance. Tied to these questions is the issue of whether SBOs are merely speculative and, consequently, whether investors are just assuming the risk of loss in return for an uncertain prospect of reward (Renneboog, Simons, Wright, 2007). To resolve this we need to determine whether private equity firms have precise plans for target companies and whether they are able to implement them.

Private equity activity is based on buying a company's equity with the goal of increasing share value while addressing two problems of the company: no price signaling from the market and no liquidity support are resolved because private equity operates outside stock exchanges (Gompers, Lerner, 1999; Kaplan, Schoar, 2005; Jensen et al., 2006). After a period of "hands-on" management, the investor hopes to demonstrate to the market an increase in the company's value and so will be able to sell the equity participation at an increased price. This should mean that the longer a private equity fund holds a company, the greater will be the value added (the more intensive the work, at least). In the event of selling shares through a subsequent SBO, this should translate into higher stock prices. Therefore, we hypothesize:

HP 1: We expect a positive correlation between transaction multiples of the SBO and holding period of the exiting fund.

From the buyer's perspective, the price paid in an SBO transaction represents a baseline; he must be sure that when subsequently selling the shares he will receive at least that value plus the required rate of return ("hurdle rate"). If the holding period of the exiting fund was long, then we can assume that the fund had more time to catch any "low hanging fruit" (easily accomplished tasks that improve performance and create value) and that, consequently, fewer such opportunities remain. Accordingly, we can assume that the longer a company has been held in the portfolio of the exiting investor, buyers in an SBO would pay a lower price in order to allow for sufficient margins for future capital gains. The buyer's motivations act in the opposite direction from the seller's. If unchecked, they would lead to opposite results. Therefore, we hypothesize:

HP 2: We expect a negative correlation between transaction multiples and holding period of the exiting fund.

We assume that a potential SBO investor, based on its due-diligence and expertise, is able to estimate by how much its possible future decisions will increase a company's value. To analyze whether SBOs are speculative transactions or deals based on specific rationales, it is relevant to determine whether there is a preexisting awareness of the private equity investing in an SBO regarding the target company (Diamond, 1985; Crawford, 1987; Cotter, Peck, 2001; Cuny, Talmor, 2007).

We will try to analyze whether the price paid is related to the investor's preexisting awareness of the company's potential for increased value. Investors who believe that they could not implement performance improvements would be willing to pay only reduced prices, while investors who believe that they could add value would be willing to pay higher prices. Therefore, we hypothesize:

HP 3: We expect a positive correlation between the entry multiple and the difference in yearly competitive performance advantage in a specific time after the transaction and competitive advantage/disadvantage gained by the target company before the SBO.

3. Empirical study and analysis

3.1. Dataset description

In order to analyze SBOs in the Italian market for corporate control, we built a dataset (164 observations) that mirrors the whole population of SBOs closed between the years 2000 and 2008 in Italy. It accounts for all the relevant transactions. Building such a dataset required great effort because the buyout market is not well developed in Italy (or in other European countries). Great care was taken to

include each transaction because even a single deal could be significant to our analysis.

The private equity industry in Italy provides very little disclosure to the market because of privacy, fiscal and legal issues. Therefore, this study can be considered unique in all its aspects due to its detailed data regarding transactions, as well as financial information regarding each target company, holding company and special purpose vehicle.

The building of the dataset started with combing through financial sources to find SBOs in the Italian market for corporate control. Research focused on prominent financial sources: the Private Equity Monitor Yearly Newsletters, Thomson Financial, AIDA-Bureau Van Dijk, Datastream and Merger Market. In particular, a database was built from the Private Equity Monitor (years 2000-2007); all transactions whose "deal origination" was designated as "SBO" and whose "exit strategy" was designated as "releverage" were included in the final dataset. In addition, all transactions listed in Merger Market (Private Equity Exits tool) with an exit strategy of "SBO" were included in the final dataset. The table in Figure 1 summarizes the results.

Database	Search key	Number of observations
Private Equity Monitor Yearly Newsletter	Deal origination – secondary buy-out	53
	Exit – Releverage	37
Merger Market	Exit – SBO	74
TOTAL NUMBER OF OBSERVATIONS (number of deals)		**164**

Fig. 1 Results of the research of SBOs through financial media

The analysis is conducted without regard to actual debt-to-equity (D/E) ratios. Thus, no threshold level was set for a transaction to be designated as an SBO, and deals in the dataset may have very different amounts of leverage. In order to be included in the dataset, the deals only had to meet the criteria set by the prominent financial media listed above (Private Equity Monitor Yearly Newsletter and Merger Market).

The 164 observations were merged into the final dataset, with the following details and statistics listed for each operation:

- Year: the year in which the transaction was closed;
- Sector: the main industry sector in which the target company operates;
- Lead Investor: the name of the private equity fund sponsoring the transaction and the one with the majority stake in the transaction;
- Lead Investor equity and % of shares: the amount of equity the Lead Investor invested and the Lead Investor's percentage of relative control in the transaction;
- Co-Investors: the names of other private equity funds, strategic players or private investors participating in the pool of investors with minority stakes in the transaction
- Co-Investor equity and % of shares: the amount of equity a Co-Investor invested and the Co-Investor's percentage of relative control in the transaction;
- Total shares acquired: the sum of the percentage of shares acquired by the Lead Investor and the Co-Investors in a target company[1];
- Total invested amount: the amount involved in the transaction, that is, the sum of equity invested and debt borrowed.
- Leverage ratio: the leverage ratio of the purchasers of the target company. It is calculated as total debt of the purchasers divided by total equity of the newly constituted company[2];
- Seller: the seller of the target company;
- Holding period of exiting investor (in months): the number of months between the closing of the first LBO and the closing of the SBO (when known); if the exact month of either transaction is unknown, a statistic was built as the year of the SBO minus the year of the former LBO times 12.

The author used the following information-providers to fill any information gaps:

- The online database of "Il Sole 24 Ore";
- CMBOR (Center for Management Buyout Research) publication of the Business School of the University of Nottingham;
- Private Equity Monitor monthly newsletter and publications;
- MergerMarket Dealscope tool;
- Fineurop Soditic newsletters;
- Web sites of the target companies;
- Web sites of the private equity firms.

The following relevant information about the

[1] In an SBO, this is not always 100%.

[2] Though often very useful for purposes of analysis, this ratio is not available for most transactions.

original LBOs was acquired in the dataset:

- Year: the year in which the transaction was closed;
- Acquisition type: a description of the typology of the first LBO;
- Lead Investor: the name of the private equity fund sponsoring the transaction and the one with the majority stake in the transaction;
- Lead Investor equity and % of shares: the amount of equity the Lead Investor invested and the Lead Investor's percentage of relative control in the transaction;
- Co-Investors: the names of other private equity funds, strategic players or private investors participating in the pool of investors with minority stakes in the transaction;
- Co-Investor equity and % of shares: the amount of equity a Co-Investor invested and the Co-Investor's percentage of relative control in the transaction;
- Total shares acquired: the sum of the percentage of shares acquired by the Lead Investor and the Co-Investors in the Target Company;
- Total invested amount: the amount involved in the transaction, that is, the sum of equity invested and debt borrowed;
- Seller: the seller of the target company to the first private equity fund.

After eliminating any duplicates and transactions for which available data were insufficient for analysis, the final dataset resulted in 88 operations and 72 companies. (The difference is because 14 companies underwent SBOs two or three times,[3] and they appear in the dataset for each instance.)

The following companies were excluded from the dataset due to insufficient data about their deals:

- Aive
- Cemp International
- Diasorin
- JAL Group
- Rodriguez Cantieri Navali

3.2. Research method rationale

With the database completed, we tested for any increase of target company value, using the marginal increase of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) as the main indicator of company value increase (Muscarella, Vetsuypens, 1990; Kaplan, 1989; Desbrierers, Schatt, 2002). If a company increases its operating margin it will also increase its cash flow, which will cause the company to gain a higher valuation (Andrade, Kaplan, 1998; Amess, 2003; Chou, Gombola, Liu, 2006; Harris, Siegel, Wright, 2005). Consequently, if the SBO investor increases the EBITDA margin, then he has added value to the company. The analysis is conducted without regard to the actual D/E ratio.

To analyze companies' profitability compared to their competitors in the same industrial sector, the *average "sector" EBITDA margin* was subtracted from the *company EBITDA margin.* Labeled the *yearly competitive performance advantage*, this measure is used to determine if a company undergoing an SBO has an *ex ante* performance advantage (or disadvantage) over its competitors or if they gain any such advantage (or disadvantage) after the deal. This calculation will enable us to verify whether SBOs are conducted on high performing companies; a positive finding would support assertions made in the literature regarding LBOs (Jensen, 1993; Thompson and Wright, 1995; Cumming, Siegel, Wright, 2007). It will also enable us to confirm whether SBOs are deals with specific rationales, or at least when picking targets, investors look for potential profitability and conduct detailed screening (Lichtenberg, Siegel, 1990; Lee, 1992; Holthausen, Larcker, 1996; Jelic, Saadouni, Wright, 2005; Nikoskelainen, Wright, 2007).

To determine if an SBO investor actually added value to a target company, the following two steps were executed. First, we established a company's average rate of competitiveness before the SBO transaction. This will serve as a baseline in the analysis of company performances after the deal. The company *competitive advantage/disadvantage before the SBO* was found by computing the average *yearly competitive performance advantage* for the five years before the SBO. Second, to test if the SBO purchaser actually made a company more profitable and added value to it, the *competitive advantage/disadvantage before the SBO* was subtracted from the *yearly competitive performance advantage* of each year following the SBO.

There is a common element in an SBO transaction that links the entering investors and the exiting investors but nonetheless assumes a different significance for each: the price paid for company's shares. For the sellers (exiting fund), the deal amount recognizes any value they added to the company and will determinate their final returns on that transaction, especially Internal Rate of Return and the Money Multiple (Palepu, 1990; Loh, 1992; Renneboog, Simons, Wright, 2007). For the buyers (entering fund), the price paid represents the bar that they must surpass in creating company value. To carry out our analysis, and especially to compare the different deals, the price paid in each transaction had to be standardized. The most efficient way to standardize deal prices is to compute transaction multiples. The

[3] This means that, including the initial LBO, the company underwent leveraged acquisitions four times!

enterprise value (EV) was computed for each deal; company EBITDA and sales were then used to compute the ratios, EV/EBITDA and EV/SALES.

Total number of deals	164
Duplicates or possible similar deals	72
Deals w/out sufficient info (see list)	5
Total number of deals in the final dataset	**87**

Fig. 2 Short list of the dataset's transactions

Companies with 1 secondary buy-out	58
Companies with 2 secondary buy-outs	13
Companies with 3 secondary buy-outs	1
Total number of companies	**72**

Fig. 3 Short list of the dataset's companies by number of buyouts (secondary, tertiary, quaternary)

3.3. Dataset description and key findings

3.3.1. The LBO transactions

In building the dataset, great effort was made to find each SBO's "mother" LBO. In order to understand the motivations behind the SBO, it is helpful to have a complete history of the target company, and especially the particulars of the original LBO.

The average value of the originating LBOs, expressed as the sum of debt and equity involved, was €220 million, and the average percentage of shares acquired was 72 percent. In 47 observations, the LBO was conducted through an investors' buyout (IBO), which means that private equity investors were the main sponsors of the original LBO. In 15 deals, a management team supported the transaction and invested in it (MBO). Very important to our analysis, 15 transactions originated from previous SBOs (meaning that they were tertiary or quaternary buyouts). Six buyouts were sponsored by teams external to the company (MBI), and two were public-to-private transactions, which counts a lot in terms of volumes due to the nature of the de-listing operation. There was one case each of a corporate buyout (CBO) and a family buyout (FBO).

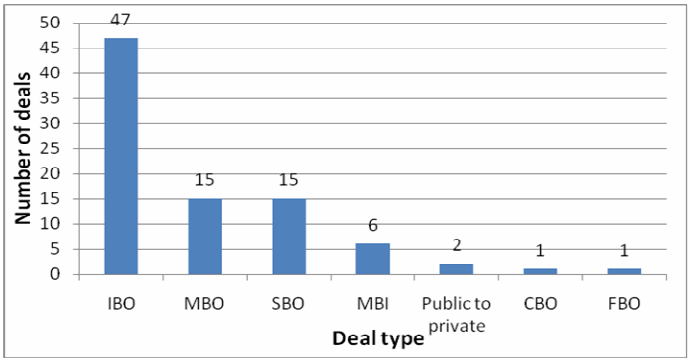


Fig. 4 SBO-originating deals, by type

It is also crucial to identify the year of the first LBO in order to determine whether SBOs are a cyclical phenomenon in the market for corporate control. It may be shown that SBOs are a natural consequence of previous high-volume activity by private equity investors, not finding on the market, when willing to exit from portfolio companies, enough cash availability from strategic player or from capital markets. This would be indicated if the deals originating the SBO were concentrated around a specific time, for example during two of our target years.

As far as the Italian market for corporate control is concerned, this theory is refuted. The distribution of LBOs that generated SBOs is fairly flat during the years 1997 to 2006, creating a constant pipeline for SBOs (Fig. 5). So far, only two deals in 2006 have originated SBOs, but this is not significant because it was so recent; over time, this number will probably increase.

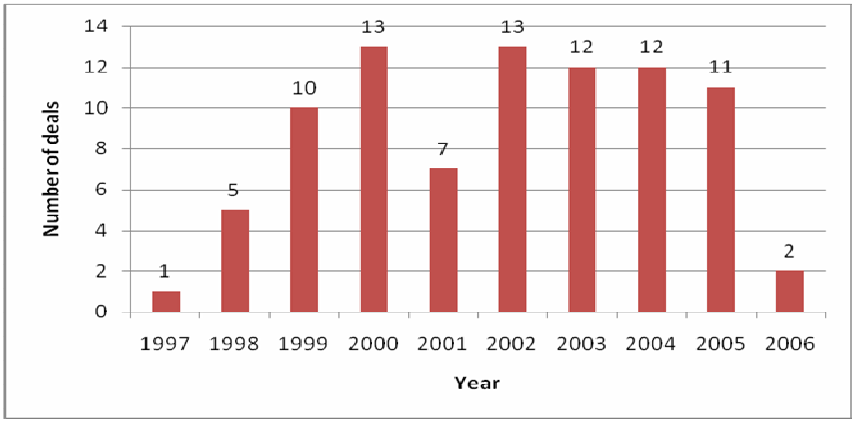


Fig. 5 LBO deals that originate SBOs, by year

Holding periods of Italian LBO companies are fairly equally distributed. There are 29 companies that were held for 24 months or less, and 54 companies were held longer. Moreover, 18 companies of the sample were held in portfolio for more than four years (Fig. 6).

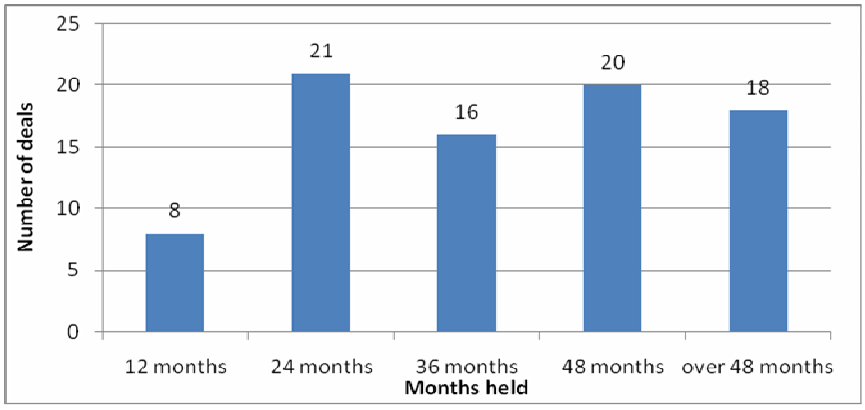


Fig. 6 Holding periods of LBO selling investors

The greatest number of companies (30) that are taken over through SBOs belong to the manufacturing and industrial sector, 12 companies are in the chemical industry, and seven are in business and financial support services (Fig. 7). Such industries are fairly noncyclical, and the literature indicates that they are the same sectors that are most suitable for LBOs (Kaplan, Strömberg, 2008).

It is impressive that seven LBOs were of companies belonging to the luxury and fashion industry, which is typically a very cyclical industry; this is not consistent with the recognized criteria for ideal LBO candidates. It is also noteworthy that in the energy industry (electricity and gas) only one transaction lead to an SBO. Usually companies in this sector have stable and predictable cash flows, making them good candidates for LBOs (Jensen, 1986; Strömberg, 2008). The probable explanation is that until recently the State owned the energy industry, and so few big players have emerged.

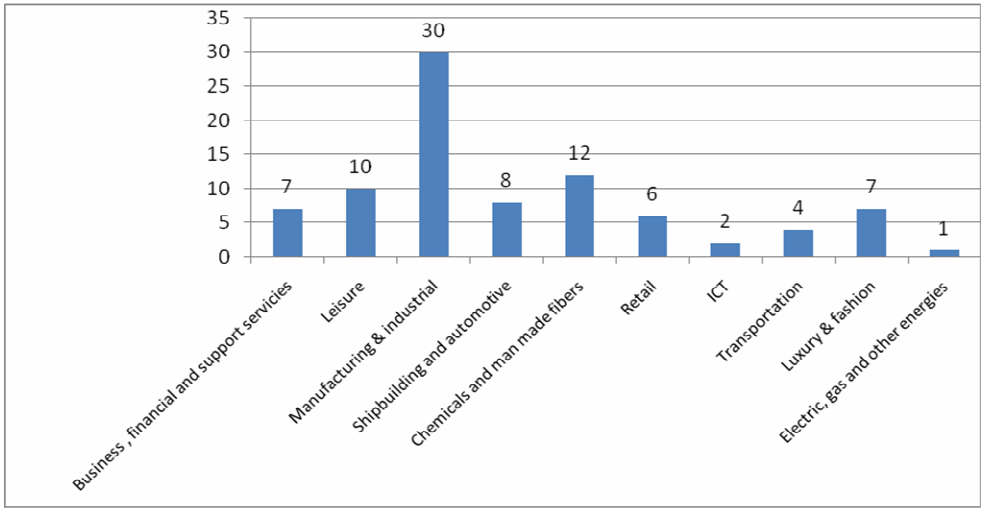


Fig. 7 Sectors of the companies of the dataset

3.3.2. The SBO transaction

For the 87 SBOs observed in the Italian market for corporate control between 2000 and 2008, the average deal size was €271 million, with an even distribution of number of deals among medium and big size (over €50 million).[4] The most populous category is small deals (under €50 million), with 25 transactions (Fig. 8). There are three likely explanations for the prevalence of so many small deals. First, little capital was employed because very few shares were acquired in each company. Second, target companies had low valuation multiples, and so little capital was employed in acquiring them. And third, companies that were targets of SBOs were simply small in size. On average, the shares acquired were equivalent to 85 percent of each company, and in almost 60 percent of transactions all of the target company's stock was acquired; thus, the first hypothesis can be discarded. Analysis also showed that very few companies in the dataset had low valuation multiples; thus, the second hypothesis is eliminated. Consequently, the main reason for so many small deals is simply the small size of target companies. This looks even likelier if we consider the texture of Italian industry, which is characterized by many small-to-medium sized enterprises.

Ironically, SBOs impose particular difficulties for small firms. They are typically highly leveraged transactions, and end up saddling target companies with large amounts of debt (Weir, Jones, Wright, 2008). The burden of paying down such debt is especially unwieldy for small companies. Such increased debt burdens pose less of a risk to larger firms, which can diversify more and are less exposed to economic cycles. Consequently, one would think that it would be wiser for SBOs to target bigger firms and avoid smaller ones.

In terms of money volume, SBO[5] activity peaked in 2006 (Fig. 9). The downward trend since then seems to continue, as volumes for the first half of 2008 are less than a third of 2007 volumes. This is most likely due to the ongoing liquidity crisis in capital markets. If mega deals (more than €500 million) are removed from consideration, the trend is positive until 2007, with a drastic downward swoop in 2008. In addition, volumes are cut in half in every year; this shows that mega deals, though few in number, play a huge role in the Italian market. Especially noteworthy is the amount of 2008 volume that is due to mega deals, more than 90 percent. This is probably due to the current liquidity crisis.

[4] Size of the transaction refers to the invested amount, which is the sum of Debt and Equity used to acquire the target company.

[5] Volumes are calculated based only on deals with disclosed amounts, so data are not completely indicative. In 13 of 87 deals, it was impossible to find the amount invested.

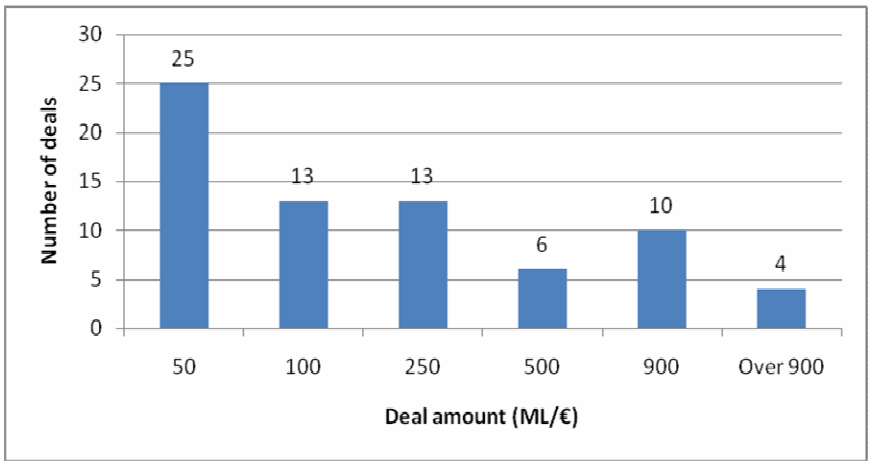


Fig. 8 SBO deals by invested amount

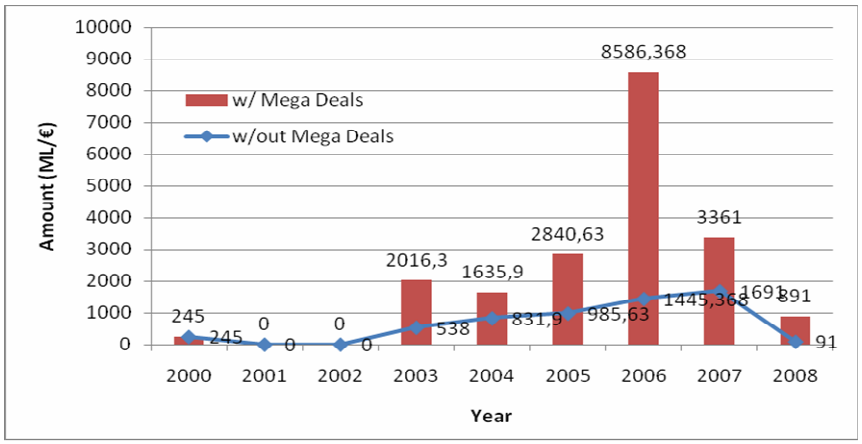


Fig. 9 SBO deals per year in terms of money volume[6]

In terms of number of transactions, a more even distribution is observed among yearly figures (Fig. 10). Nonetheless, amounts increase from year 2000, peak in 2005, and decrease in 2006 and 2007. The first semester of 2008 registered six SBOs, almost the half the amount (13) for all of 2007. Differences in term of mega deals per year are not significant; big deals are not concentrated in any certain period, and they occur every year so they are not to be considered extraordinary.

We analyzed the valuations of target companies, using valuations given by the buying fund, or if available, the valuation that resulted from the negotiations.[7] The purpose of the analysis was to define a metric for the valuation of companies undergoing an SBO; in the process, we considered multiples achieved in each deal. As enterprise values, we used the deal amount multiplied by the percentage of shares acquired. We then divided these figure by EBITDA and Sales, respectively, from the income statement of the SBO year to calculate two multiples for each company. These multiples were immediately available from the dataset already built and are the ones most commonly relied on by professionals of private equity firms (Bierman, 2003; Weir, Laing, Wright, 2005; Wright, 2007).

Transaction multiples concentrate around "normal" values for EV/EBITDA and EV/SALES. A consistent number of deals reach very high multiple values and consequently assign very high values to the acquired companies. Specifically, nine deals were valued with EV/EBITDA ratios greater than 21 (Fig. 11), and 11 deals were valued with EV/SALES greater than three (Fig. 12). It would be interesting for a future study to analyze whether these companies had some common features before the SBO, and whether they were the best achievers in their sectors or had the greatest performance improvement.

[6] 2008 column represents only half a year.
[7] Multiples were computed for only 74 transactions because the amounts of 13 deals were undisclosed.

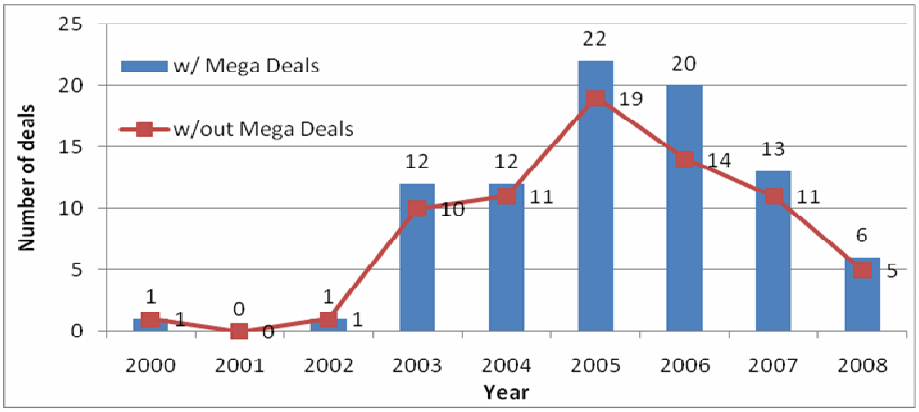


Fig. 10 SBO deals per year[8]

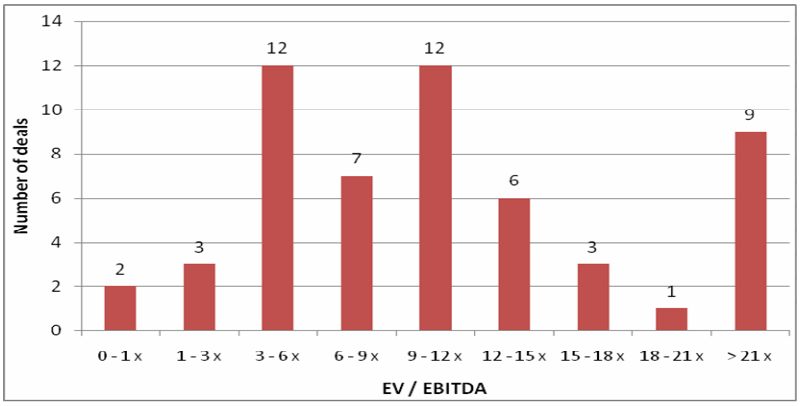


Fig. 11 EV/EBITDA multiples of SBO transactions

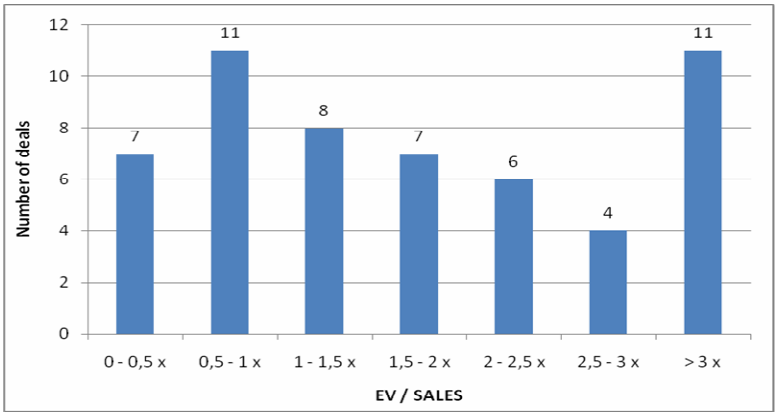


Fig. 12 EV/SALES multiples of SBO transactions

[8] 2008 column represents only half a year.

3.3.3. Improving governance performance

In his book on private equity and LBOs, Povaly (2007) cites many researchers (Gilbert, 1978; Baker and Wruck, 1989; Jensen, 1989; Muscarella, Vetsuypens, 1990; Kaplan, 1991; Opler, Titman, 1993; Kosedag, Lane, 2002; Peck, 2004) who have documented that firms involved in LBOs typically have high free-cash profiles and low growth opportunities; and subsequent to buyouts, the firms increase their operating efficiency and profitability (Wright, 1991; Wright, Thompson, Robbie, 1992; Zahra, 1995; Van de Gucht, Moore, 1998; Wright, Hoskisson, Busenitz, 2001). We analyze whether SBOs also lead to increased operating efficiency and profitability.

In order to gain perspective on the development of each of the 72 companies, and to measure their operating efficiency and profitability, EBITDA margins were tabulated for years 1996 to 2006. The EBITDA margin is computed as $\frac{EBITDA}{SALES}$.

For statistical purposes, after tabulating results for "relative years" (1996 to 2006), the EBITDA margin was tabulated for "absolute years" (Year 0 is set at the time of the SBO, Time 1 (-1) at one year after (before) the SBO, and Time 2 (-2) at two years after (before) the SBO, and so on.

To collect these data, we mainly used Bureau Van Dijk's electronically published Aida, a prominent database, to locate balance sheets. LBOs are often conducted through special purpose vehicles, and a target company may change its fiscal code and business name after the acquisition. This caused difficulties in locating some balance sheets because Aida did not have complete sets for all of them. To fill gaps, we referred to scanned-copies obtained directly by Bureau Van Dijk and, when available, to balance sheets downloaded from companies' web sites.

In order to have benchmarks, EBITDA margins of companies comparable to the ones in our dataset were collected, and results were tabulated for "relative years" and "absolute years." In order to conduct an unbiased comparison of the EBITDA margin for each company, it was necessary to find comparable companies operating in the same industry, and especially companies that were also similar in size. To achieve greater accuracy and realism, we built a customized set of comparables rather than rely on generalized benchmark sector indicators. This was especially helpful because of the great range of size of our dataset companies. (Sales of the smallest firm were only €2 million, while sales of the biggest firm were more than €1.5 billion.)

In order to find comparable companies, we searched Aida for firms with the same ATECO 2002 code [9] and with similar sales amounts, plus or minus 40 percent, of a target company's sales during the last four years available (2006, 2005, 2004, 2003). We tried to find on average 20 comparables for each target company, with a maximum of 30 and a minimum of 10. When not enough comparables were available because the target company's sales were too big or it operated in a niche business, the ten closest companies in term of sales within the same ATECO 2002 code were selected as comparables.

In some cases, a company's listed ATECO 2002 code referred to the activity of "financial intermediation" or "holding companies," reflecting the original purpose of the company created as a shell for purposes of the acquisition. In such cases, we found an appropriate ATECO 2002 code that mirrored the company's real industrial activity.

[9] ATECO 2002 is a business classification created by the Italian National Institute of Statistics.

Company / Deal	# of comparables	Company / Deal	# of comparables
AEB	30	Gruppo Lince	10
Alfatherm	20	Guala Closures SpA	12
Appliances Components Companies SpA	10	Intercos Italia S.p.A. (Intercos Group srl SPV)	11
Arena International	30	Italmatch Chemicals	30
Arketipo	30	Limoni	10
Azelis 1	15	Lucomed (formerly Medfin)	30
Azelis 2	15	Luxy (spv Seating People S.R.L.)	30
Bianchi Vending (formerly Nuova Bianchi)	14	MC Mini Gears	14
Blumen srl	20	Metalcastello Spa	14
Bluvacanze 1	14	N&W Global Vending Spa (formerly Wittenborg and Necta Vending)	29
Bluvacanze 2	14	Palini&Bertoli (newco Palber Uno)	20
Bodio Properties Srl	15	Piquadro	29
Bruno Magli	11	Raco 1	24
Byte Software House	14	Raco 2	24
Castaldi Illuminazione 1	30	Redecam Group S.p.A.	30
Castaldi Illuminazione 2	30	Rhiag Group Ltd	10
Ceme	30	Riello Group (holded throught Sigla Engineering S.p.A.)	12
Co.Import	10	Saet	17
Compagnia Italiana Turismo Spa	27	Schmid s.p.a.	30
De Fonseca	22	Seat Pagine Gialle	13
Ducati	10	Selective Beauty 1	29
Eagle Pictures	10	Selective Beauty 2	29
Eco	10	Servizio Trasporti Combinati - S.T.C.	30
Emmeci s.r.l.	30	Seves (formerly Vetroarredo)	10
Emmegi Detergents	10	Sicurglobal S.p.A.	11
Eurolites SpA	10	Sirti	12
Farmigea	30	Sisal 1	12
Faster SpA 1	28	Sisal 2	12
Faster SpA 2	28	Società Europea Autocaravan SEA 1	10
Ferretti	14	Società Europea Autocaravan SEA 2 (six SPV)	10
Fiat Avio	10	Società Gasdotti Italia (formerly Edison Gas)	29
FL Selenia SPA (Formerly Fiat Lubricants Group) 1	10	Sonus Faber	18
FL Selenia SPA (Formerly Fiat Lubricants Group) 2	10	Stroili Oro 1	13
FL Selenia SPA (Formerly Fiat Lubricants Group) 3	10	Stroili Oro 2	13
Galileo Tp Process Equipment	30	Sympak 1	30
Gamma Croma	26	Sympak 2	30
Gardaland 1	11	Teamsystem	29
Gardaland 2	11	TecnoWind SpA	23
Giochi preziosi (holding Ludica SpA)	13	Trudi	13
Global Garden 1	10	Unopiù	17
Global Garden 2	10	Util Industries	25
Grandi Navi Veloci	12	Vending System	30
Gruppo Argenta 1	10	Wire Industries	20
Gruppo Argenta 2	10	*Average*	*18,6*

Fig. 13 Comparable companies for the deals of the dataset

3.3.4. Companies performance before the SBO

After comparable companies were selected, *"sector" EBITDA margins* were computed for each company of the dataset. These were the average of EBITDA margins of comparables companies for each year, tabulated on the basis of relative and absolute years.

To identify how target companies performed compared to their sector competitors, the *average "sector" EBITDA margin* was subtracted from the *EBITDA margin of the company.* This measure, called *yearly competitive performance advantage*, is used to determine if a company that underwent an SBO had any *ex ante* competitive performance advantage over its competitors or if they gained any advantage after the deal.

$$EBITDA\ margin_{company\ yr\ N} - EBITDA\ margin_{sector\ yr\ N} == yearly\ competitive\ performance\ advantage_{yr\ N}$$

The results show that the *yearly competitive performance advantage* average of the dataset is positive by at least 3.6 percent and peaks at 9.0 percent the year before the SBO. Years 5 and 6 are not so significant because very few companies underwent SBOs so long ago, but the figures are nonetheless impressive and noteworthy. In the following table, negative numerals designate the number of years before the SBO and positive numerals designate the number of years after the SBO (absolute years).

We can then state that, on average, SBOs are conducted on high performing companies. This finding aligns with and provides empirical evidence for comparable statements in the LBO literature regarding LBOs cited in Section 3.2. It also confirms the hypothesis that SBOs are deals with a specific rationale or that at least, when picking SBO targets, investors look at these characteristic and conduct detailed screening (Fig. 15). The quartile analysis (Fig. 16) gives a clearer picture of the relative

performance distribution of the companies.

6	5	4	3	2	1	SBO YEAR	-1	-2	-3	-4	-5	-6	-7
14,31%	14,11%	12,74%	7,10%	8,99%	8,64%	9,01%	9,80%	8,69%	7,44%	5,67%	9,41%	6,59%	3,60%

Fig. 14 Average yearly competitive performance advantage

	3	2	1	SBO YEAR	-1	-2	-3	-4	-5	-6	-7
0	-6,06%	-11,39%	-51,12%	-28,22%	-19,08%	-37,04%	-24,87%	-47,91%	-51,81%	-47,91%	-51,81%
1 st quartile											
1	1,61%	0,61%	1,75%	2,04%	2,25%	1,10%	0,12%	0,84%	0,46%	-1,19%	0,00%
2 nd quartile											
2	4,23%	5,95%	7,51%	6,11%	7,50%	7,40%	4,09%	5,76%	8,27%	6,74%	0,18%
3 rd quartile											
3	8,01%	10,52%	13,21%	12,44%	15,25%	13,86%	14,65%	10,14%	14,54%	13,97%	10,47%
4 th quartile											
4	25,74%	43,60%	36,97%	39,69%	38,67%	42,84%	42,84%	35,26%	81,21%	26,34%	23,84%

Fig. 15 Yearly competitive performance advantage (minimum and maximum values of quartiles)

We set out to analyze differences between SBO operations. Accordingly, we established criteria to classify SBOs as *speculative*, *coerced* or *pure*. There is great agreement among the literature on LBOs and SBOs that a target company must be among the best performers in its sector (Cumming, Siegel, Wright, 2007). For our purposes, target companies that are in the first quartile (worst performers) of their respective industries *ex ante* are deemed to be targets of *speculative* SBOs.

Companies that perform in the second quartile of their industries do not manifest clear advantages vis-à-vis their sector comparables. Looked at three years before the SBO, such companies perform only 0.12 percent better than their sector (Fig. 15); any marginal advantage is insignificant. And focusing on the time one year before an SBO, this quartile reaches a top comparative advantage of 7.5 percent; this is an improvement, but is hardly impressive when compared with the concurrent figures posted by the better performing half of the industry (15.25 percent for the third quartile and 38.67 percent for the fourth quartile). Accordingly, target companies from second quartiles are classified as *coerced* SBOs.

Companies in the third and fourth quartiles have clear marginal advantages over their comparables. Accordingly, such target companies are classified as *pure* SBO. Focusing on the time three years before an SBO, the comparative advantage of these companies range up to almost 43 percent. And at least 50 percent of SBOs on the Italian market for corporate control are *pure* SBOs, and so are not based on speculative or coercive approaches.

3.3.5. Companies' performances after the SBO

In order to determine whether an investor that takes over a target company through an SBO actually adds value to the company, the following two steps were executed. First, the *competitive advantage/disadvantage gained by the target company before the SBO* was calculated. This measure was computed as an average of *yearly competitive performance advantage* of the five years before the SBO. This process aimed to establish the target company's average grade of competitiveness reached before the SBO transaction. It will be used as the baseline for analyzing company performance after the deal.

$$\sum_{-5}^{-1} \frac{yearly\ competitive\ performance\ advantage_{yr\ N}}{5} == competitive\ \frac{advantage}{disadvantage}\ gained\ by\ the\ company\ before\ the\ SBO$$

To test whether the SBO investors actually enhanced profitability and added value to the target company, the *competitive advantage/disadvantage gained by the company before the SBO* was subtracted from the *yearly competitive performance advantage* of each year following the SBO.

$$yearly\ competitive\ performance\ advantage_{yr\ N} - competitive\ \frac{advantag}{disadvantage}\ gained\ by\ the\ company\ before\ the\ SBO$$

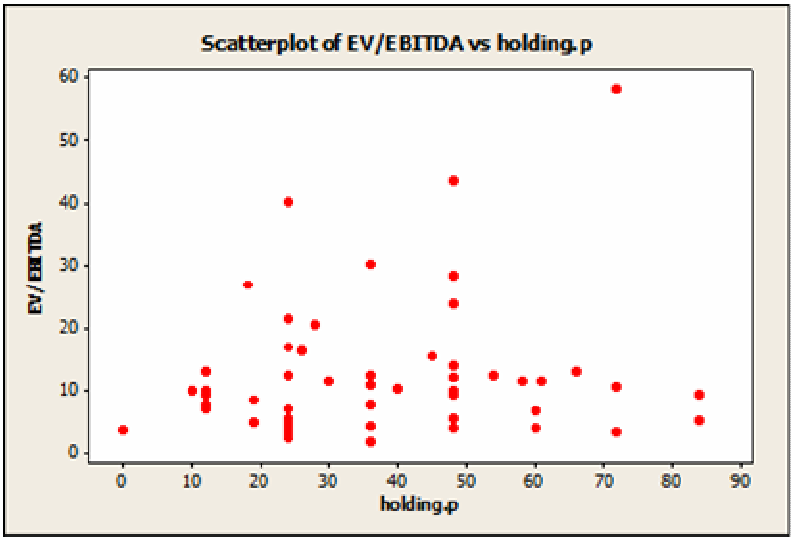
The calculation was conducted for the fiscal year of the SBO and three subsequent years (Fig. 16). (Few companies in our dataset have a history of more than three years post-SBO.)

Years after the SBO	3	2	1	SBO YEAR	competitive advantage/disadvantage gained by the company before the SBO
0	-5,59%	-11,00%	-5,81%	-44,76%	-31,36%
1 st quartile					
1	-0,85%	-5,52%	1,68%	-1,37%	0,76%
2 nd quartile					
2	1,71%	-1,22%	7,03%	1,14%	4,96%
3 rd quartile					
3	3,24%	3,53%	13,41%	3,62%	13,78%
4 th quartile					
4	21,19%	36,84%	37,70%	23,46%	36,30%

Fig. 16 Yearly competitive performance advantage minus competitive advantage gained by target companies before the SBO (minimum and maximum values of quartiles)

3.4. Empirical analysis and results

To compare different deals, the price paid in each transaction was standardized by computing the transaction multiples. We computed EV as the deal amount multiplied by the percentage of shares acquires. We then used company EBITDA and sales to compute the ratios, EV/EBITDA and EV/SALES. We tested hypotheses HP 1 and HP 2 by conducting respective regressions of EV/EBITDA and EV/SALES against the buying group's holding period. Figures 17 and 18 show the dispersion charts and regression results.



Regression Analysis: EV/EBITDA versus holding.p

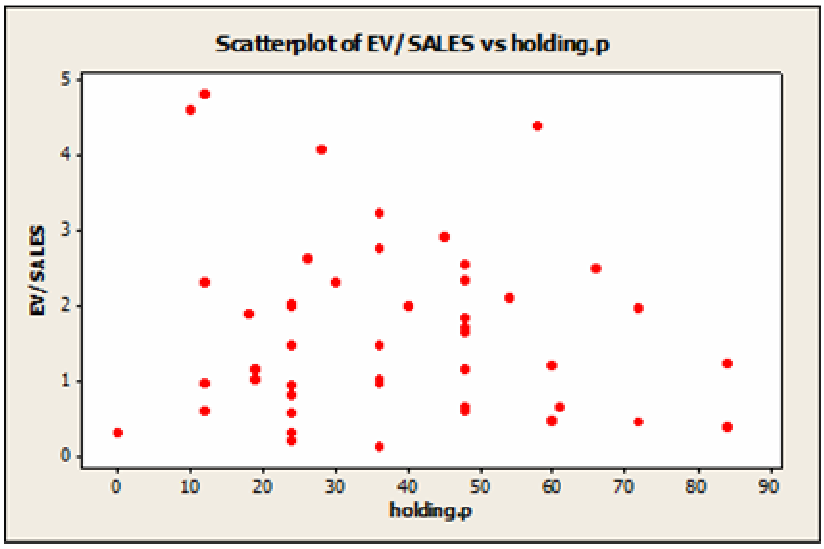
The regression equation is EV/EBITDA = 10.0 + 0.0716 holding.p

Predictor	Coef	SE Coef	T	P
Constant	10.010	3.304	3.03	.004
holding.p	.072	.077	.93	.358

S = 11.0867 R-Sq = 1.7% R-Sq(adj) = .0%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	105.7	105.7	.86	.358
Residual Error	49	6,022.8	122.9		
Total	50	6,128.5			



Regression Analysis: EV/SALES versus holding.p

The regression equation is
EV/SALES = 1.85 – 0.00506 holding.p

Predictor	Coef	SE Coef	T	P
Constant	1.8453	.3589	5.14	.000
holding.p	- 0.0051	.0085	-0.59	.555

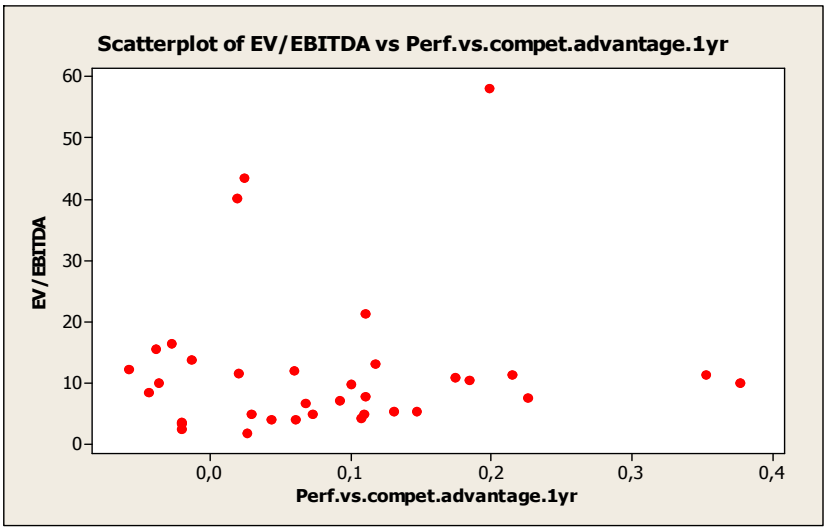
S = 1.17740 R-Sq = 0.8% R-Sq(adj) = 0.0%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	0.490	.490	.35	.555
Residual Error	46	63.769	1.386		
Total	47	64.259			

The Scatterplots and regression results (Fig. 17 and Fig. 18) show that neither hypothesis is confirmed with an R squared coefficient of determination close to zero and a high P-value in both regressions. Possibly, one hypothesis or the other applies, depending on the particulars of a case. Or it could be that price is a result of the complex negotiation process between sellers and buyers, and is influenced only slightly by the amount of time the seller has held the company in portfolio.

We test whether the price an investor pays for a company relates to his pre-deal awareness of his potential to increase the company's value (Hypothesis HP 3). In order to verify this hypothesis, we conducted respective regressions between the entry EV/EBITDA multiples and EV/SALES multiples and the EBITDA margin reached one year after SBO and the average EBITDA margin reached two years after SBO. Figures 19-22 show the dispersion charts and regression results.



Regression Analysis: EV/EBITDA versus Perf.vs.compet.advantage.1yr

The regression equation is EV/EBITDA = 11.2 + 7.5 Perf.vs.compet.advantage.1yr

Predictor	Coef	SE Coef	T	P
Constant	11.227	2.634	4.26	.000
Perf.vs.compet.advantage.1yr	7.530	19.790	.38	.706

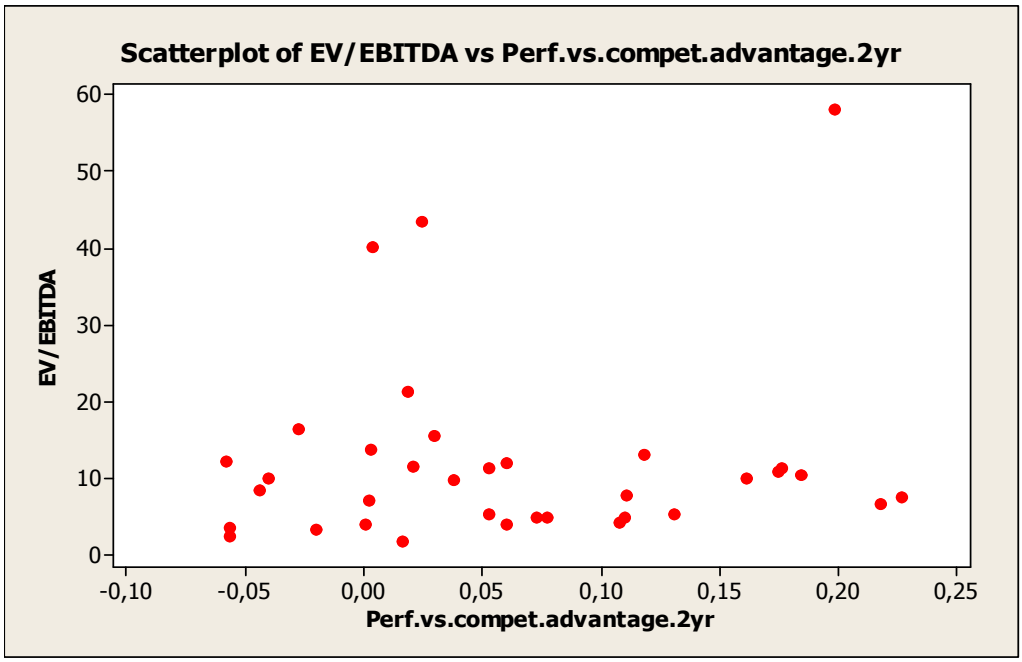
S = 12.1853 R-Sq = 0.4% R-Sq(adj) = 0.0%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	21.5	21.5	.14	.706
Residual Error	33	4,899.9	148.5		
Total	34	4,921.4			

9

Scatterplot and regression of Year 1 competitive performance advantage minus competitive advantage gained by the target company before the SBO versus entry multiple EV/EBITDA



Regression Analysis: EV/EBITDA versus Perf.vs.compet.advantage.2yr

The regression equation is EV/EBITDA = 10.9 + 15.2 Perf.vs.compet.advantage.2yr

Predictor	Coef	SE Coef	T	P
Constant	10.921	2.557	4.27	.000
Perf.vs.compet.advantage.2yr	15.190	24.910	.61	.546

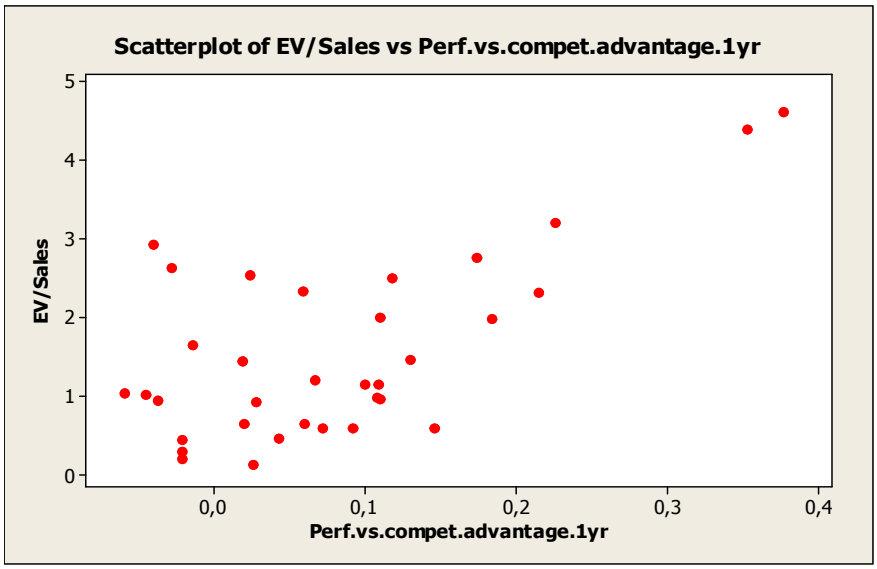
S = 12.1437 R-Sq = 1.1% R-Sq(adj) = 0.0%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	54.9	54.9	.37	.546
Residual Error	33	4,866.5	147.5		
Total	34	4,921.4			

Fig. 20 Scatterplot and regression of Year 2 competitive performance advantage minus competitive advantage gained by the target company before the SBO versus entry multiple EV/EBITDA

The analysis on the EV/EBITDA multiple (Fig. 19 e Fig. 20) doesn't confirm our third hypothesis and cannot be considered as a good proxy of investor's preexisting awareness of the company potential for increased value: the results of the regression have a R-squared close to zero and there is an high P-value.



Regression Analysis: EV/Sales versus Perf.vs.compet.advantage.1yr

The regression equation is
EV/Sales = 0.993 + 7.00 Perf.vs.compet.advantage.1yr

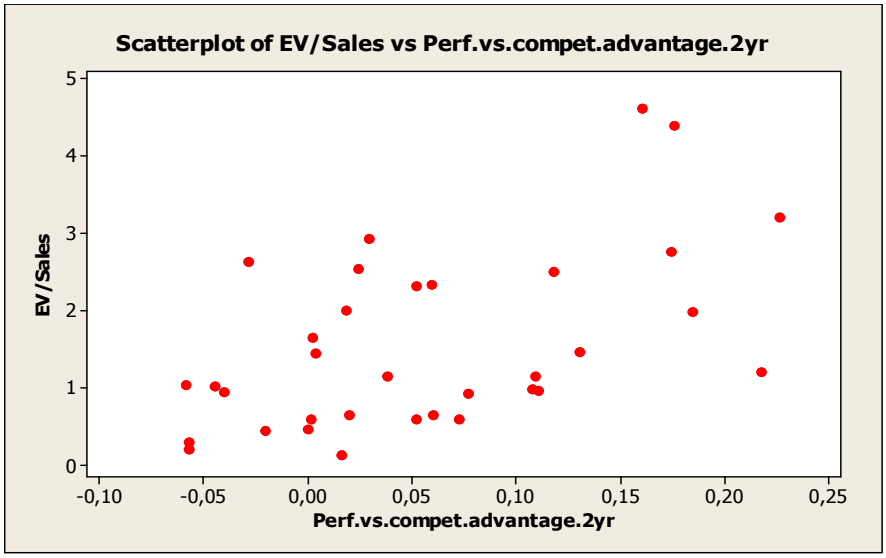
Predictor	Coef	SE Coef	T	P
Constant	.993	.190	5.22	.000
Perf.vs.compet.advantage.1yr	6.997	1.457	4.80	.000

S = 0,88063 R-Sq=41,9% R-Sq(adj)=40,1%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	17.884	17.884	23.06	.000
Residual Error	32	24.817	.776		
Total	33	42.701			

1 Scatterplot and regression of Year 1 competitive performance advantage minus competitive advantage gained by the target company before the SBO versus entry multiple EV/SALES



Regression Analysis: EV/Sales versus Perf.vs.compet.advantage.2yr

The regression equation is EV/Sales = 1.13 + 7.35 Perf.vs.compet.advantage.2yr

Predictor	Coef	SE Coef	T	P
Constant	1.129	.207	5.45	.000
Perf.vs.compet.advantage.2yr	7.349	2.104	3.49	.001

S = 0.982857 R-Sq = 27.6% R-Sq(adj) = 25.3%

Analysis of Variance

Source	DF	SS	MS	F	P
Regression	1	11.789	11.789	12.20	.001
Residual Error	32	30.912	.966		
Total	33	42.701			

Fig. 22 Scatterplot and regression of Year 2 competitive performance advantage minus competitive advantage gained by the target company before the SBO versus entry multiple EV/SALES

The two regressions based on the EV/Sales multiple show that the transaction multiples based on Sales are positively related to the company's performance improvement after the SBO. The R-squared value in the regression of the first-year results is 41.9 percent, and the R-squared value in the regression of the second-year is 27.6 percent. P-value in both regressions is very low making them significant. Accordingly, we can state that EV/Sales is a good proxy for performance improvement implemented by the buying fund.

Thus, there is a positive correlation between the price paid, in terms of the entry multiple EV/SALES, and the performance improvement put in place after the SBO. These results are probably due to the investors' awareness before investing of how much they could improve the target company's performance. Investors are willing to pay more if they perceive that the performance improvement will be greater.

This implies that SBO sponsors have an *ex ante* awareness of the possibility of increasing the target company's value. This is exactly the opposite of what a speculative investment is, since the definition of speculation is the assumption of the risk of loss, in return for the *uncertain* possibility of reward. In this case, the awareness of reward, in terms of performance improvement, is known.

4. Conclusions

Our analysis shows that SBOs are not a cyclical phenomenon. Thus, they are not caused only by excess liquidity in the financial system. Consequently, it should not be assumed that they are conducted because there are few other deals to pursue. Even if the flow of private equity deals is sizeable, and even if target companies originate through means other than a previous LBO, SBOs will remain relevant in the market. A better theory based on our evidence would be that private equity is a business with a limited time horizon and that SBOs compensate for this lack of time.

If SBOs help improve performance, then it is proved that operating under (heavy) leverage may create incentives for top management and workers alike to achieve better results because of greater commitment to their jobs. Strategically, the effect could be to limit or even eliminate investments with negative present values or are part of the company's core business.

The price paid in a SBO transaction, expressed in term of entry multiple EV/SALES or EV/EBITDA, is not based on the holding period of the exiting investor. This implies that there is no acknowledgement of the work done inside the company by the exiting investor.

An SBO implemented on a company with an EBITDA margin lower than its industry sector average does not comply with the usual criteria of target selection posited by many authors who have researched LBOs. Thus, such an SBO can be considered speculative. Based on EBITDA margin differentials of industry comparables, most Italian transactions can be classified as pure SBOs. Accordingly, most SBOs in Italy are not speculative in nature.

The most meaningful result of this work is that it has identified a positive correlation between the price paid for SBOs, in terms of the entry multiple EV/SALES, and the performance improvement put in place after the SBO. This means that an SBO's sponsors have an *ex ante* awareness about the possibility of increasing the target company's value; and the greater the perceived future value increase, the more they are willing to pay. Their awareness of reward, in terms of performance improvement, is known. This is the opposite of a speculative

investment, which is defined as the assumption of the risk of loss in return for the uncertain possibility of reward.

This whole study was conducted without regard to actual D/E ratios of the dataset's transactions. Deals were picked based on information given by financial media we referred to, and capital structures were undisclosed. A possible limit of this study is its lack of an analysis based on capital structure and its influences on the factors tested. Similarly, we did not analyze variables such as debt availability and credit spreads at the time of the transaction, though they may have influenced the decision to undertake an SBO.

This study was conducted on the Italian market for corporate control which, as previously explained, is not as big and developed as in other countries; hence, it could be not fully representative of SBOs transactions. Value creation was measured in terms of EBITDA margins; this is an appropriate measure, but may not give a full picture of a company's profitability or value. This opens the possibility for further research that investigates even "soft" drivers of value creation (e.g., the relationship of the buying fund's management team with the banking system in terms of credit spreads, the company's existing relationship with suppliers, etc.).

SBOs and private equity investments are phenomena less than a decade old in Italy. Consequently, it would have been meaningless to try to analyze the life of a company after an SBO. Such research should wait at least seven years. Points to analyze might include to whom a company is sold after an SBO and whether a capital gain is obtained. Future researchers might consider the present work as a starting point.

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EXECUTIVE COMPENSATION AND INVESTOR CLIENTELE

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Abstract

We provide a setting where due to a lack of sophistication, possibly arising from high opportunity costs of learning about accounting conventions and financial markets, nave (unsophisticated) investors are unable to decipher true executive compensation accurately. Expected compensation is therefore higher when such investors form a more significant clientele in the market for a firm's stock. Our model further suggests that increased information asymmetry between informed and uninformed traders may deter the entry of uninformed investors and keep executive compensation in check. Technologies that lower the cost of trading facilitate entry of relatively unsophisticated investors and raise expected compensation. In general, such compensation can be reduced through requirements that increase disclosure transparency. Empirical tests provide support to the key implication of the model that indirect executive compensation is higher in stocks with higher liquidity, which are likely to have greater unsophisticated investor participation.

Keywords: coprorate governance, executive compensation, investors

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1 Introduction

Issues surrounding executive compensation have taken on increased prominence in recent times. According to Forbes, April 2007, ``CEO Compensation," the total compensation of the chief executives of America's 500 largest companies reached $7.5 billion, with an average of $15 million.[10] In the list of those highly compensated executives, Steven Jobs from Apple ranked #1 by receiving a total compensation of $646.6 million. Angelo Mozilo, Countrywide Financial, got a total compensation of $142 million, ranked #7. At the bottom of the list, Google's CEO Eric Schmidt received $ 0.56 million pay for the previous fiscal year, more than 1000 times less that of #1 on the list.

These numbers and ranks have attracted considerable attention from the academic world and efforts have been spent toward understanding the nature of compensation, particularly since the work of Jensen and Murphy (1990). Specifically, much research (e.g., Aggarwal and Samwick, 1990, Barro and Barro, 1990, and Kaplan, 1994) has focused on pay-for-performance sensitivities across different companies. Aside from compensation levels, an additional issue relates to the lack of transparency about executive compensation packages. A recent article in the New York Times highlighted the case of Analog Devices where deferred CEO compensation was not disclosed for a number of years.[11] Also in the spotlight has been the apparent delinkage of compensation with financial performance.[12] Spurred by these concerns, the SEC has recently mandated clearer disclosure of executive compensation. Yet a third issue has been the levels of executive compensation in relation to average employee compensation. For example, Bebchuk and Fried (2003) indicate that the pay of the top five best-paid

[10] Total compensation here includes salary and bonuses; other compensation, such as vested restricted stock grants, LTIP payouts and perks; and stock gains, the value realized by exercising stock options. http://www.forbes.com/lists/2007/12/lead_07ceos_CEO-Compensation_Rank.html

[11] ``A `Holy Cow' Moment in Payland," by Gretchen Morgenson, *New York Times*, February 19, 2006.

[12] See, for example, ``Cendant Chief's Compensation Soared in 2005," by Ryan Chittum, *Wall Street Journal*, March 2, 2006, or ``At Visteon, Bonuses Defy Gravity," by Floyd Norris, *New York Times* April 14, 2006.

U.S. executives amounts to as much as 10% of their company's profits. Bebchuk and Grinstein (2005) suggest that the dramatic growth of non-equity compensation in the 1990s has not been matched by a corresponding decrease in equity-based compensation.

In this paper, we analyze executive compensation with a perspective that relates corporate pay to another seemingly disparate set of phenomena, namely, the increased participation of investors in the financial markets. Chordia, Huh, and Subrahmanyam (2007) report that turnover increased by 500% over the 1980 to 2002 period, and average bid-ask spreads have declined steeply in recent years (Jones, 2002). At the same time, technologies like the advent of online trading, as well as secular regulatory events such as the lowering of the tick size, have increased access to the financial markets.[13]

Amongst market participants, individual investors represent the much less sophisticated clientele of shareholders. The recent decreases in trading costs documented in Jones (2002), among others, have likely attracted more trading by such small investors who appear content to trade in financial markets even though, on average, they lose money (see, for example, Kumar, 2006).[14] These individual investors are not likely to be sophisticated enough to actively participate in the governance of the companies in which they choose to invest. In addition, many institutions follow short-termist strategies like herding and positive feedback (Grinblatt, Titman, and Wermers, 1995), and mutual funds as a group do not realize significant abnormal returns (e.g., Daniel, Grinblatt, Titman, and Wermers, 1997). Further, as Black (1998) points out, while some pension funds with defined benefit plans have clear incentives to be involved in corporate governance, few other institutions participate in such governance by way of shareholder proposals and annual meetings. In sum, there is reason to believe that many individuals as well as institutions may not be sophisticated enough to understand the nuances of financial statements and influence governance.

Motivated by the above observations, the starting point for our framework is that managerial attempts to negotiate their compensation are linked to the tendency of outside shareholders to monitor wages and total compensation (viz. Burkart, Gromb, and Panunzi, 1997, Hartzell and Starks, 2003, and Efendi, Srivastava, and Swanson, 2007).[15] For example, unsophisticated investors are unlikely to detect practices like spring-loading and backdating options (Lie, 2005) that essentially transfer wealth from shareholders to executives. Concealed arrangements, consisting of deferred compensation, post-retirement income guarantees, and stock option packages, are not only difficult to value but likely difficult to understand.[16]

The challenges faced by unsophisticated investors in properly deciphering compensation packages imply that, in equilibria where such agents are more active, expected executive compensation is greater than otherwise. Since such agents are more likely to find it worthwhile to trade when markets are more liquid or have greater trading activity, and are also likely to add to liquidity by their actions (Black, 1986), the model predicts that *ceteris paribus*, executive compensation will be positively related to trading volume and liquidity.[17] The analysis also suggests that technological innovations that make it cheaper to trade stocks increase the tendency of unsophisticated investors to be more strongly represented in the shareholding clientele, so that managers are more likely to successfully mask their compensation to outsiders and concomitantly increase their true compensation.[18] Increases in executive compensation may then simply be explained by decreases in the sophistication of the clientele who trades a company's stock.[19] We also show that while

[13]Heaton and Lucas (1999) document the sharp increase in the number of shareholders in U.S. stocks during the 1990s.

[14]Small investor losses from trading may result from cognitive limitations or outside activities that create high opportunity costs of learning about financial markets as well as accounting rules and conventions. See, for example, Benartzi and Thaler (2001), Lo, Repin, and Steenbarger (2005), or Hong, Stein, and Yu (2007) for evidence regarding investor naveté about financial markets. More generally, for evidence that agents often have nave notions about complex issues (such as scientific inquiry or the intricacies of scientific subjects such as physics), see Reif (1995).

[15]Our work, unlike that of Bolton, Scheinkman, and Xiong (2006), does not focus on the choice between short-term and long-term investment projects and their relation to investor clientele.

[16]A press release dated July 6, 2006 from Reuters notes that more than 50 companies' option granting practices are being investigated. See also http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html for an updated list of companies currently under examination for options scandals. Other recent articles have focused on how details of compensation packages are difficult to decipher. Core, Guay, and Larker (2007) is one of many related studies that focuses on the role of media in bringing the levels and types of executive compensation to the attention of the public.

[17]In related work, Bhide (1993) and Holden and Subrahmanyam (1996) suggest that short-term agents may be more active in more liquid stocks. In turn, Bhide (1993) informally argues that trading costs may therefore be positively associated with corporate governance .

[18]An alternative interpretation is that technologies that make it cheaper to trade lead to an increase in short-term investors (individuals or others) who are less concerned with carefully monitoring executive compensation than the ``traditional'' institution.

[19]Gabaix and Landier (2006) explain the rise in executive compensation by linking it to a rise in market capitalization. In their model, top executives of larger firms are paid more

an increase in the precision of private information held by sophisticated institutions decreases liquidity, it can keep executive compensation in check by deterring the entry of unsophisticated investors.

We test some empirical implications of our model using executive compensation data. Our model suggests both time-series and cross-sectional implications. The main time-series implication is that compensation should grow as liquidity and trading activity increase. In our view, this time-series implication is inherently difficult to test owing to other factors that may affect both variables over time. Thus, we instead provide evidence that executive compensation is cross-sectionally linked to trading volume and, more specifically, that indirect executive compensation is positively related to total trading volume, and negatively related to bid-ask spreads.[20] These results are consistent with the notion that stocks with greater participation by unsophisticated investors have greater levels of indirect compensation. Our conclusions survive a host of robustness checks, including controlling for firm size, procedures that address endogeneity, and different proxies for liquidity.

This paper is organized as follows. Section 2 presents a simple model of unsophisticated investors and sophisticated investors dealing with management that puts forth opaque financial statements that effectively conceal the actual amount of resources available for compensation. Section 3 endogenizes the entry decision of unsophisticated investors. Section 4 provides results to empirical tests, and Section 5 concludes. Proofs appear in the appendix.

2 The Basic Model

2.1 The Economic Setting

We consider a simple model of a firm with assets that are dedicated to executive compensation and an uncorrelated ongoing project that generates a random cash flow $F \equiv \overline{F} + \delta$, where $\overline{F}$ is non-stochastic and positive, and δ is a normally distributed variable with zero mean. For now, we assume there is no trading in claims on F; we relax this assumption in the next section. The minimum payment required to keep the manager employed in order to generate F is a number L. Thus, L can be construed to represent a reservation level of managerial compensation -- without a minimum compensation of L, the manager quits and the firm ceases to exist. We assume that the manager's basic compensation level is fixed at L but that he has the opportunity to pay himself hidden compensation in addition to L.

There are two types of investor: Type U: unsophisticated investors, and Type S: sophisticated investors. While we make this sharp distinction within the model, our aim is simply to distinguish between active and sophisticated investors who can decipher compensation packages from company disclosures and less sophisticated or passive investors who cannot or are not willing to. The former class of agents includes activist institutions and financially trained and wealthy individuals. The latter class of investors includes relatively less ``specialized'' individual investors or their intermediaries for whom the deciphering of disclosures is challenging. The lack of investor sophistication can arise from limited cognitive ability, or a relative lack of knowledge about accounting procedures and a high opportunity cost of learning about such rules and conventions.[21, 22] We suppose that there is a

simply because they span a larger asset base. This model, however, explains neither why pay appears to be delinked from performance (Bebchuk and Grinstein, 2005, Bebchuk, Fried, and Walker, 2002), nor why there is an impetus to increase disclosure, presumably in response to efforts by management to hide true compensation (viz. Footnote 1). Some papers (e.g., Dow and Raposo, 2005) have attributed the rise in CEO pay to the greater incentives required due to increased uncertainty in recent times, but this argument has been challenged in a calibrated model by Gayle and Miller (2005). In a recent paper, Hermalin (2005) argues that tighter corporate governance increases CEO pay because there is less job security, but again, the issues surrounding concealment of compensation are not addressed by this argument. Furthermore, the evidence suggests that lack of adequate corporate governance, rather than too much of it, is the issue (Bebchuk and Fried, 2004). Another proposed explanation for the generally high levels of executive compensation is the tournament model of Rosen (1986) which suggests that CEO compensation may be seen as a ``prize'' for winning a within-firm tournament wherein participants accept low pay before the tournament begins in order to play in it. O'Reilly, Main, and Crystal (1988), however, do not find support for this theory. In sum, it appears that there is room in the literature for understanding corporate governance from different viewpoints.

[20] Our measure of indirect compensation consists of long-term incentive payouts (payments emanating from incentives set by management), option value grants. and all other compensation, which can include severance payments, debt forgiveness, payment for unused vacation, tax reimbursements, signing bonuses, 401K contributions, life insurance premiums, but excludes salary and bonus.

[21] Our supposition, as that of scholars in psychology such as Wechsler (1958) and Jensen (1998), is that cognitive abilities vary in the cross-section of individuals; such differences can arise, for example, due to unequal access to quality education. We emphasize, however, that in no way should this paper be viewed as subscribing to the notion that there are *inter-group* differences in cognitive abilities.

[22] One might question why unsophisticated individuals do not simply hold mutual funds. Based on prior literature (Kumar, 2006, among others), we assume that individual investors derive some utility from trading, and will therefore trade as long as the sum of their expected profits from trading and the monetary-equivalent utility from trading exceeds entry costs.

representative Type U investor who, if present, holds a fraction β of the firm's shares; the remainder are held by the Type S --- active institutional investor.[23]

We model in a stylized fashion the outcomes on executive compensation that can obtain when different types of clientele hold shares in the company's stock. For brevity, however, we do not model in detail the specific process of governance, e.g., election of the board of directors by plurality or some other method.[24]

We denote the value of the assets used to pay compensation as W. We assume that there are two possible beliefs for W: H or L, with $H > L$. While the Type S investor knows that the true value of W is H, an outside Type U investor initially believes that $W = L$.[25] We allow for the possibility that the Type U investor undertakes a costly investigation, following which he deciphers the true realization of W with a positive probability. For now, we take the Type U's decision to investigate and his beliefs about W to be exogenous. We endogenize these in Subsection 2.3.

Before proceeding further, we note here that our aim is to model a situation where managers can pay themselves extra compensation above their reservation wage if unsophisticated investors mistakenly believe that resources available for compensation are lower than the true level of such funds. This is captured by postulating the scenario that the Type S knows that $W = H$ while allowing for the possibility that Type U investor beliefs are anchored at $W = L$. The appendix shows that in the case not considered in our model, namely where the Type S correctly believes that $W = L$, no additional compensation beyond L is possible regardless of Type U investor beliefs.[26]

Governance is controlled by the investing clientele through a board of directors (BOD). In our framework, the role of the BOD is to simply offer responses to managerial payout proposals on behalf of the investors. The proposal that comes into force is that made by the majority of the BOD. Each category of investor has a proportional share in the composition of the board and that share recommends responses by the category of investor it represents.

First, suppose that the Type S investor is the only shareholder. In this case, we assume a fraction γ ($\gamma < 0.5$) of the BOD passively accepts the strategy proposed by the manager. The remaining fraction acts on behalf of the institution by following the accept/reject strategies the institution proposes. When the Type U investor is present, we seek to capture the phenomena resulting from the possibility of Type U having a majority say in the governance of the firm, rather than Type S investor. The Type U investor holds a fraction β of the shares and a proportion β of the BOD follows the accept/reject strategies proposed by the Type U investor. A fraction γ of the Type S share of the board remains passive in this case. We also assume that the fraction of the Type S share of the BOD that is active, $(1-\gamma)(1-\beta)$, is less than 0.5; i.e., the sophisticated investor is not able to control managerial strategies in the presence of the unsophisticated investor. This assumption is intended to ensure that when the Type U investor is present, the compensation outcome is the result of whether he finds it worthwhile to undertake costly investigation to ascertain the true value of W.[27]

2.2 Strategies

Managerial proposals involve the size of profit paid to the investors (after the executive compensation, the rest of the payoff on the project F is automatically passed on to investors and is not discretionary). The two allowable levels of this payout are zero and $H - L$. If the equilibrium payout is non-zero, it is apportioned between Type U and Type S investors in proportion to their holdings. The manager's strategy space is to propose one of the two levels of total payout. The investors' strategy space is to either accept the proposal or reject it and propose the other level of the payout. For technical reasons, in order to break ties in strategy preferences, we assume that opposing a managerial proposal causes an investor to incur an arbitrarily small cost of $\varepsilon > 0$. We look for an equilibrium in pure strategies.

If the manager proposes a zero payout to the investors and it passes unopposed, then the manager pays himself a hidden compensation of $H - L$. It is evident that a proposal of a payout of $H - L$ can only reduce the manager's compensation, therefore it

[23]The representative Type U investor can be viewed as a coalition of outside investors. In Section 3.3, we consider the case of multiple outside investors.

[24]See ``Deal Spurs Embarrassment of Riches: Capital One's Acquisition Of North Fork Throws Focus On the Actions of Directors,'' *Wall Street Journal*, March 18, 2006, for details on the different voting procedures followed by corporations.

[25]Postulating a different initial prior for Type U investors complicates the analysis, but does not materially alter the intuition we seek to exposit.

[26]Also, in the spirit of the models of Barberis, Shleifer, and Vishny (1998), Daniel, Hirshleifer, and Subrahmanyam (1998), and Hong and Stein (1998), in our model, unsophisticated investors do not have perfect foresight expectations.

[27]We note that we do not claim that retail investors affect board composition; rather, our model is based on the possibility that greater retail investor participation simply changes the character of the (given) board. That is, an existing board member may become more passive as retail investor participation increases.

is at least a weakly optimal strategy to propose a zero payout. We therefore postulate that the manager always proposes a zero payout.

Consider first the equilibrium where the sophisticated investor is the only shareholder. Recall that the Type S investor knows the value of W to be H. Thus, if the Type S is the only shareholder, its optimal strategy is to reject the zero-payout proposal through the BOD and pay itself an immediate cash amount of $H-L$. Thus, in equilibrium, the managerial proposal is rejected and the compensation is L.

When the unsophisticated investor is present, the governance question is whether the surplus $H-L$ is paid to the investors or covertly extorted by the manager as extra compensation. Recall that the unsophisticated investor is pivotal if he is present, so the Type S's response to managerial proposals can be ignored in the presence of the Type U investor. In cases where the Type U either does not investigate or investigates and finds the true value to be L, a majority of the BOD accepts the manager's zero payout proposal on the basis that there are no funds available to pay an immediate cash amount through dividends or other forms (because opposition is costly, the manager's proposal passes unopposed in equilibrium).[28] In this case, in equilibrium, the manager pays himself an extra compensation of $H-L$ over L, i.e., a total compensation of H.

In the case where the Type U investor investigates and assesses the value of W to be H, because their optimal strategy is to reject the manager's proposal of a zero payout to shareholders, the investors capture the surplus through the BOD by way of an extra cash payment of $H-L$.

For convenience, Table 1 summarizes the board's response to the managerial proposal of a zero payout to shareholders, as well as the ensuing compensation within the model. In the table, as well as in the remainder of the paper, we consider the limiting case of $\varepsilon \to 0$ for convenience. The Type U investor's entry decision is endogenized in the next section.

2.3 The Type U Investor's Decision to Investigate

We now consider the equilibrium investigation decision of the unsophisticated Type U investor. At a cost of C_I, the Type U investor may investigate to ascertain the true value of W. If he does investigate, he concludes $W=L$ with probability p and $W=H$ with probability $1-p$. We assume that the probability p of the Type U investor concluding $W=L$ is a control variable for the manager.[29] We endogenize p by explicitly modeling a cost of obfuscating financial statements. We suppose that an external regulatory agency can investigate managerial disclosure after time 0 but prior to the release of the firm's true value at time 1. While the costs and benefits of the agency are not incorporated into the analysis, we suppose that if the manager is found to have masked the actual level of resources available for compensation (i.e., set a positive p), the penalty incurred is a positive quantity C_r. The penalty captures the reputational and potentially monetary costs incurred by the manager after being discovered.[30] The probability the agency discovers misrepresentation by the manager is $0.5kp^2$, where k is a variable such that $0<k<1$. The notion captured by this parameterization is that an overly disingenuous assessment is more likely to be uncovered than one that is somewhat less extreme.[31] Thus, the expected cost of setting p is $0.5cp^2$, where $c \equiv kC_r$. We note that the quantity cp^2 may also be construed as representing a psychic cost (that captures the inherent disinclination to be dishonest), as in Becker (1976); by way of this parameterization, the greater is p, the degree of obfuscation, the greater is the psychic cost. The costs of setting too

[28] We assume that the investigation is done by the Type U investor, and his response to the manager's proposed compensation and payout is transmitted to the manager by way of the portion of the BOD attributed to him. An alternative interpretation is that the investigation is done by the Type U investor's apportioned BOD, and the Type U does not have the power to get rid of BODs who are not competent enough to decipher the true W. The analysis remains essentially unchanged under this alternative interpretation.

[29] In our setting, the manager has an incentive to understate W. Generally, managers are presumed to have an incentive to overstate total earnings in order to boost stock prices and thereby increase their compensation. While our mechanism does not allow for this type of misrepresentation, our analysis exemplifies the notion that misrepresentation can take various forms; for example, merely by showing low cash flow numbers but retaining the flexibility to issue options and deferred compensation packages, the manager can misrepresent the likely size of the eventual compensation package to the BOD. It would require the forecasting of future cash flow numbers to assess the extent to which such compensation would be possible, and managers would be able to manipulate beliefs about forecasts through disclosures such as annual reports.

[30] The modeling of this behavior is closely related to the approach of Subrahmanyam (2005).

[31] The notion that the actual level of resources is not verifiable with complete certainty is in the spirit of costly state verification models of Townsend (1979), Gale and Hellwig (1984), Larker and Weinberg (1989), Winton (1995), and Crocker and Morgan (1998).

high a p then have two interpretations: the first is that the manager's behavior is more likely to be discovered, and the second is that the psychic cost is greater.

Assuming the Type U investor is present and that he investigates, the manager maximizes his net expected extra payoff,

$$p(H-L)-0.5cp^2,$$

which yields

$$p=\frac{H-L}{c}. \quad (1)$$

Since $H>L$ and $c>0$, p is strictly positive. For $p<1$, we need $H-L<c$, and we will assume that this condition holds. Furthermore, we will often treat p as a given parameter in the model, while implicitly recognizing its dependence on other parameters through (1). The expected compensation, assuming investigation, is L plus the expected extra compensation arising from concealing the true firm value. Denoting the mean compensation by $E(W)$, we then have

$$E(W)=\frac{(H-L)^2}{2krC_r}+L. \quad (2)$$

Now consider the Type U investor's problem. Note that this agent will investigate if

$$\beta(1-p)(H-L)>C_I,$$

where C_I represents the cost of investigation to the Type U investor. Thus, in equilibrium, there will be investigation so long as

$$\beta\left[1-c^{-1}(H-L)\right](H-L)>C_I, \quad (3)$$

which leads us to the following proposition.

Proposition 1

1. Ex ante expected executive compensation is lower when the Type U investor is not present as a stockholder.
2. If the Type U investor is present as a stockholder, expected executive compensation is higher when the Type U investor does not investigate than when he does.

The above proposition proves our basic result that if relatively nave Type U investors are present in the market, managers are able to randomize on the variable that represents their true compensation and hence raise the *ex ante* expected compensation.[32] In the next section, we model the Type U investor's entry into the financial market.

3 The Securities Market

To model the link between financial markets and compensation, we now extend the model to account for trading on the firm's securities. The claims traded are on the project that pays $F=\overline{F}+\delta$, and not on the assets used for compensation (i.e., L). This separation helps maintain tractability but is of no other material consequence for the purposes of our intuition.[33]

3.1 Endogenous Entry with a Single Type U Investor

We will assume a standard adverse selection model of market microstructure for trading claims on the project with a payoff of F. Private information is possessed by the single Type S investor who observes δ perfectly.[34] If the Type U investor is present, the noise demand is contributed by this agent and totals z where $z:N(0,v_z)$. As usual, the price P set by a risk-neutral market marker is a linear function of the total order flow Q, and takes the form $P=\overline{F}+\zeta Q$.[35] If the Type U investor does not participate in the market, then, in effect, there is no market because there is no liquidity or noise trading. Assuming the Type U investor participates (in the spirit of Admati and Pfleiderer, 1988, Kyle 1985, or Subrahmanyam, 1991), the illiquidity parameter ζ in this market is given by

$$\zeta=\frac{1}{2}\sqrt{v_\delta v_z^{-1}}. \quad (4)$$

Note that the Type U investor earns negative expected profits in our setting since he has no private information. This is consistent with the work of Kumar (2006) and Odean (1998, 1999) who indicate that unsophisticated investors seem to actively trade stocks even if they earn inferior returns. We thus assume that the Type U investor directly derives utility from trading (as a consumption good) and that

[32]It may be worth considering if excessive compensation resulting from insufficient ability to decipher compensation packages can be addressed by takeovers by other companies or the removal of the CEO by large institutions. Such actions, however, are likely to be prohibitively costly. For example, the costs involved in mounting a takeover bid likely exceed the excess compensation of a few top executives. Further, removal of an entrenched CEO with a sympathetic board is potentially a difficult undertaking. See, for example, Fisman, Khurana, and Rhodes-Kropf (2005), among others.

[33]Similar assumptions are found in Ozdenoren and Yuan (2007), and Subrahmanyam and Titman (2001).

[34]This information may be interpreted either as obtained from security analysis, or through ``tips" from corporate insiders by way of social networks between institutions and wealthy corporate executives.

[35]For convenience, we assume that unlimited short-sales are allowed.

the monetary equivalent of this is K.[36] In addition, we suppose a fixed cost C_E has to be paid by the Type U investor to enter the stock market. This can be interpreted as the setup costs associated with opening a brokerage account and cognitive costs involved in familiarizing oneself with the equity markets and the trading process.

It is well-known that in our setting (see, e.g., Admati and Pfleiderer, 1988), the expected losses of the uninformed investor to the informed agents are ζv_z.[37] Also note that once the agent enters the market he has the option (but not the obligation) to investigate. These observations imply that the agent will enter into the market for the firm's stock if

$$K - C_E + \max[\beta(1-p)(H-L) - C_I, 0] > \zeta v_z, \quad (5)$$

where p is given by (1). When the agent does enter, there is more uninformed (``noise'') trading, which leads increased trading volume and liquidity. The conditions that encourage entry are a low C_E, a high K, and a smaller standard deviation of information.

This leads us to the following proposition.

Proposition 2

1. The Type U investor enters the market whenever the cost of entry and the variance of the cash flows (v_δ) is sufficiently low, and the monetary equivalent of utility from trading is sufficiently high.
2. Expected executive compensation, trading volume, and liquidity are higher when the Type U investor enters the stock market than when he does not.
3. Given that the Type U investor enters the stock market, expected executive compensation is greater when the agent does not investigate than when he does.

Within our setting, if the Type U investor enters, he *de facto* obtains control of the firm's governance. This presents the problem that due to naveté, the agent may not be able to decipher compensation packages accurately, which, in turn, precludes the agent from forcing the compensation down to L and therefore leads to increased executive compensation on average. Note that policies that reduce the cost of financial market access, i.e., the parameter C_E, increase the parameter set under which the Type U investor enters. Therefore expected executive compensation is greater when the cost of entry is lower. This argument suggests that easing access to financial markets by way of technologies such as online trading do create liquidity but have the possibly unintended consequence of introducing unsophisticated investors whose cognitive limitations or lack of sophistication allow managers to blur financial statements and thereby increase expected compensation.[38]

3.2 The Effect of Signal Precision

3.2.1 The Quality of Private Information and Type U Investors

We now consider an interesting extension of our basic setting when the Type S investor observes δ with some noise. We suppose that the information signal is $\delta + \varepsilon$ where $\varepsilon : N(0, v_\varepsilon)$ and is independent of all other random variables. The illiquidity parameter ζ is given by (see the appendix)

$$\zeta = \frac{v_\delta}{2}\sqrt{\frac{1}{(v_\delta + v_\varepsilon)v_z}}. \quad (6)$$

The above expression is decreasing in v_ε. The equivalent of (5) now becomes

$$K - C_E + \max[\beta(1-p)(H-L) - C_I, 0] > \frac{v_\delta}{2}\sqrt{\frac{v_z}{v_\delta + v_\varepsilon}}. \quad (7)$$

This leads us to the following proposition.

Proposition 3 *An increase in the precision of private information reduces the parameter set under which the Type U investor participates in the financial market and therefore tends to reduce expected executive compensation.*

Basically, since the right-hand side becomes smaller as v_ε (which is inversely related to signal precision) becomes larger, increasing the precision of information makes it less likely that the Type U investor will enter. Thus, an increase in the precision of the private signal, that traditionally is supposed to hurt financial markets by increasing adverse selection, actually increases the likelihood that more sophisticated agents will be holding a firm's stock. This enables more effective control of executive compensation. Therefore, a benefit of more accurate private information (either as inside information or by way of advance access to an analyst's signal -- viz., Green, 2006) is that it allows for more successful managerial monitoring by deterring the entry of

[36] An alternative way to interpret K is as an unmodeled benefit of trading. A similar construct is used in Glosten and Milgrom (1985).

[37] To understand this, note that the losses are given by the negative of $E[(F-P)z]$. Substituting $P = \overline{F} + \zeta Q$ yields the relevant expression.

[38] The role for financial markets in conveying information about investment choices is not present in our model. In other models, such as the one of Holmström and Tirole (1993), information from stock prices may be used to monitor self-interested managers, forcing them to make the appropriate investment choices.

unsophisticated traders.

3.2.2 The Effect of Policies that Reduce Signal Precision

Suppose regulatory authorities can preclude the trading on certain types of precise signals (e.g., by way of prohibiting trading on material information). Would it necessarily be optimal to enforce such regulations? Of course, a full analysis of this question requires consideration of fairness in the form of equal access to information. Abstracting from considerations of this type, consider the following tradeoffs in the context of our model. Increasing signal precision tends to deter the entry of unsophisticated investors. This allows for improved governance and thereby facilitates extra payments to shareholders while precluding extra executive compensation. Yet, it also reduces the liquidity of the financial market. Thus, the net effect is ambiguous.

To formalize the above notion consider that the regulatory authority seeks to maximize $w(\zeta^{-1}) + (1-w)E(D)$, where ζ is the illiquidity parameter, $E(D)$ is the expected extra cash paid to all investors out of W, and w is the weight that trades off the benefit between liquidity and the expected extra payment to the shareholders. In the base model, ζ^{-1} is zero when the Type U investor is not present ($\zeta \to \infty$ when the Type U investor is not present). Consider two levels of signal noise variances, v_ε^G and v_ε^S, where $v_\varepsilon^G > v_\varepsilon^S$. Suppose policymakers can choose one of the two signal precisions by way of appropriate regulations on the types of information that can be traded upon.[39] Further, suppose that

$$\frac{v_\delta}{2}\sqrt{\frac{v_z}{v_\delta + v_\varepsilon^G}} < K - C_E + \max[\beta(1-p)(H-L) - C_I, 0] < \frac{v_\delta}{2}\sqrt{\frac{v_z}{v_\delta + v_\varepsilon^S}}. \quad (8)$$

This implies that the unsophisticated Type U investor enters the financial market only when the signal noise variance is v_ε^G. In this scenario, one can state the following proposition.

Proposition 4 *If v_ε^G is high enough and v_ε^S is low enough such that (8) holds, and if*

$$p(1-w)(H-L) > 2wv_\delta^{-1}\sqrt{(v_\delta + v_\varepsilon^S)v_z}, \quad (9)$$

then the optimal choice of the regulatory authority is the lower signal noise or higher signal precision represented by v_ε^S.

Thus, in cases where the weight placed on minimizing executive excess is large enough and the weight on liquidity is low enough, the optimal response of the regulatory authority indeed may be to allow trading on a signal with higher precision.

3.3 Many Type U investors

We now extend our analysis to include many Type U investors. For convenience, we use the model where the information about δ is perfect. The assumptions about the BOD share controlled by Type U investors as a group and the fraction of the BOD that is passive remain unchanged from the previous section. Suppose that there are I Type U investors present in the stock market. Assume the noise demand is contributed to equally by each of the agents and thus totals Iz, where $z : N(0, v_z)$. This implies that the illiquidity parameter ζ is given by

$$\zeta = \frac{1}{2I}\sqrt{\frac{v_\delta}{v_z}}.$$

We assume that the total number of Type U investors is bounded above by M.

Each investor can investigate; the probability of any one investor concluding that $W = L$ is p. Note that if J Type U investors investigate, the probability of any one investor uncovering the actual funds available is $1 - p^J$, i.e., one minus the probability of anyone discovering the same. For simplicity, we assume that if any one investor infers the true value of W (i.e., H), then this investor communicates with other investors and forms a coalition, which subsequently forces the payment of an extra dividend $H - L$.[40] Further, this facility is independent of the number of type 1 investors who trade in the financial market. If the compensation is indeed L, the payout received by each Type U investor is $\beta I^{-1}(H-L)$. We also assume that if the I'th investor enters, all other agents who are not Type U investors change their strategies in a consistent fashion in response to this move, and the investor takes this into account when choosing to enter (as in Admati and Pfleiderer, 1988).

Under the preceding conditions, assuming $I-1$ investors are already present, and $J-1$ of those investigate, it follows from (3) that an I'th investor will enter if

[39] The assumption here is that it is prohibitively costly to trade on both types of information, so only one signal is available and it can have one of two levels of signal precision.

[40] More complicated communication rules are possible; for example, one could require a critical mass of investors to conclude that $W = L$ before the compensation is forced to L. Modeling such rules, however, would detract from the central points we wish to make.

$$K - C_E + \max[\beta I^{-1}(1-p^J)(H-L) - C_I, 0] > (2I)^{-1}\sqrt{v_\delta v_z}, \quad (10)$$

where the value of p (from a simple modification of (1)) is the J'th root of $(H-L)/c$. It can be seen from the above condition that if $K - C_E > 0$, then, so long as M is sufficiently large, there will always exist an equilibrium where all M Type U investors enter the market. If C_I and v_δ are large, however, there also may exist an equilibrium where none of the agents enter because illiquidity and investigation costs with just one investor may be too high to make it worthwhile for the first agent to enter.

An issue in the equilibrium where all M agents enter is that of how many choose to investigate. Note, however, that if the cost of investigation is lower than $\beta M^{-1}(1-p^M)(H-L)$ (as will be the case, for example, when C_I is zero), they all will investigate. Rather than analyze several equilibria of this setting, for brevity we report the following proposition of interest:

Proposition 5

1. Assuming that $K > C_E$, the equilibrium under which all Type U investors enter exists as long as the maximum number of such investors is sufficiently large.
2. Expected executive compensation is higher in the equilibrium where all Type U investors enter the stock market than in that where no Type U investor enters.
3. Given that all Type U investors enter the stock market, expected executive compensation is smaller if they all investigate than when nobody does.

In general, when the population of Type U investors is large, it will be more likely that they all enter for two reasons. First, their presence makes the market more liquid, which benefits them all. Second, the investors are more likely to discover the true compensation if there are more of them. The countervailing force is that when there are more Type U investors, they receive less of the share of the surplus $H-L$ generated when managerial manipulation is discovered. The basic result, that Type U investors increase expected compensation, survives in this scenario as well.

3.4 Implications

To develop cross-sectional implications using the above analysis, we rely on the model as well as out-of-model arguments. We conjecture that managers of complex firms are more likely to conceal compensation than those of focused firms because Type U investors are less able to decipher the complicated accounting statements of such firms with multiple lines of business. This implies that cases of obfuscated disclosures and covert compensation are more likely to arise in large firms than in small, concentrated firms. In formal terms, the parameter c (related to the probability of detection) is likely to be small for diversified firms. Thus, true compensation is likely to be more difficult to decipher for larger, more diverse, corporations. Closer investigation following increased transparency should reveal greater levels of hidden compensation for such companies (e.g., in the form of hard-to-detect deferments and retirement packages).

Proposition 2 indicates that trading activity and liquidity are positively related to executive compensation, because active, liquid markets tend to be highly populated by uninformed, unsophisticated investors. An additional implication relates to how we expect the utility from trading K to vary across Type U investors. Lottery-type stocks with high skewness and volatility (as defined by Kumar, 2006) may provide greater monetary-equivalent utility from trade (i.e., K may be greater in such stocks), leading to a more unsophisticated clientele and hence more blurred levels of compensation and excessive compensation packages.

4 Empirical Tests

4.1 Basic Regressions

One of our main arguments is that there should be more cases of obfuscated compensation in firms that are more actively traded (more liquid) and more complex. Since not all cases of obscured compensation are detected, the theory is inherently difficult to test. However, our theoretical results suggest that the characteristics of the firm may play a role in executive compensation. Specifically, our analysis predicts that executive compensation is positively related to trading activity and proxies for firm liquidity.[41]

Our goal in this section is not to perform a full-fledged empirical analysis, but to provide some rudimentary evidence that sheds light on our theoretical model. We focus on fiscal year 2005, the most recent year for which we could obtain compensation data (results from additional years of data are discussed in the next subsection). We also restrict ourselves to NYSE/AMEX stocks for two reasons. First, as will be seen, our variables require voluminous transactions data, and this restriction keeps our exercise manageable. Second, we wish to

[41] Indirect compensation can be viewed as ancillary parts of remuneration such as long-term incentive payouts, severance payments, payment for unused vacation, tax reimbursements, 401K contributions, life insurance premiums, and so on. We define this term precisely later in this section.

exclude very small Nasdaq stocks with possibly error-prone compensation and trade data. Because our phenomena are likely to be less strong in stocks listed on NYSE/AMEX, owing to the fact that listing on these exchanges is subject to more stringent disclosure requirements, this restriction works against the likelihood of finding support for our hypotheses.

Compensation and shareholding data are from the executive compensation (Execucomp) database on Wharton Research Data Services (WRDS). These data are collected from each company's annual proxy, which must be filed 120 days after each company's fiscal year end. Execucomp collects data for up to 9 executives per firm for a given year, though over 80% of companies in our sample report data for only 5. As the dependent variable in our first set of regressions, we use the logarithm of each firm's average total current compensation across executives. Total compensation (reported in millions of dollars) is comprised of salary, bonus, long term incentive payouts, option grants and all other compensation. Our regressors are at the firm level so we choose to have firm-level averages rather than executive-level data. Because average compensation is likely to be lower in firms with more executives (i.e., additional executives are probably paid less than the top five), we use two versions of the dependent variable; the first averages data for the top five executives (ranked by total current compensation), while the second averages data across all executives whose compensation levels are reported by Execucomp.

Our arguments also suggest more specific predictions about *indirect* compensation: namely, that such compensation, which is more difficult to understand than total compensation, will be greater not only in stocks that have greater active participation from Type U investors but also in those that attract greater interest from Type U investors. Thus, we employ the ratio of indirect compensation relative to total compensation as an additional dependent variable. Our measure of indirect compensation consists of long-term incentive payouts (payments emanating from incentives set by management), option value grants, and all other compensation, which can include severance payments, debt forgiveness, payment for unused vacation, tax reimbursements, signing bonuses, 401K contributions, life insurance premiums, but excludes salary and bonus.

The controls are as follows. We include log total annual dollar volume (in billions of dollars) as a measure of liquidity. As proxies for a variable that is likely to attract Type U investor interest, we use the standard deviation and skewness of daily returns over the year (Kumar, 2006). We capture firm complexity by the number of business segments (obtained from Compustat) and firm size, measured by book value of total assets (obtained from COMPUSTAT, in billions of dollars) as of the end of the year.[42] We also include the compounded stock return over the past thirty-six months as a link to an incentive mechanism whereby managers receive greater compensation when their stock performs well. To mitigate the problem of endogeneity, all control variables are measured as of the year 2004, while our dependent variables are measured as of 2005.

The total sample consists of 803 firms. Table 2 presents summary statistics associated with our variables. We retain in our sample those firms that report data for at least five executives. The compensation variables and firm size show considerable skewness (the mean is in each case is quite different from the median), justifying the use of logarithmic transformations for these variables.

To distinguish the effect of trading activity from firm size, we form portfolios sequentially sorted into quintiles based on book assets and trading volume. Based on the previous year's firm size, measured by the total assets of the firm at the end of 2004, the sample is sorted into 5 quintiles. Within each size quintile, we further partition the sample by the annual total trading volume in 2004. We then document the average compensation for each of the 25 portfolios.

The sort results shown in Table 3 clarify the relation between the executive compensation and the trading volume and company size. The average and median of the total compensation, reported in Panel A and B, increase with the size of the company quite consistently across different trading volume quintiles. The evidence is also persistent in indirect compensation in Panel C and D, measured as a percentage of total compensation. Trading volume is able to explain the higher executive compensation well across all the size quintiles, except that the mid-sized firms the executive compensation tends to reach its peak for the second largest volume quintile. T-test and Median-Test are performed to compare the location of quintile 1 and quintile 5's mean and median, and the results are statistically significant. From the perspective of economic significance, note that within the smallest firm quintile, indirect compensation in the most actively traded firms is about five times greater relative to that in the least actively-traded ones. Overall, the results indicate that both total and indirect compensation bear a positive relation to trading activity independent of firm size.

In Table 4 Panel A we report the results from the cross-sectional regression of total executive compensation on volume and our control variables. In the middle panel, we average total compensation over the top five executives (ranked by total compensation), and in the rightmost panel, we average over all executives. Within both regressions, we find that trading volume is strongly and positively

[42]Using market capitalization as a measure of firm size does not substantively alter the results.

related to compensation along with size measured by the log scale of company assets, and the adjusted R^2, just under 56%, appears healthy. The number of business segments, which is another proxy for the complexity of the firm's operations, turns out to be insignificantly negative. Additionally, executive compensation is significantly positively related to the 3-year compounded returns, which is consistent with existing literature. Overall, our results lend support to the notion that executive compensation is higher for more actively-traded and more complex (i.e., larger) firms.

In Panels B and C, we use the turnover rate instead of total trading volume as the regressor which represents trading activity. The first turnover measure is defined by the ratio of dollar volume to the market capitalization at the end of 2004. The second turnover rate is computed by the ratio of share volume to the total shares outstanding as of 2004. Similar to the trading volume, the higher the turnover rate, the more the total compensation. However, here the number of business segments and the return volatility have significantly negative explanatory power for executive compensation. This result is surprising and deserves analysis in future research.

Results from using the indirect compensation measure as our dependent variable are presented in Table 5. In order to examine whether institutions are relevant in controlling hidden compensation, we also add institutional holdings as an additional regressor. This variable is measured as the logistic transform of the proportion of shares held by institutions as of the end of 2004. In the regression, the signs of the coefficients for return and return skewness remain positive, though not significant.[43] This is consistent with the notion that the base salary and bonus of the management are more strongly related to stock performance than indirect compensation. We also find that total volume is positive and significant at the 1% level.

We note that total volume may not necessarily be related to liquidity, and, in turn, the activity of small investors, as it might simply represent buying or selling pressures of large investors. For this reason, in unreported regressions, we use the bid-ask spread as a liquidity measure to test whether more liquid companies pay their executives higher indirect compensation. The spread is measured as the average quoted spread of each company across all intraday observations throughout 2004. The results confirm our thesis that stocks with low spreads, corresponding to higher liquidity, have greater executive compensation. The coefficient of the return volatility variable remains marginally significant, with a negative sign, while the institutional holdings is insignificantly positive.

[43]Including institutional holdings in the regression for total compensation does not alter our central results materially.

4.2 Some Robustness Checks

Though we find that total trading volume is positively related to indirect compensation, it is possible that an increase in volume in general does not cause greater executive compensation. For example, firms in which managers are able to extract more compensation may have poorer corporate governance or more entrenched managers which may result in shareholders wanting to unload their positions. Or, per Merton (1987), individuals may select stocks of companies with high name recognition (see also Frieder and Subrahmanyam, 2005). The CEOs of such companies may have greater salaries (and, even be well-known because of their salaries). Given such alternative interpretations of our results, we attempt to address the issue of causality. Note that by lagging the right-hand variables, we already have allayed this endogeneity concern to some extent. Nonetheless, we also perform the following two-stage least-squares estimation. In the first equation, we model indirect compensation as a function of the variables in Table 5. In the second equation, we model volume as a function of all the right-hand variables in the first equation except total volume, and add indirect compensation as an explanatory variable. Results from estimation of the system appear in Table 6. As can be seen, we obtain respective coefficients of 0.08 (t=6.23) on trading volume, Return and Return skewness remain positively insignificant. Firm size has a marginally negative sign, both economically and statistically, -0.023 with a t-stat -1.90. There is no substantive change in the other coefficients. Thus, our results survive the system estimation that accounts for endogeneity.

The next concern is that we have used only the most recent year of data (2005) in our analysis. Extending our results to a long time-series presents problems because executive compensation data are available only since the mid-90s. Running panel regressions also raises the issues that the time-series response of compensation to clientele changes may be sluggish, and a handful of years may not be able to capture this effect. These caveats notwithstanding, we consider results from using a longer sample from 1997 to 2004. We chose this period for two reasons: First, tick size reductions beginning in 1997 may have attracted retail investors, and second, intuition suggests that technological innovations such as online trading became prevalent during the late 1990s.

We use our extended sample to conduct three exercises. Initially, we consider the cross-sectional correlation between the total average compensation of the top five executives and total trading volume over the period 1997 to 2005 (lagging the volume variables by one year). We find statistically significant correlations of 0.29, supporting our premise that changes in compensation are related to trading activity. Next, we conduct annual regressions

analogous to the last regression in Table 5 for the period 1997 to 2005, and the year by year regression coefficients are reported in Table 7. Among other results, note that the significance of institutional holdings has decreased over time. This may be a result of an increased tendency towards indexation, which may have reduced the influence of institutions on compensation. The result that is most relevant for our purposes is that trading volume is the only variable which has been consistently significant over time. Indeed, the Newey-West corrected coefficient of trading volume is 0.060 with a t-statistic of 19.84.

Overall, the preceding empirical results lend reasonable support to the ideas developed in our paper.

5 Conclusion

In this paper, we attempt to understand how investor clientele interacts with managerial compensation. In our framework, unsophisticated investors have difficulty in ascertaining true executive compensation from financial disclosures. An optimal extent of camouflage in managerial compensation is obtained by consideration of the degree of investor sophistication together with regulatory penalties. We show that the greater is retail investor participation, the greater is expected executive compensation. Our empirical analysis suggests that total and indirect compensation are positively related to trading volume. Indirect compensation is negatively related to bid-ask spreads. These results obtain after controlling for firm size, and are consistent with the postulated theoretical notion that stocks with greater liquidity and greater unsophisticated investor participation are associated with greater levels of direct and indirect compensation.

Our work implies that policies that improve access to capital markets can increase expected executive compensation because governance may pass to investors who are unable to decipher true compensation from disclosures. Greater precision of private information reduces liquidity but has a potential benefit in that it can discourage unsophisticated investors from participating in financial markets and thereby maintain a check on executive compensation. Increased penalties for fraudulent disclosures and increasing disclosure transparency can also lower expected executive compensation.

The analysis presented in this paper suggests many avenues for further investigation. First, it would be useful to identify the traders who create the volume in the market place. Is the volume contributed by the unsophisticated investors correlated with the higher level of executive compensation? Further, the relation between investor clientele and executive compensation in international settings is also of interest. For example, do countries with less institutional dominance have higher levels of executive compensation relative to the average wage? When technological innovations make it cheaper to trade within a country, what happens to executive compensation? We leave such issues for future work.

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Appendix

Proof of Proposition 1: If there is no investigation, the expected compensation is simply H. Furthermore, the right-hand side of (2) is less than H because the first term on the right-hand side, which equals $0.5p(H-L)$, is less than $H-L$.

The Case when the true value of W equals L: We provide a brief analysis of the equilibrium when the value of $W=L$. Our aim is to show that under reasonable suppositions, the equilibrium compensation in this case will equal L across all states. The prior belief of the individual remains L. If the individual does not investigate, the manager's proposal of a zero dividend is accepted. If the individual investigates, we assume that he correctly concludes that $w=L$ with a probability p and $w=H$ is probability $1-p$. If the individual incorrectly concludes that $w=H$ and rejects the zero dividend proposal, the manager has to incur a vanishingly small cost of $\gamma \to 0$ to convince the individual that $W=L$ (e.g., by opening up the ``books''). Further, in this case the cost of misrepresentation positively varies with $1-p$ rather than p, because p here is the probability that the individual *correctly* concludes that $w=L$. Under these assumptions it is evident that the objective function of the manager is to choose $1-p$ to maximize

$$pL+(1-p)(L-\gamma)-0.5c(1-p)^2 = -(1-p)\gamma-0.5c(1-p)^2+L,$$

which has the optimal solution of $1-p=0$, or $p=1$, given that all parameters are positive. So, in this case, the individual investor always concludes that $W=L$, ensuring that the compensation remains L in all states.

Proof of Proposition 2: We first prove (4). The informed and noise traders submit market orders to the market maker who then quotes a price contingent on the net (combined) order flow of both types of traders. The informed maximizes his trading profit, given by

$$E[\{(F-P)x\} \mid \delta].$$

Given a linear pricing rule $P=\overline{F}+\zeta Q$, where $Q=x+z$, his order works out to be $\delta/2\zeta$. The market maker sets prices such that $E(Q(P-v) \mid Q)=0$, so that $P=E(v \mid Q)$. From this, we have

$$\zeta = cov(\delta,Q)/var(Q).$$

We thus have

$$\zeta = \frac{1}{2}\sqrt{\frac{v_\delta}{v_z}}.$$

The proof of part 1 of Proposition 2 follows from a simple examination of the right-hand side of the condition in (5). When only the institution is the shareholder, there is no camouflage for the informed agent, so trading volume and liquidity are zero. Thus, if the Type U investor does enter the market, then compensation drops below H and volume trivially rises from zero to a positive number. Further, liquidity (the inverse of ζ) trivially increases from zero to the expression in (4). This proves Part 2. For part 3, it suffices to note that under investigation the compensation is greater than L but smaller than H.

Proof of Equation (6): The informed maximizes expected profits given by $E[\{(F-P)x\} \mid \delta+\varepsilon]$, where x is his chosen trade. Substituting for F and $P=\overline{F}+\zeta Q$, where Q, as in the proof of (4), is the order flow, it follows that his order equals

$$x = \frac{k(\delta+\varepsilon)}{2\zeta} \tag{11}$$

where

$$k \equiv \frac{v_\delta}{v_\delta+v_\varepsilon}$$

Let $\beta =\equiv k/(2\zeta)$. Then ζ is given by

$$\zeta = \frac{cov[\delta,\beta(\delta+\varepsilon)+z]}{var[\beta(\delta+\varepsilon)+z]}$$

implying

$$\zeta = \frac{v_\delta}{2(v_\delta + v_\varepsilon)}\sqrt{\frac{v_\delta + v_\varepsilon}{v_z}}.$$

Proof of Proposition 3: The condition under which the Type U investor enters is given by

$$C_E - K + 0.5v_\delta\sqrt{\frac{v_z}{v_\delta + v_\varepsilon}} < \max[\beta(1-p)(H-L) - C_I, 0]. \tag{12}$$

The left-hand side of this expression is decreasing in v_ε, or increasing in signal precision. Thus, increasing precision decreases the parameter set under which the condition holds. Again, starting from a point where v_ε is low enough where the Type U investor is present and increasing it high enough so that the Type U investor exits, expected executive compensation rises.

Proof of Proposition 4: If

$$K - C_E + \max[\beta(1-p)(H-L) - C_I, 0] < \frac{v_\delta}{2}\sqrt{\frac{v_z}{v_\delta + v_\varepsilon^S}}, \tag{13}$$

then the Type U investor does not enter when the signal noise variance is v_ε^S. If

$$K - C_E + \max[\beta(1-p)(H-L) - C_I, 0] > \frac{v_\delta}{2}\sqrt{\frac{v_z}{v_\delta + v_\varepsilon^G}}. \tag{14}$$

the Type U investor enters the financial market when the signal noise variance is v_ε^G. Now, if the Type U investor does not enter the financial market, then the illiquidity parameter is infinite so that ζ^{-1} is zero. The expected dividend when the Type U investor is not present is $H - L$, whereas this quantity when the Type U investor is present is $(1-p)(H-L)$. From the regulatory authority's objective function and Equation (6), we then have that v_ε^S is preferred if (8) holds, and

$$(1-w)(H-L) > w(2/v_\delta)\sqrt{(v_\delta + v_\varepsilon^S)v_z} + (1-w)(1-p)(H-L).$$

The above condition reduces to Condition (9) in the proposition.

Proof of Proposition 5: For part 1, note that the entry condition for the I 'th investor is

$$(2I)^{-1} std(\delta) std(z) < K - C_E + \max[\beta I^{-1}(1-p^{J+1})(H-L) - C_I, 0], \tag{15}$$

where $J < I$ is the number of agents who choose to investigate. If $K - C_E > 0$, then, as $I \to \infty$, the left-hand side of the above inequality goes to zero whereas the right-hand side remains positively bounded. Thus, so long as the maximum number of Type U investors, M, is high enough , an equilibrium where all M Type U investors enter the market exists. The proof of Parts 2 and 3 of Proposition 5 is a simple modification of that of Proposition 2.

Table 1. Managerial Proposals and Outcomes

This table presents the board of directors' response to the managerial proposal of a zero payout to the shareholders, as well as the ensuing managerial compensation.

Clientele	Type S	Type U + Type S		
Type U's investigation decision	-	Yes		No
Investigation outcome	-	$W = H$	$W = L$	-
Manager's zero dividend proposal	Rejected	Rejected	Accepted	Accepted
Hidden compensation	0	0	$H - L$	$H - L$
Total compensation	L	L	H	H

Table 2. Summary Statistics

This table presents the summary statistics for the data used in the empirical tests for our sample of NYSE/AMEX stocks. Total compensation (measured in 2005) is salary plus bonus plus long term incentive payouts, option grants and all other compensation, averaged across the top five executives for each firm. The other variables (all measured in 2004) are total dollar volume, number of business segments, return volatility (standard deviation of daily returns) and skewness over the year, the compounded stock return over the past thirty-six months, and total assets as of the end of the year (firm size). We also use two turnover rate measures, the ratio of dollar volume to the market capitalization (Turnover 1) and the ratio of share volume to the total number of shares outstanding (Turnover 2) in our robustness test.

Variable	Mean	Median	Std. Dev.
Total compensation ($ millions)	2.622	1.711	2.800
Trading volume ($ billions)	1.019	1.058	1.528
Number of business segments	3.260	3.000	1.855
Return volatility	0.018	0.017	0.007
Return skewness	0.036	0.098	1.155
Return	0.596	0.392	0.990
Firm size (Assets) ($ billions)	13.230	2.441	59.957
Turnover 1	1.268	1.031	0.875
Turnover 2	1.699	1.393	1.194

Table 3. Total and Indirect Executive Compensation, based on Size and Volume

This table presents the results of executive compensation by portfolios based on the firm size and trading volume. Based on the logarithm of previous year's total assets, the sample is sorted into 5 quintiles. Within each size quintile, the sub-sample is partitioned into 5 sub-quintiles by the logarithm of total dollar trading volume. Total compensation (measured in 2005) is salary plus bonus plus long term incentive payouts, option grants and all other compensation, averaged across the top five executives for each firm. Indirect executive compensation using the sum of long-term incentive payouts (payments emanating from incentives set by management), option grants and all other compensation (excluding salary and bonus), as a proportion of total compensation. The sample includes all NYSE/AMEX stocks which remain in our former analysis. T-test is performed for the comparison of the sample means between two extreme quintiles, and corresponding t value is reported. Median-test is performed for the comparison of the sample medians between two extreme quintiles and corresponding Z value is reported.

Panel A Mean of Total Compensation							
		Firm Size					
		Small	2	3	4	Large	t-value
	Low	0.47	1.24	1.07	1.62	3.54	-4.81
	2	0.95	1.54	1.38	2.28	3.33	-5.34
Volume	3	0.93	1.38	2.17	2.41	4.43	-5.32
	4	1.16	1.68	3.02	4.32	5.46	-7.77
	High	1.38	2.41	2.71	4.54	7.54	-7.91
	t-value	-4.94	-2.34	-4.07	-4.95	-4.05	
Panel B Median of Total Compensation							
	Low	0.39	0.82	0.99	1.31	2.35	-7.44
	2	0.63	1.20	1.14	1.68	2.61	-5.95
Volume	3	0.77	1.31	1.92	2.25	3.75	-6.95
	4	0.98	1.48	2.14	3.20	4.47	-6.45
	High	1.13	2.04	1.83	3.51	6.14	-6.95
	Z-value	-5.46	-2.98	-2.97	-4.96	-4.96	
Panel C Mean of Indirect Compensation							
	Low	0.13	0.56	0.37	0.72	1.79	-3.96
	2	0.46	0.73	0.51	1.22	1.97	-3.70
Volume	3	0.27	0.61	1.17	1.22	2.74	-4.01
	4	0.53	0.83	1.66	2.14	3.08	-6.85
	High	0.70	1.53	1.17	2.99	4.40	-5.77
	t-value	-4.54	-2.20	-3.81	-4.72	-3.44	
Panel D Median of Indirect Compensation							
	Low	0.07	0.2	0.40	0.42	1.01	-5.46
	2	0.14	0.48	0.40	0.69	1.36	-4.46
Volume	3	0.18	0.39	0.83	1.17	2.15	-4.96
	4	0.40	0.64	1.36	1.70	2.50	-5.95
	High	0.60	1.01	0.69	2.45	3.47	-5.46
	Z-value	-3.47	-3.47	-1.98	-5.46	-3.97	

Table 4. Cross-Sectional Regressions for Total Executive Compensation

This table presents the results of individual stock executive compensation using the logarithm of total compensation (salary plus bonus plus long term incentive payouts plus option grants plus all other compensation) as the dependent variable. The main regressor is log total dollar volume in Panel A, turnover1 (the ratio of total dollar volume to the market capitalization) in Panel B, and turnover2 (the ratio of total trading volume to the number of shares outstanding) in Panel C. The other explanatory variables are return volatility (standard deviation of daily returns) and return skewness over the year, number of business segments, total assets as of the end of the year (firm size in billions of dollars), and the compounded stock return over the past thirty-six months. The second and third columns report results averaged across the top five executives (ranked by the dependent variable) within each firm. The fourth and fifth columns report results averaged by firm across all executives whose compensation levels are reported in the Execucomp database. The sample includes all NYSE/AMEX stocks, and the dependent variable is measured in 2005 whereas the independent variables are from the year 2004.

Panel A Trading Volume as Regressor				
	Top five executives		All reported executives	
Variable	Coeff.	t-stat.	Coeff.	t-stat.
Trading Volume	0.243	11.903	0.243	12.037
No. of Business Segments	-0.008	-0.700	-0.009	-0.735
Return Volatility	0.296	0.089	-0.451	-0.136
Return Skewness	0.041	2.298	0.044	2.460
Return	0.115	5.395	0.118	5.569
Firm Size (Assets)	0.214	9.801	0.211	0.753
Adjusted R^2	0.550		0.554	
Panel B Turnover Rate 1 as Regressor				
Turnover1	0.230	5.700	0.227	5.665
No. of Business Segments	-0.025	-2.012	-0.026	-2.073
Return Volatility	-7.918	-2.093	-8.561	-2.281
Return Skewness	0.039	2.042	0.042	2.175
Return	0.141	6.217	0.143	6.386
Firm Size (Assets)	0.390	23.945	0.387	23.966
Adjusted R^2	0.491		0.493	
Panel C Turnover Rate 2 as Regressor				
Turnover2	0.236	5.775	0.235	5.797
No. of Business Segments	-0.025	-1.991	-0.025	-2.042
Return Volatility	-9.604	-2.472	-10.310	-2.677
Return Skewness	0.033	1.733	0.036	1.875
Return	0.132	5.809	0.135	5.976
Firm Size (Assets)	0.384	23.397	0.381	23.419
Adjusted R^2	0.492		0.494	

Table 5. Cross-Sectional Regressions for Indirect Executive Compensation

This table presents the results of individual stock indirect executive compensation using the sum of long-term incentive payouts (payments emanating from incentives set by management), option grants and all other compensation (excluding salary and bonus), as a proportion of total compensation as the dependent variable. The explanatory variables are log total dollar volume, return volatility (standard deviation of daily returns) and return skewness over the year, the compounded stock return over the past thirty-six months, the number of business segments, total assets as of the end of the year (firm size in billions of dollars), and the logistic transform of the proportion of stock held by institutions. The middle panel reports results averaged across the top five executives (ranked by the dependent variable) within each firm. The rightmost two columns provide results averaged by firm across all executives whose compensation levels are reported in the Execucomp database. The sample includes all NYSE/AMEX stocks, and the dependent variable is measured in 2005 whereas the independent variables are from the year 2004.

	Top five executives		All reported executives	
Variable	Coeff.	t -stat.	Coeff.	t -stat.
Trading Volume	0.065	7.839	0.064	7.829
No. of Business Segments	-0.002	-0.433	-0.002	-0.379
Return Volatility	-2.461	-1.869	-2.387	-1.822
Return Skewness	0.008	1.088	0.008	1.111
Return	0.010	1.124	0.008	0.983
Firm Size (Assets)	-0.011	-1.214	-0.011	-1.214
Institutional Holdings	0.007	0.912	0.007	0.904
Adjusted R^2	0.155		0.154	

Table 6. Two-stage Least Squares Estimation for Determinants of Indirect Executive Compensation

This table presents the results of individual stock indirect executive compensation using the sum of long-term incentive payouts (payments emanating from incentives set by management), option grants and all other compensation (excluding salary and bonus), as a proportion of total compensation as the dependent variable. The explanatory variables are log total dollar volume, return volatility (standard deviation of daily returns) and return skewness over the year, the compounded stock return over the past thirty-six months, the number of business segments, total assets as of the end of the year (firm size in billions of dollars), and the logistic transform of the proportion of stock held by institutions. Two-stage least squares estimates are presented with relative small order volume modeled as a function of all of the determinants of indirect compensation except total volume. This table reports results averaged across the top five executives (ranked by the dependent variable) within each firm. The sample includes all NYSE/AMEX stocks, and the dependent variable is measured in 2005 whereas the independent variables are from the year 2004.

	Top five executives		All reported executives	
Variable	Coeff.	t -stat.	Coeff.	t -stat.
Trading Volume	0.079	6.231	0.079	6.219
No. of Business Segments	0.000	-0.096	0.000	-0.044
Return Volatility	-2.370	-1.794	-2.296	-1.748
Return Skewness	0.009	1.217	0.009	1.239
Return	0.008	0.917	0.007	0.778
Firm Size (Assets)	-0.022	-1.902	-0.022	-1.898
Institutional Holdings	0.003	0.372	0.003	0.367
Adjusted R^2	0.133		0.132	

Table 7. Cross-Sectional Regressions for Indirect Executive Compensation, Year by Year

This table presents the results of individual stock indirect executive compensation using the sum of long-term incentive payouts (payments emanating from incentives set by management), option grants and all other compensation (excluding salary and bonus), as a proportion of total compensation as the dependent variable. The explanatory variables are log total dollar volume, return volatility (standard deviation of daily returns) and return skewness over the year, the compounded stock return over the past thirty-six months, the number of business segments, total assets as of the end of the year (firm size in billions of dollars), and the logistic transform of the proportion of stock held by institutions. Panel A reports results averaged across the top five executives (ranked by the dependent variable) within each firm. Panel B reports results averaged by firm across all executives whose compensation levels are reported in the Execucomp database. The sample includes all NYSE/AMEX stocks, and the dependent variable is measured in year t whereas the independent variables are from the year $t-1$.

Panel A: Top 5 Executives										
Variable		1997	1998	1999	2000	2001	2002	2003	2004	2005
Trading Volume	Coeff.	0.05	0.05	0.05	0.06	0.07	0.05	0.06	0.08	0.06
	t-stat	6.74	6.61	7.19	8.84	10.30	8.19	8.65	9.62	7.83
No. of Business Segments	Coeff.	0.02	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	t-stat	2.87	1.20	0.25	-0.37	-1.02	0.40	0.42	-0.63	-0.43
Return Volatility	Coeff.	3.24	2.75	0.76	0.82	0.98	1.37	-1.00	0.02	-2.46
	t-stat	2.93	2.60	0.95	1.06	1.41	1.94	-1.71	0.02	-1.87
Return Skewness	Coeff.	0.00	0.00	0.01	0.01	0.03	0.01	-0.01	-0.01	0.01
	t-stat	-0.27	-0.45	1.11	1.49	4.22	0.61	-1.29	-0.90	1.09
Return	Coeff.	0.02	-0.01	0.00	0.01	0.00	0.00	0.00	0.01	0.01
	t-stat	1.96	-0.79	-0.26	1.93	1.63	-0.09	0.29	0.95	1.14
Firm Size (Assets)	Coeff.	0.00	0.00	0.00	0.00	0.00	0.00	-0.02	-0.03	-0.01
	t-stat	-0.36	0.34	0.27	-0.25	0.49	0.38	-2.48	-3.39	-1.21
Institutional Holdings	Coeff.	0.03	0.03	0.03	0.01	0.02	0.02	0.02	0.01	0.01
	t-stat	3.11	3.41	3.12	0.86	1.86	1.78	2.58	1.36	0.91
Panel B: All Reported Executives										
Variable		1997	1998	1999	2000	2001	2002	2003	2004	2005
Trading Volume	Coeff.	0.05	0.05	0.05	0.06	0.06	0.05	0.06	0.07	0.06
	t-stat	6.52	6.50	7.21	8.95	10.01	8.48	8.29	9.53	7.82
No. of Business Segments	Coeff.	0.02	0.01	0.00	0.00	-0.01	0.00	0.00	0.00	0.00
	t-stat	2.87	1.18	0.13	-0.60	-1.18	0.37	0.37	-0.80	-0.38
Return Volatility	Coeff.	3.31	3.13	0.97	0.92	1.08	1.46	-0.62	0.19	-2.39
	t-stat	3.03	3.01	1.23	1.21	1.56	2.11	-1.08	0.22	-1.82
Return Skewness	Coeff.	0.00	0.00	0.01	0.01	0.03	0.01	-0.01	-0.01	0.01
	t-stat	-0.36	-0.33	1.25	1.24	4.09	0.66	-1.54	-0.69	1.11
Return	Coeff.	0.02	0.00	0.00	0.01	0.00	0.00	0.00	0.01	0.01
	t-stat	1.91	-0.32	-0.01	2.05	1.66	-0.06	0.34	0.99	1.00
Firm Size (Assets)	Coeff.	0.00	0.00	0.00	0.00	0.00	0.00	-0.02	-0.03	-0.01
	t-stat	-0.29	0.21	0.28	-0.26	0.36	0.22	-2.08	-3.32	-1.21
Institutional Holdings	Coeff.	0.03	0.03	0.03	0.01	0.01	0.02	0.02	0.01	0.01
	t-stat	3.08	3.22	3.19	0.58	1.46	1.88	2.91	1.55	0.90

STAKEHOLDER MANAGEMENT CAPABILITY: EXPLORING THE STRATEGIC MANAGEMENT OF DISSENTING STAKEHOLDER GROUPS

Mark Wickham*, Tommy Wong**

Abstract

Since its inception, Stakeholder Theory has served as an important corporate governance theory, providing an holistic framework for situation analyses and strategic decision-making. Since its conceptualisation, there has been a call to go beyond normative models of stakeholder management to explore the implications of 'stakeholder conflict management' and the development of 'stakeholder management capabilities'. This paper undertakes an analysis of the regional Tasmanian state government's approach to the management of dissenting stakeholder groups towards a controversial retail development. The paper provides a discussion of the manner in which their governance structure included the use of delay tactics, the abdication of responsibility, and the building of bureaucratic layers that effectively diluted the will of stakeholder groups to continue their dissenting activities.

Keywords: Stakeholder Theory; Stakeholder Management Capability; Dissenting stakeholder strategies

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1. Introduction

Since its inception some 25 years ago, Stakeholder Theory has served as an important theory of the firm, providing an holistic framework for situation analyses and strategic decision-making (Freeman, 1984; Frooman, 1999; Hendry, 2001; Nwanji and Fu, 2007; Preble, 2005; Sternberg, 1997). Stakeholder Theory's intuitive appeal, and relative simplicity of operationalisation, has contributed to its widespread acceptance by both academics and practitioners alike as an important corporate governance tool (Fassin, 2008; Friedman and Miles, 2006; Tomasic and Fu, 2006). Since its original conceptualisation, substantial research effort has been undertaken to solidify its tenets (see for example Donaldson and Preston, 1995; Gibson, 2000; Wolfe and Putler, 2002) and to prescribe a means for the effective management of stakeholders (see Greenwood, 2007; Roloff, 2008; Schaefer, 2007; Szwajkowski, 2000; Zakhem, 2008). The almost singular focus on the practical implementation of Stakeholder Theory has increased in recent years (see Bourne, 2008; Frynas, 2008; Johansson, 2008; Vilanova, 2007), and there has been a call to go beyond normative models of stakeholder management to explore the strategic implications of 'stakeholder conflict management' and the development of 'stakeholder management capabilities' (Letza, Sun and Kirkbride, 2004; Zakhem, 2008).

2. 'Stakeholder Management' Versus 'Stakeholder Management Capability'

'Stakeholder management' is the term given to the system by which organisations pursue their objectives whilst considering the interests of its stakeholders (Freeman, 2004; Jackson, 2005). To develop specific strategies to manage its stakeholder relationships, organisations first need to determine "who is a stakeholder?" and "what is the nature of the relationship between the organisation and the stakeholder?" (Frooman, 1999; Greenwood, 2001). Within the realm of Stakeholder Theory there is a divergence between the normative and instrumental doctrines. The normative theorists have attempted to develop a more comprehensive framework of strategic management by broadening the definition of stakeholders to include any group or individual who affects or is in any way affected by the organisation. One problem for the construction of effective corporate governance regimes is that this virtually includes 'everyone, everything and everywhere' (Sternberg, 1997, 2000). Under this broad definition, organisations may be faced with a bewilderingly complex set of claims that cannot reasonably be accommodated (Letza, Sun and Kirkbride, 2004; Zakhem, 2008). The instrumental theorists have recognised this vaguely defined term of stakeholder limits the usefulness and validity of the concept,

therefore, they have put forward a more narrow view which is based on the actual limits of the organisation's resources, time, attention and patience of managers for dealing with external constraints (Letza, Sun and Kirkbride, 2004; Mitchell, Agle and Wood, 1997). A typical instrumental process model for the identification (and 'management') of an organisation's stakeholder groups is represented in Figure 1.

Figure 1. An Instrumental Process Model for Stakeholder Management (Johansson, 2008)

1. Identification of salient stakeholder groups, perspectives and agendas
Perceived legitimacy, influence, urgency and coherence of stakeholder claims

2. Stakeholder synthesis: Accommodation of disparate stakeholders.
Hostile/instrumental/ethical organisational stance

3. Emergent system: Philosophy, process, performance criteria etc.
Stakeholder perceptions of management system

4. System operation: Perceived equity.
Procedural justice – stakeholder perceptions of performance management

5. System outcomes: Decisions on reward, progression etc.
Distributive justice-stakeholder perceptions of performance management system decisions

6. System evaluation: Stakeholder evaluation of system efficacy, efficiency and equity. Stakeholder's perceptions of overall operation of performance management system.

7. System reporting: Level and quality of information disclosure and significance of stakeholder reaction. Stakeholder's satisfaction with dissemination and use of information of performance management system

Typically, instrumental process-driven models have been widely accepted as 'an effective means to identify and manage stakeholder groups'. To effectively manage the potential conflict between the various stakeholders, and to minimise its impact on an organisation's ability to achieve its objectives, it needs to work towards a balance between its resources and the various claims from its stakeholders (Asher, Mahoney and Mahoney, 2005; Frooman, 1999). In order to provide management with a more functional and less complicated framework, researchers have attempted to establish a set of determinants of stakeholder salience for managers (Asltonen, Jaakko and Tuomas, 2008; Harrison and Freeman, 1999). Stakeholder salience goes beyond the identification of stakeholders, and refers to the degree to which managers give priority to competing stakeholder claims, as current stakeholder framework does not clearly explain the dynamics and the complex considerations inherent in each stakeholder (Michell et al., 1997; Parent and Deephouse, 2007). The salience of discrete stakeholder groups is dependent upon three key relationship attributes: power, legitimacy and urgency.

Power is the central determinant of outcomes in situations where a stakeholder and a firm hold opposing interests (Frooman, 1999). In an early definition of power, Weber (1947) described power as a situation where one social actor within a social relationship would be in a position to carry out his/her own will despite resistance from others. According to Etzioni (1964) there are three types of power base within the stakeholder network setting: coercive power – physical power, the use of a loaded gun, a whip, or physical sanctions; utilitarian power – material power, the use of material or financial means such as rewards, or granting material to allow one to acquire goods and services; and social power – symbolic resources, the use of symbols such as prestige and esteem. Mitchell et al. (1997: 866) proposed that power is not a stable state and is transitory: it can be acquired as well as lost. Therefore within a relationship a party that can gain access to resource/s needed to exercise its power has

the ability to impose its will in the relationship.

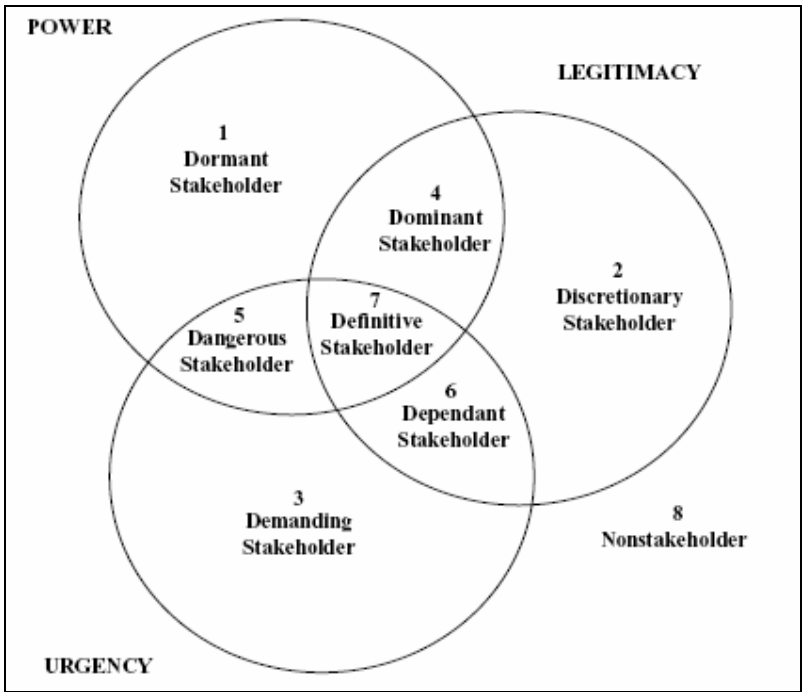
The notion of legitimacy is often coupled with power when people attempting to evaluate the nature of relationships in society (Mitchell et al., 1997). Various scholars have made implicit assumption that legitimate stakeholders are fundamentally powerful (Mitchell et al, 1997). Suchman (1995), for example defines legitimacy as "…a generalised perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions" (1995: 574). Mitchell et al. (1997) accept that Suchman's (1995) definition contains descriptions that are useful in the approach to stakeholder identification, but it is difficult to operationalise. Mitchell et al. (1997) consider legitimacy as only one of the three vital attributes to achieve salience for a firm's managers.

A stakeholder group also needs urgency to drive the claim and the power to enforce it. Urgency refers to the degree to which the stakeholder claims call for immediate action. The two vital conditions of urgency as described by Jones (1995) and Mitchell et al. (1997) are: time sensitivity – when a relationship or claim is of a time-sensitive nature; and criticality – when the relationship or claim is critical to the stakeholder. Attending to stakeholder claims in a timely fashion has been a focus of management for decades (Wartick and Mahon, 1994). However, being time sensitive is necessary, but not sufficient. To be identified as urgent and call for immediate action by the management, the stakeholder's claim or its relationship must be viewed by the firm as critical or highly important (Mitchell et al., 1997).

The three critical attributes of stakeholder salience as proposed by Mitchell et al. (1997) can be summarised as follows:

- Power itself does not necessitate high salience in a stakeholder-manager relationship. Power gains its authority through legitimacy and its exercise through urgency.
- Legitimacy needs the other two attributes, power and urgency to gain its power and voice.
- Urgency, when combined with at least one of the other two attributes, will increase the level of salience in a stakeholder-manager relationship.

Figure 2 Pictorial representation of this interrelationship



Source: Mitchell *et al*., 1997.

Notwithstanding the general acceptance of the descriptive models of stakeholder management as presented above, their ability to prescribe the actual conflict management capabilities required to manage dissenting stakeholders groups is quite limited (Greenwood, 2007; Roloff 2008; Zakhem, 2008; Schaefer, 2007). Recent literature in stakeholder management has called a movement away from the instrumental process-driven approach to one that adopts a strategic view to understanding the resources

and capabilities needed to effectively deal with conflict and dissent between an organisation and its stakeholder groups (Freeman, 2004; Frooman, 1999; Zakhem, 2008). 'Stakeholder management capability' has been forwarded as one potential concept upon which to conceptualise the strategic management of dissenting stakeholder groups, and recommends that the effective management of stakeholders must occur at the 'rational', 'process' and 'transaction' levels of analysis (Daake and Anthony, 2000; Elias, Cavana and Jackson 2002; Malvey, Fottler and Slovensky, 2002; Olden, 2003).

At the rational level of analysis, strategic managers must "map" their organisational stakeholder groups and accurately define the interests each has in its operations. Whilst this at first may appear a simple or straightforward exercise for the strategic manager, the effective development of stakeholder management capabilities requires extensive market research to understand the nature and the source of the interest. At the 'process' level of analysis, strategic managers must include stakeholders in the firm's actual strategic decision-making process (e.g. to invite stakeholders into the boardroom discussions) with the view to use their multiple perspectives as a resource for the organisation. At the 'transaction' level of analysis, strategic managers must establish and execute "win-win" transactional exchanges with their stakeholders. Given that it is in the early stages of its development, the research that has been done into the development of stakeholder management capabilities has focused largely on private sector organisations. There has been some work done on public-private sector partnerships' stakeholder management (see El-Gohary, Osman and El-Diraby, 2006; Johnson, 1998; Lim, Tan and Pan, 2007), but as yet little empirical work has been done to explore governments' stakeholder management capabilities and the manner in which they deal with the 'power', 'legitimacy' and 'urgency' of dissenting stakeholder groups.

3. Method

This paper undertook an analysis of the manner in which the Tasmanian state government's dealt with dissenting stakeholder groups that were concerned with a controversial retail development proposed for a Hobart Airport shopping precinct. This paper draws upon the content analysis of a considerable number of secondary data sources on the matter, which included local councils' media publications, official newspaper reports, special reports commissioned by peak business bodies (and Tasmanian-based daily newspaper) over a period of 35 months (i.e. from August 2005 to June 2008). After the conversion of these sources to a Microsoft Word document format, they were uploaded to the NVIVO qualitative data analysis software program. Each of the documents were then scrutinised and its content coded to provide a basic definition of the types of stakeholder group represented in the reports (i.e. whether the report concerned a dissenting stakeholder group or not), as well as the concomitant stakeholder management strategy adopted by the Tasmanian state government.

The contents of the first round coding categories were then further scrutinised to explore and define the stakeholder management capabilities demonstrated by the Tasmanian state government in their management of the dissenting stakeholder groups. The identification of similarities in the systematic implementation of the stakeholder management strategy, therefore, formed the unit of analysis for this stage of coding. The text searching functions, interpretations of data, coding, and the verification of conclusions were facilitated by the use of the QSR NVIVO software package. In the method literature, it has been emphasised that computer software programs such as NVIVO are of significant value in qualitative analysis and any subsequent pattern matching and theory building (Kelle, 1995; Weitzman and Miles, 1995). The following section details the case of the Tasmanian Direct Factory Outlet, and the evidence of stakeholder management capability that emanated from it.

In order to facilitate the theory building process later in the research process, memos were maintained about the data, their categories, and the relationships between them as they emerged. Designed to store and organise ideas about the data, they were integrated into the analytic process. Wilson suggests that memos assist in the development of theory in five important ways:

- They require that you move your thinking about the idea to a conceptual level.
- They summarise the properties of each category so that you can begin to construct operational definitions.
- They summarise propositions about relationships between categories and their propositions.
- They begin to integrate categories with networks of other categories.
- They relate your analysis to other theories (1985: 420).

NVIVO has a facility for the creation and retention of such memos for later consideration and analysis. Utilising the memo capability within the NVIVO package, memo reports were generated by the software during 'stage two' coding. From these reports, the interaction between the parties' became clearer, the context of the various phenomena surfaced, causes and effects were revealed, and motivations were exposed. The themes emanating from the 'second round' coding form the basis of the discussion section that follows.

4. The Case of the Tasmanian Direct Factory Outlet (DFO)

In 2005, Austexx a leading Australian development company proposed to build Australia's largest Direct Factory Outlet (DFO) at Hobart Airport in Tasmania. A DFO concept is described by Fernie (1997) and Omar and Kent (2001) and as the "fourth wave of retailing". A DFO incorporates a large range of premium branded manufacturers under one roof in the (form of a shopping mall) that is then promoted as a discount distribution channel. The proposed Hobart DFO is a circuit of about 100 direct factory outlets organised so that shoppers move past them all between entering and exiting the complex. Given the relatively small size of the Tasmanian market (i.e. Tasmania has a population of approximately 500 000 people), the proposed AUD$100 million development would be by far the largest Greenfield retail development in the states' history. Indeed, the proposed DFO was to be the largest of its type in the whole of Australia. Throughout 2005 and 2006, the developer and the Tasmanian state government identified three important factors underpinning the development: Firstly, that statistics indicated approximately 50 per cent of retail spending by Tasmanians is 'leaked' to similar DFO complexes interstate; secondly, that it would contribute to the economic development of the state; and thirdly, that it would lead to the creation of additional jobs in the retail sector:

> …the DFO will provide lower prices and more variety and cut the spending done outside the municipality (*The Mercury*, 2005a).
>
> This demonstrates council's long-held view that Cambridge and the airport precinct has great potential for economic development (*The Mercury*, 2006a).
>
> …the DFO will create 600 construction jobs and 1000 full-time and part-time jobs for the state labour market (*The Mercury*, 2005b).

After the DFO announcement was made to the public, five distinct stakeholder groups presented their arguments against the development. The first of these groups were the opposition parties in the state parliament, whose objections were concerned with the state government's planning process and its business dealings with the DFO developer, Austexx:

> The state government had "refused" to exercise its right to have the DFO go through state planning processes (*The Mercury*, 2006e).
>
> The state government's inappropriate use of taxpayer's money to shepherd through a "controversial" DFO development (*The Mercury*, 2006d).

The second dissenting stakeholder groups were classified as 'Local Councils' whose objection was concerned with the state government's infrastructure priorities. This group has expressed strong opposition to the DFO development because of the likely increase in public infrastructure costs, such as upgrades to roads, stormwater, sewerage systems and public transportation. To ask their constituents to pay and support a mainland style development, which has been labelled as unfair to local businesses was not perceived to be a viable option for this group:

> …it's outrageous that the state government prepared to support the massive project without assessing its social and environmental implications and its impacts on existing Tasmanian businesses (*The Mercury*, 2005c).
>
> ...if these extra costs are not born by the developer or by the state government, then they will become the responsibility of the relevant councils (*The Mercury*, 2005d; 2006b; 2006i).

The third dissenting stakeholder groups were classified as 'peak business bodies' such as the Shopping Council of Australia, the Property Council of Australia, the Australian Retailers Association and the Tasmanian Chamber of Commerce and Industry. This group's objection concerned with the state government's planning process, which most of this group perceived as assisting the developer to get the DFO into the state through the backdoor:

> …if the DFO is approved, it will create unfair competition in Tasmania's retail market, which in turn will destroy the local businesses in the CBD and its surrounding areas (*The Mercury*, 2006c; 2006g; 2006h; 2006j).

The fourth dissenting stakeholder groups were classified as 'local business owners' whose objections were concerned with the uncertainty that the DFO has created within the local business community and the state government's planning process. This group argued that the proposed DFO is too big for the state and that it will destroy established local businesses:

> ...using the Australian Airport Act as a way to exempt the DFO is having a negative effect on local businesses as it creates an unfair competition environment in the state (*The Mercury*, 2005d).
>
> ...the DFO will "disembowel" the CBD, and Hobart City will lose its appeal to local shoppers and tourists (*The Mercury*, 2006k).

The fifth dissenting stakeholder groups were classified as 'private citizens' whose objections were concerned with the state government's infrastructure priorities and the planning process. They perceived that the state government's infrastructure priorities do not include the needs of the local communities and that the state government's planning process is not working in the interest of the local business

community:

> …the DFO will be a huge white elephant funded by the Tasmanian people (*The Mercury*, 2006h).

> The state government should have 'got off its arse' long ago and pressured the federal government to allow the project to go through state planning laws (*The Mercury*, 2006g).

In order to manage (and perhaps marginalise) the dissenting stakeholder groups' position on the DFO development, the Tasmanian state government was observed to have demonstrated three important governance tactics (i.e. stakeholder management capabilities) that reduced their salience. Firstly, the state government was able to abdicate its own power base by not opting to bring the DFO development under the state planning laws, thereby enabling it to claim that it's not the decision maker:

> ...it [the state government] is not the decision maker for the proposed DFO development; the federal government is. (*The Mercury*, 2006f; 2006g; 2006h).

This abdication of power and responsibility had the effect of outsourcing the responsibility for the process (and the perceived equity therein) to a legitimate alternative third party, thereby reducing the local stakeholder group's legitimate power-base to complain to their direct political representative about the controversial development. In terms of the stakeholder management capability concept, the Tasmanian state government demonstrated an ability to outsource any responsibility they may have been perceived to have on the controversial issue, and thereby abdicate any concomitant responsibility for the equitable treatment of the stakeholder groups' members. This capability also enabled the government to deflect any criticism concerning delays in the appeal/complaint process away from itself and onto the legitimate third party.

Secondly, and in order to diminish the urgency of the dissenting stakeholder groups' claims, the state government was observed not to lobby the third party (in this cast the Australian federal government) to expedite the process, and continued with its position that 'the state has to wait for the federal government's decision'. By refusing to intervene or provide lobbying support for the dissenting stakeholder group, the Tasmanian state government was able to diminish the urgency of the issue by elongating the decision making process. In terms of the stakeholder management capability concept, the Tasmanian state government demonstrated an ability to diminish the stakeholder group's motivation for their cause, as well as their concern about the overall processes, reporting procedures, and the outcomes of the governance system.

Lastly, by removing the power to complain and the urgency of the claims, the Tasmanian state government effectively reduced the legitimacy of the entire DFO controversy. Over time, the relevance and importance of the DFO issue faded in its relative importance, as the local community either 'moved on' or was challenged by a new or more pressing issues:

> …the last few months have been quite good and things are only going to get better. We are looking to expand. I think the DFO will have an impact for a short time only (*The Mercury*, 2007a).

It seems that the Tasmanian state government achieved its objective by adopting a 'governance' stance of simply doing 'nothing' for long enough. However, it is the manner in which the state government mobilised its resource and governance processes to 'do nothing' that is of most interest here. The Tasmanian state government did not simply employ a naïve set of delay tactics, but rather set in play a series of legitimate inactions that could not easily be criticised by the dissenting stakeholder groups. The following discussion will attempt to delineate some specific strategies and 'stakeholder management capabilities' displayed in this case.

5. Discussion

This exploratory research suggests that the 'stakeholder management capability' concept has a number of important implications for the 'instrumental process model for stakeholder management' depicted in Figure 1. Firstly, institutions must go beyond the mere recognition that different stakeholder groups exist, and develop specific capabilities to accurately define the factors that make a stakeholder group legitimate, influential and their cause urgent within their community. This would entail developing greater boundary spanning capabilities, as well as the allocation of resources for high quality environmental scanning. Secondly, and in addition to the above, the organisation must strive to specifically define the ideology of the stakeholder groups, as well as the motivations of the individuals within relevant stakeholder groups. Only when such information is known to the organisation can it effectively conceptualise its position within the community, and fully understand the relationship and expectation that the various stakeholder groups have with it.

Thirdly, when an organisation is required to respond to criticism or action by a dissenting stakeholder group they must be capable of deflecting or abdicating their responsibility for the issue at hand. In the Tasmanian state government case, this stakeholder management capability included the creation of a 'power vacuum' (or more simply, a capacity 'to do nothing' and get away with it) when dealing with dissenting stakeholder group criticism. By this, we interpret the Tasmanian state government's action to abdicate their own power and

legitimacy to another body (in this case, the Australian federal government) meant that the dissenting stakeholder groups were similarly unable to exercise their own power as constituents of the Tasmanian state government. The effective stakeholder management capability, therefore, would consist of an 'ability to remove or reduce the power of the dissenting stakeholder groups' to influence their direct representatives in any political process.

Lastly, in terms of the 'system operation and outcomes', we feel that the Tasmanian state government was able to use the procedures they themselves developed to constrain the legitimacy of the dissenting stakeholder groups by instituting a number of due-process systems that served to extend the time of the project's evaluation. This in turn diminished the capacity of the dissenting stakeholders to continue their protest given the time and cost implications associated with a protracted campaign. Essentially, the Tasmanian state government was able to 'out-wait' the dissenting stakeholder groups, and to marginalise the agitators at their core. Similarly, the 'urgency' associated with the controversial project was diminished by the abdication of responsibility and the protracted process employed by the Tasmanian state government – over the period of several months, the DFO issue changed from a controversial one to one that became relatively 'routine' (perhaps even a *fait accompli*) in the eyes of the majority of Tasmanian residents, and the urgency of the matter (and that of the dissenting stakeholder group) was similarly and diminished over time. Figure 3 proposes a model of stakeholder management capability that reflects the evidence and coding insights of this research.

Figure 3. A Model of Dissenting Stakeholder Management

1. Identification of salient stakeholder groups, perspectives and agendas
The ability to define the legitimacy, influence, urgency of stakeholder groups

2. Stakeholder synthesis: Recognition of disparate stakeholders. The ability to specifically define the ideological stance of dissenting stakeholder groups

3. Emergent system: Philosophy, process, performance criteria etc.
The ability to manage stakeholders' perception of the firm's management system

4. System operation: Outsourcing responsibility for equity of treatment.
The ability to deflect or abdicate responsibility for the system's performance

5. System outcomes: Outsource and/or delay decisions on reward, progression etc.
The ability to deflect or abdicate responsibility for the system's outcomes

6. System evaluation: Stakeholder evaluation of system efficacy, efficiency and equity. The ability to diminish the dissenting stakeholder groups' concern for the performance management system as well as their own cause.

7. System reporting: Level and quality of information disclosure and significance of stakeholder reaction. The ability to diminish the dissenting stakeholder groups' concern for the performance management system as well as their

'Stakeholder management capability' as a corporate governance concept appears worthy of further research. This single case explored the manner in which an Australian state government used (and indeed 'didn't use') its resources strategically to marginalise those stakeholder groups opposed to the construction of a controversial DFO. The DFO case demonstrates the state government's capacity to build and influence legitimate systems that serve to marginalise stakeholder dissent by removing their ability to exercise power, and to reduce the urgency and legitimacy of their dissent. In terms of theory, it would appear that this case has implications at the 'rational', 'process' and 'transaction' levels of stakeholder management. At the rational level of analysis, the case indicates that managers must do

more than simply "map" their organisational stakeholder groups and go beyond simply defining the interests each has in its operations instead to understanding the ideology and personalities at the core of the stakeholder group. At the 'process' level of analysis, managers must consider developing alternatives to the widely espoused 'inclusive' management techniques that may include disengaging dysfunctional stakeholder relationships and/or ignoring stakeholder groups altogether. At the 'transaction' level of analysis, the case suggests that strategic managers need not necessarily establish and execute "win-win" exchanges with their stakeholder groups – and instead consider the possibility that some stakeholder group exchanges may result in a 'nil-all draw' that somehow favours the organisation.

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BRAZILIAN CONSULTING CARTOGRAPHY AND THE NEW RECONTEXTUALIZATION AND INTERNATIONALIZATION OF INTERCHANGES AND MANAGERIAL CONTENTS

Julio Cesar Donadone*

Abstract

The aim of this study is to investigate the social articulations which result in internationalization and the naturalization of their managerial contents, specially the influence of management financial logistic – financing – and corporate governance. The main focus of this research project is to investigate how the agents, specially the ones related to consulting, bring new economic internationalization to Brazil and fulfill all the needs to achieve it. Hence, this study contributes towards understanding the Brazilian consulting market development process, its trends, strategies, and relationship with other organizations, its main changes over the last decades, and its particularities in the Brazilian Sector.

Keywords: consulting, brazil, internationalization

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Introdution

The question of research is , together with an Brazilian consultants' agents mapping, to understand how the consultants obtain their own social representations and the consulting services extent in the market, the competitors' strengths and weaknesses, the consultants approaches, the forms of dispute in the market, their interdependence on the international consulting market, and how they relate with the sectors that interact directly with the consulting universe, mainly the companies managerial staff and those sectors related to the production and dissemination of organizational practices and concepts.

1.1. First analysis step: Brazilian consulting cartography

This study aims at contributing to understanding the Brazilian consulting market development process, trends, strategies, and relationship with other organizations based on three factors.

Firstly, focusing on the international consulting market to identify its characteristics, main changes over the last decades, and its particularities in the Brazilian Sector.44.

Based on an agents mapping, the focus is to understand how the consultants obtain their own social representations and the consulting services extent in the market, the competitors' strengths and weaknesses, the consultants approaches, the forms of dispute in the market, their interdependence on the international consulting market, and how they relate with the sectors that interact directly with the consulting universe, mainly the companies managerial staff and those sectors related to the production and dissemination of organizational practices and concepts1.

Next, the focus is on the managerial and entrepreneurial recent changes. The objective is to investigate the role of managers in facing the organizational configurations and demands of the 80's and a contrast with the ideas resulting from consulting. Thus, following that, it is important to consider the formulations of the concepts associated to the growing influence of the financial logistic on entrepreneurial management relating them to the consulting growth and strategies and the role of managers to face such circumstances. Hence, for a thorough recontextualization of these conditions and circumstances and their consequences on the Brazilian organizational process (sector), it is necessary to concentrate on the formulations, merging processes, and privatizations in the country in the last few years.

This study also aimed at discussing the strategies used to forward the managerial ideas and the sectors involved in this process focusing on consulting companies' approaches and connection with related sectors, mainly the business media. Based on managerial new strategies, an investigation was

[44]For theoretical references, the two studies of Bourdieu and followers were referred to. The first includes their general ideas, and it can be easily accessed: P. Bourdieu: La distinction: critique socilale du jugament. Paris, Ed. De Minuit, 1979. La Noblesse D'Etat, Paris, Ed. De Minuit, 1989 and more recently : a Les structures sociales de l'économie, Paris, Éditions du seuil, Maio de 2000.

carried out in order to understand the relationship company-consulting.

Research methods

The research was conducted using Bourdieu's concepts addressing not only the pre-constructed representation of the interviewees, but also the cognitive structure involved in their environment. The study focused on the understanding of how people lead their lives facing different situations sharing and relating with their surrounding environment besides questioning about the social issues that make them possible focusing on the relationship between social and mental structures and the world's objective structure and the cognitive structures through which the former is fully understood (Bourdieu, 1991) *45.*

Eighty semi-structured interviews were conducted focusing on the following:

1. The Brazilian market strategies and structure in order to indentify:

- the major companies in the market;
-sector diversities;
-origin and reference sources;
-relationship network;

2. The building of a legitimate network business and organizational news diffusion focusing on the relationship between consulting companies, business media, and academic institutions in order to indentify:

- diffusion of managerial ideas and strategies in the last few years;
-using consulting companies as audit and advice report sources;
-relationship between consultants and financial and economic journalists;
-establishing academic foundations and/or organizations through which faculty members can work as consultants;

3. The consultant/consulting firm relationship with the companies they work for in order to indentify:

-consultants approaches in the companies;
- mangers/consultants relationship;
- legitimating organizational aspects pointed out by consultants;

Firstly, twenty-five interviews were divided as follows: the first set focused on international recognition consulting firms and how they operate in the Brazilian market. The second set was based on a list of organizations in the national consulting sector concentrating on the prominent firms, unions and related professional associations.

Field work Second stage

Following this first exploratory stage and based on the data gathered on the theoretical aspects of the Brazilian consulting market, some special issues that stood out as consulting market influential factors were selected. This choice was based on Bourdieu's ideas about social space and field concept. According to Bourdieu, the field consists of a set of objectives, historical relations between positions anchored in certain forms of power (or capital).

The field consists of a system of objective forces (just like a magnetic field). It is a relational configuration with a specific gravity, which is imposed to objects and agents that are part of it. The field is at the same time a space of conflict and competition just like a battle field, in which people fight to exert the monopoly of the varieties of capital and the power to impose conversion taxes between the authorities within the field of power.

This is the way to avoid been caught in the trap of preconceiving and take the field for granted and instead, search for the intrinsic conceptualization of the construction, i.e. the possibility of understanding the construction of the world, the strategies and social representation of the actors from their actions towards the others related to the question.

The option for this kind of research, aimed at providing elements that could be related to the interpretation and legitimacy of the interviewees' answers investigating the logics of their justification. Hence, Douglas46,, concepts were used in order to understand the managers and consultants formulations about the questions related to the managerial work and companies' management techniques.

According to Henry47, opting for a research centered on the agents discourse would present three problems: the discourse could be outside the scope of the agent's social properties; the overwhelming discourse, i.e. an attempt of overvaluing certain characteristics; use of clichés that would contribute too little towards the analysis.

Nevertheless, the Idea of field and consequently the formulation of *habitus* make it possible to solve those questions since the differences between the

[45]In: Bourdieu, Pierre and Löic J. D. Wacquant. An Invitation a Reflexive Sociology. University of Chicago Press. Chicago 1992. Pág. 247.

[46]Especialy his works: Thought Styles. Critical essays on good taste. London, Sage publications. 1996; Understanding the enterprise Culture. Themes in the work of Mary Douglas. HEAP, Shaun Hargreaves., ROOS, Angus (Ed.), Edinburgh, Edinburgh University Press. 1992; DOUGLAS, Mary., WILDAVSKY, Aaron: Risk and Culture. An Essay on the selection of technological and Environmental Dangers. Berkeley. CA – USA: University of California Press. 1982.

[47] HENRY, Odile. Entre savoir et povoir. *Actes de la Recherche en Sciences Sociales*, Nro 95, Pág 37-54. Paris. Decembre 1992.

duration and practices are not based on an absolute autonomy but on the interviewees' own history and social position.

It is worth mentioning that the interviews, including their sequence, were carried out according two simultaneous and complementary processes.The first one focused on a certain group until the interviews answers led to recurrent ideas about the influences and formulations of the specific consulting strategies. The second process, in which based on the sequence of the interviews the initial attitudes were reviewed and elaborated again, focused on the recontextualization of the relationship and the power of influence of the several groups previously chosen.

Based on the theoretical discussion above, in the selected groups, 55 interviews were conducted in order to include the several hierarchical positions, i. e. interviews were carried out in the several organizations of the chosen sub poles with people occupying positions ranging from the high profile ones to the recent included in the consulting sector.

In two of the companies, a specific study was carried out focusing on answering the questions raised in this research through the interviews conducted throughout all levels of the organizational structure. In addition, a set of interviews conducted with students who were about to graduate and would likely occupy consulting positions, who are former interns, or had withdrawn from universities that founded companies in this sector.

To complement the analysis material, other interviews were conducted to collect information with people from different sectors but related to consulting such as members of professional associations, managers in charge of hiring services, former consultants as well as a literature search on this subject.

Second analysis step: the new recontextualization and internationalization of interchanges and managerial contents

The Brazilian entrepreneurial universe has been undergoing major changes in the last 20 years becoming more complex, bigger, and gaining international recognition. Thus, the organizational management and properties' structure have changed, so although each process should be investigated alone, they depend strictly on each other.

In both cases, there has been a considerable advance in "financing48": internal companies' management strategies are more and more based on worldwide organizational financial approaches, and enterprises are diversifying and managing financial assets portfolios49.

An important consequence is that well characterized financial assets are estimated and negotiated on a daily basis (or at least potentially) and their market value depends on o their current and renewed reputation according to estimate experts and the media7.

This change has introduced important effects on the managerial field and others, mainly those related to "production of sense". The traditional distinction between producers of goods and producers of ideas weakens when the entrepreneurial field approaches the several sectors in which there are intellectual work and producers of symbolic goods. Hence, through the entrepreneurial universe, it is possible to visualize the field of power in Brazil50.

51.

[48] Regarding this issue, A fact that deserves mentioning is the invaluable help of Professor Neil Fligstein for the course he taught and the innumerous meetings we held while I was visiting the University of California, Berkley, in 2002. It is also worth mentioning the contributions of my colleague, Dr. Roberto Grun, who is also a professor at the production department, at UFSCar and his works on this subject : GRUN, R.:"Modelos de empresa, modelos de mundo: sobre algumas características culturais da nova era econômica e da resistência a ela", Revista Brasileira de Ciências Sociais, São Paulo: , v.14, n.41, p.121 - 140, 1999.

[49]This theoretical construction contributes enormously to this study. Firstly, due to the issues related to need of transparency of the economic codifications as essential tools of power and influence of companies' financial logistics. This means the ability of evaluating the companies' performances. The consulting sector development has been based on reports about the financial health of the companies such as the Survey's Bank. Fligstein (1990)'s theory about the development of the financial logistics was also useful since companies make use of financial analysis as a way to follow and evaluate the performance of acquisitions in non familiar sectors, which is also a characteristic of institution investors.

[50] Regarding this concept, see P. Bourdieu: "La Noblesse D'Etat", Paris, Ed. De Minuit, 1989, pg. 548.

[51] As I tried to demonstrate, the different groups of actors who play the role as active businesspeople and modern intellectual people are actually competing with each other and respect each other through the partial recovering of production of sense already done by their rivals leading them to ones that are more convenient.. That means, they are "on the same boat". According to the business media, the success of consulting would improve their legitimacy as their mouthpiece in the "organizational news" media market allowing them to dare trying new launches. According to the managerial field, the ideas divulged by the business media and consulting have been new ways to face the managerial content changes and the companies shape in the last twenty years. In Donadone, J. C: Os hunos ja chegaram!": *Dinâmica organzacional, difusão de conceitos gerenciais e atuação das consultorias.* Março de 2002; A more recent evaluation of the phenomenon, based on the French case, and which can be easily generalized is in : J. Duval: "Concessions et conversions à l'Economie: le journalisme économique en France depuis les années 80",

According to Bourdieu's statement *"allongement des circuits de légitimation",* our object became very sensitive to the development of other sectors, on which it is more and more interdependent. On one hand, there is the interface entrepreneurial field and the media (which has become quotidian), especially the business media, that establishes more complex relationships that could be called "investigation object" by those who seem unaware52.

Therefore, the financiers who now focus more on working for manufacturers and commercial companies have made constant use of consulting53 when evaluating the worth of companies to be purchased or sold and to solve organizational and computing problems. They would rather choose such solutions instead of the traditional hiring of managers and other professionals working under the legislation

Such preference can be explained not only by accounting issues54, but also by the known updated consulting in relation to the management strategies considered efficient by the USA and followers nowadays.

If the business media and consulting are considered, it can be said that the internationalization has strongly developed including worldwide involved national agents with more intensity than before (this can only be affirmed considering a linear perspective which would not make sense considering a historic analysis. Maybe, it is safer to affirm that the inclusion of those agents is now more intense than it was in the period immediately before). Both the contracts of the business media and the consulting products are imported from hegemonic centers rapidly and undergo a less important recontextualization than in the past55.

Actes de la Recherche en Sciences Sociales, n. 131-2, pg. 56-75, 2000.

[52] As I tried to demonstrate, the different groups of actors who play the role as active businesspeople and modern intellectual people are actually competing with each other and respect each other through the partial recovering of production of sense already done by their rivals leading them to ones that are more convenient.. That means, they are "on the same boat". According to the business media, the success of consulting would improve their legitimacy as their mouthpiece in the "organizational news" media market allowing them to dare trying new launches. According to the managerial field, the ideas divulged by the business media and consulting have been new ways to face the managerial content changes and the companies shape in the last twenty years. In Donadone, J. C: Os hunos ja chegaram!": *Dinâmica organzacional, difusão de conceitos gerenciais e atuação das consultorias.* Março de 2002; A more recent evaluation of the phenomenon, based on the French case, and which can be easily generalized is in : J. Duval: "Concessions et conversions à l'Economie: le journalisme économique en France depuis les années 80", Actes de la Recherche en Sciences Sociales, n. 131-2, pg. 56-75, 2000.

[53] As theoretical support, I make use of my doctoral thesis research, cited earlier, in which I intend to investigate the international consulting market based on three steps: i) first of all, an analysis of the international consulting market to identify its characteristics, main changes over the last decades, and its particularities in the Brazilian Sector. Based on an agents mapping, the focus is to understand how the consultants obtain their own social representations and the consulting services extent in the market, the competitors' strengths and weaknesses, the consultants approaches, the forms of dispute in the market, their interdependence on the international consulting market, and how they relate with the sectors that interact directly with the consulting universe, mainly the companies managerial staff and those sectors related to the production and dissemination of organizational practices and concepts. Next, the focus is on the managerial and entrepreneurial recent changes. The objective is to investigate the role of managers in facing the organizational configurations and demands of the 80's and a contrast with the ideas resulting from consulting. Thus, following that, it is important to consider the formulations of the concepts associated to the growing influence of the financial logistic on entrepreneurial management relating them to the consulting growth and strategies and the role of managers to face such circumstances. This study also aimed at discussing another element of the construction used in this research focusing on the strategies of the consulting companie and their relationship with other sectors involved in this process focusing on consulting companies' approaches and connection with related sectors, concentrating on the mainly the business media. Based on managerial new strategies, an investigation was carried out in order to understand the relationship company-consulting.

[54] The most popular entrepreneurial thought focuses on the fact that consulting can be hired or fired any time with no residual direct costs while work contracts can have medium and long term consequences, so they can be called unforeseeable. This notion can result from the financial view that the companies should always be ready to be sold and the evaluation of contentious legislation issues and pension plan holders makes the company duties less clear compromising its Market liquidity. A sociological approach of the attempt to implement this idea outside the scope of the north American economic space, its origin, is presented by: Dezalay Y.: "Technological Warfare : The Battle to Control the Mergers and Acquisitions Market in Europe", in Dezalay Y., Sugarman D. (eds), "Professional Competition and Professional Power", Londres, Routledge, pp. 77-103

[55] The contextualization differential spaces seem to be the key to an explanation. R. Cole said that in order to make the total quality methods, from Japan, work in other countries it is necessary " to reinvent the wheel", quoting this expression creatively, highlighting the difference between the new entrepreneurial organizations and the old ones.; see R. Cole: Strategies for learning: small-group activities in American, Japanese, and Swedish industry. University of California Press, Berkeley, 1989. According to the recent financial approach, we should not reinvent the wheel since it should work the same way no matter the environment. The new organizational approaches resulting from financing makes the

Brazilian initial consulting cartography

The international space

The first influential consulting companies considered in this study are the ones derived from the accounting firms and leaders in the global market. Analyzing the international consulting market leaders in the 90's, all the following companies, Pricewaterhousecoopers, Arthur Andersen, Ernst &Young, KPMG e Deloitte Consulting, have offices in Brazil. They were established in the country at the end of the 50's, following their clients' moves and the American multinational companies which had been involved in the audit sector since the thirteenth century56.

Regarding Brazilian competitors, they are present in the high number of small consultancies. Two companies are commonly referred to due to their partnership, mainly in the process of privatization, and two universities due to advantages granted by the legislation 8.666(21/06/1993), in invitations for bid for consulting services to the public sector. Although the respondents were aware of the presence of such agents, their standing as competitors is weak as highlighted by one of the respondents: There are also the small consulting companies and universities that have become more apparent, but they are not considered competitors due to their kind of business" *57*.

Universities consulting

Another set of consulting that deserves attention is the Brazilian consulting field related to universities. Consultancy is carried out through an institution, for example, The Getúlio Vargas Foundation (GV Consulting) or services providing is done through an extension provided by the universities.

Its legitimacy basis is related to the academic knowledge of their professors-consultants. Two other factors corroborate to the development of this kind of consulting in Brazil. The first is related to the legislation 8666 which assures the priority to hire services conquered through invitations for bid. The second one is related a more frequent search for graduate courses by Brazilian company managers offering an exchange of information and possible prospective consultancies. Since company managers are demanding courses that approach them to the academic proposals and logistics to deal with organizational aspects, it has made it easier for agents to become consultants.

Discussions about financing systems, their details, and universities activities legitimacy have become more frequent in public universities in Brazil. For example, the situation during the creation of at the *Fundação de Desenvolvimento Gerencial* which involved a dispute making the members of the *fundação Cristiano Othone* leave the Federal University of Minas Gerais and serious discussions between union faculty representative and other

non explicit sociological assumption of an unsocialized view of the agent, which is close to mainstream manuals idea of a rational actor while the former, characterized by Cole, is more loyal to the social contexts that focus on action. It is easy to notice the homology between the conceptual basis of the new "micro" management methods and the prevailing macroeconomic approach, meaning reinforcements in the several different high rank economic positions, the bankers responsible for financing, and other groups of agents who have been trying to free us from the load of the past.

Citing Robert Cole works on this them some can be highlighted such as Fads, imitation, and learning. The case of American Quality Movement. Center for Research in Management. University of California Press. Berkeley. CA. EUA.1994; e mais recentemente Managing quality fads: How american business learned to play the quality game University of California Press. Berkeley. CA. EUA. 1998.

Citing original research, there are : *Difusão de novidades organizacionais e dinâmica social: a formação do guru gerencial brasileiro. Teoria e Pesquisa. Revista do Departamento de Ciências Sociais – UFSCar. Nro 30-31, jul-dez. 1999; e Imprensa de Negócios, Dinâmica Social e os Gurus Gerenciais, no I ENCONTRO DE ESTUDOS ORGANIZACIONAIS - ENEO. Org. Associação Nacional de Pesquisa em Administração – ANPAD. Junho de 2000.* These studies were carried out during my sabbatical year abroad as a visiting scholar under the supervision of Professor R. Cole at the Haas School of Business, University of California, Berkeley, (1998/99) and studies of related to the construction and legitimacy of managerial gurus: *DONADONE, J.C. A apropriação e recontextualização de práticas organizacionais. In: Revista de Adminsitraçao de Empresas Eletronica- RAE-eletrônica. ano 1 número 1 - ISSN 1676-5648. janeiro/ junho – 2002 Imprensa de Negócios, Dinâmica Social e os Gurus Gerenciais, no I ENCONTRO DE ESTUDOS ORGANIZACIONAIS - ENEO. Org. Associação Nacional de Pesquisa em Administração – ANPAD. Junho de 2000. DONADONE, J.C.; GRÜN, R.: Participar é preciso! Mas de que maneira? In: Revista Brasileira de Ciências Sociais – RBCS. Volume 16, numero 47. outubro de 2001.*

[56]Consulting developed in the first few decades after the after the war. It was first associated to the American effort towards the post-war European reconstruction. Managerial practices included two American aid elements and opened new consulting areas. As an example, Arthur D. little introduced a representation office in Paris, where the Marshall Plan central coordination office was located. Since the 60's the consulting has developed and grown due to the presence of American multinational companies. Arthur D. Little, Booz-Allen e Mckinsey introduced representation offices in Europe that focused on organizational aspects, specially forwarding management and organization related to the implementing of a multidivisional (M-form) structure. As examples, Arthur Andersen established in Brazil in 1957 and Peat Marwick and Mictchel, one of the major creators of KPMG, which had established in Brazil since 1915 with auditing.

[57]Interview with na internationalconsulting manager (see DONADONE, 2002).

entities of São Paulo University about proposals to end investigations of the use of the money in university foundations..

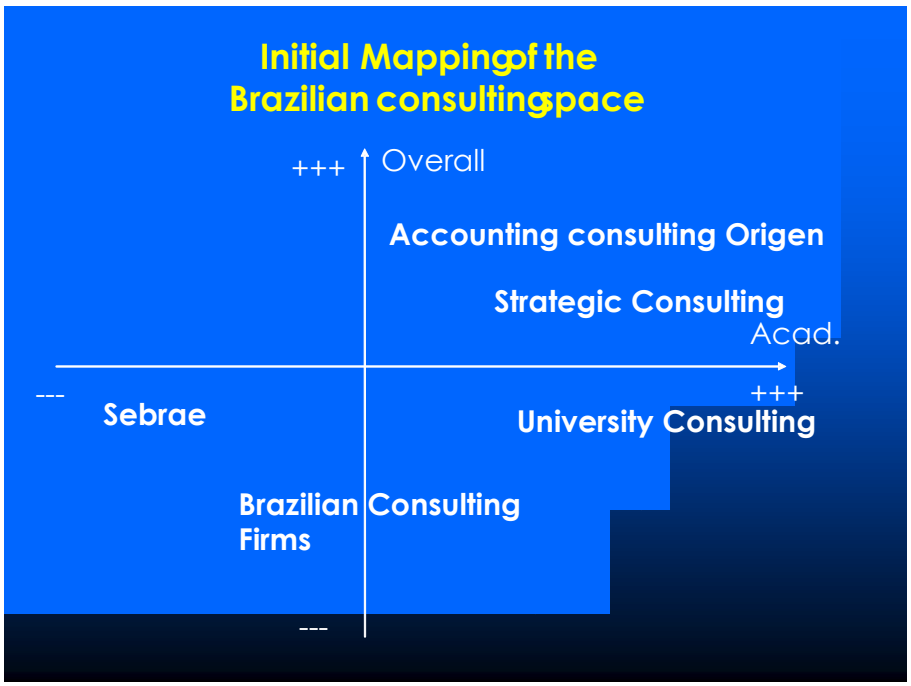
2. Brazilian Consulting Companies

Despite the poor statistics results on the consulting sector in Brazil, it can be said its legitimacy is based on the knowledge of specific characteristics of the institutions and the Brazilian market highlighting the fiscal aspects. Brazilian consulting has associated to international consulting in order to evaluate companies to be privatized providing them with knowledge of the Brazilian legislation.

It is also possible to identify a crescent number of former employees of privatized or multinational companies who have become consultants sometimes working for their former employers. They focus on specific knowledge and on relationships developed during the time they were working in the economic sector.

Another market that has been developing is SEBRAE - the Brazilian Service of Support for Micro and Small Enterprises - responsible for activities and resources made available for entrepreneurs and small business entrepreneurs, and the creation of consultant cooperatives that can be as big as 300-member cooperative with low educational, social, and cultural capital involved in the direct sale of small managerial strategies pack of a known technique to small businesses.

Although distant from the dominant pole of the Brazilian consulting field, represented by international consulting, the consulting cooperatives and SEBRAE activities demonstrate and support the consultant's importance and the need of managerial strategy packs even in far away cities and small businesses.



,
Where the axes represent:
X: proximity/distance from academic centers
Y; International Generality/legitimacy of the solutions proposed

Conclusion

In analyzing the organizational dynamic of the period, at first glance it is possible to establish connections that make it possible to understand the growth of the consulting sector. The process of reorganization associated with the new configurations of company control and emblematically represented by mergers and acquisitions and Brazilian privatization process. opened up lots of room for consulting firm activity. To aid in understanding how the relationship between consulting firms and businesses takes place it is necessary to focus on the consultants' functions. As a starting point, I refer to Coget's (1999) theoretical formulations, according to which consulting firms' activities are concentrated in three areas. The first is linked to the use of consultants in arbitrating internal and external company disputes to provide legitimacy

for company actions. The second function is related to the capacity to produce and disseminate concepts about the business world. As a last characteristic, consultants are used in the implementation of organizational changes.

With regard to external arbitration, clashes among the new company "owners" provide a broad field for the use of consulting firms as a legitimate means to analyze the financial performance of companies. As an example there is the way the sale of state enterprises is structured. Consultants evaluate the companies, point out their problems and suggest buyers. In internal disputes it has become common to use consulting firms as weapons in the dispute to validate the performance of a certain unit or department in the face of other sectors of the company, principally with the growing focus on the "core processes" and the consequent sale or deactivation of unprofitable areas.

The issue of using the ideas coming from consulting firms, as well as consultants themselves in implementing organizational changes is at the heart of the restructurings. Managers seek to improve the performance of their units in an attempt to achieve the expected economic performance. In this way, they seek solutions that can help them with this objective. It is worth underlining that the search to legitimize actions and the implementation of organizational changes are intimately related, since the justification for the choices in many cases lends support to their implementation.

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CORPORATE GOVERNANCE, EXTERNAL AUDIT AND THE AUDIT PROCESS

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Abstract

This paper reports on interviews with audit partners of listed companies on their perspectives of impact of corporate governance on the audit process. Based on responses received the study finds that audit risk framework is dynamic enough to incorporate expected changes in control environment brought about by greater consciousness on the part of directors on the need for good internal control. However there is still skepticism that good governance practice has filtered through clients' control environment as auditors believe dominant CEO's may still moderate the effectiveness of audit committees.

Keywords: control risk, audit risk model, corporate governance, audit process, PN9

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Introduction

This paper reports on a study of what auditors perceive of the audit process carried out under an internal control environment, which conforms to best practice found in the Code of Corporate Governance. In 2001 Bursa Malaysia enforced The Code of Corporate Governance (Code) on listed companies by way of Practice Note 9 (PN 9). Corporate governance characteristics of firms and the corporate governance environment may influence the role of the statutory auditors and the audit evidence accumulation process (Piot, 2005). Auditors are an important oversight mechanism over the truth and fairness of information presented in a corporation's financial statements. In Malaysia, the law recognizes the importance of the external audit function as all companies incorporated under the Companies Act 1965 are required to have the annual accounts audited before submission to shareholders for approval at the company's annual general meeting. Existing research suggests that governance attributes impact on various components of the financial reporting process (Beasley *et al.,* 2000, O' Sullivan, 2000, Craswell, 2001, Abbot *et al*., 2003). One of these components is the internal control environment which, if effective, would be able to detect and prevent financial statements from being misstated. Auditing standards require that auditors examine internal control and assess whether the internal controls are reliable or not before deciding on the extent, nature and timing of audit procedures. Using the audit risk model, auditors are required to asses the internal control of clients before determining how much more audit evidence needs to be gathered and how.

La Porta *et al*. (1998) pointed out that most studies on corporate governance focus on countries like Japan, US or UK. whilst emerging markets, like Malaysia, have been described as having corporate governance framework and institutional settings which are not similar to those found in more developed markets like the US and UK (Fan and Wong, 2005). Hence international research findings on external audit and corporate governance in an American or British setting may not be generalisable to a Malaysian corporate governance setting. Puan (2006) examines governance structures and its impact on audit by way of audit fees of Malaysian listed companies. However, the study did not ask auditors what they see as the impact of governance on audit process itself. It is therefore the objective of this study to examine how auditors perceive the impact of governance on the audit process, whether governance matters or not and if so at which stage of the audit. Best practice as per the Code is expected to improve the internal control environment of listed companies and internal control environment determines quality of internal controls as a whole. If control environment changes then, the scope of the audit work could change (leading to a more efficient audit) and the risk of misstatement could be better detected and prevented making the internal control more reliable and therefore the audit process more effective. Hence not only will such an environment reduce the risk of

poor quality financial statements but also enhances the monitoring role of external audit.

The paper is organized as follows: the next section will discuss the literature review followed by the research method. Then the results are discussed and the paper concludes.

Literature review

The Code is at the heart of the Malaysian corporate governance framework (Zarinah and Kar, 2003). There were legal provisions and regulatory requirements already in place before the Code was launched (Koh, 2002). These include the Companies Act 1965, The Securities Industries Act 1983, the Financial Reporting Act 1997 and the Bursa Malaysia's (BM) Listing Rules. The provisions in these laws and regulations deal with the duties and obligations of directors, company officers and controlling shareholders to address the issues of good governance and reduce conflict of interests at the expense of stakeholders of the company. However the Code is at the most micro level because it identifies the oversight activities to be undertaken by directors and the control environment that should emerge in a corporation if these activities are in compliance with the spirit of the Code. The Code is not legally binding but the intent is that directors explain in their annual reports how the principles of good governance have been complied with or else "explain" why not. The oversight mechanisms take the form of board sub-committees of audit committee, remuneration committee and nomination committee. The external auditors represent the external monitoring mechanism and are recognized in the Code as the focus of the activities of one of the sub-committees, the audit committee. The best practice guide in the Code prescribes, *inter alia,* that the audit committee is responsible for the appointment, dismissal and resignation of auditors, the audit fee to be paid, discussion of the nature of the audit work to be performed and the resultant findings of the auditors, notably problems and reservations arising from the interim and final audits. By bringing the audit completely within the jurisdiction of the audit committee, the best practice guide on accountability and audit recognizes the importance of the relationship between audit committees and the external audit. Collier and Gregory (1996) have shown that higher audit fees are incurred for corporations with audit committees because more meetings are required between audit committees and external auditors and audit committees may require more audit work to be performed to justify their own monitoring role. However, the study was carried out in the United Kingdom when audit committees were not compulsory, in contrast to Malaysia, where audit committees have been mandatory since 1994. In addition to audit committees, the Code expects greater independence of the board in terms of the composition of non-executives to executive directors as well as the separation of the role of the Chief Executive Director from the Chairman. These changes produce board characteristics of company governance that makes the environment in which financial statements are produced as better able to detect and control misstatements from being included in financial statements. The Code identifies three related parties in governance: directors, shareholders and auditors. It exhorts the external auditors to independently report to shareholders in accordance with statutory and professional requirements and independently assure the board of directors on the discharge of their responsibilities regarding financial reporting and internal control. By discharging its duty, the auditors help ensure that stakeholders receive good quality financial reports (free from material misstatements) as financial reports are used by investors and other stakeholders for making decisions (Anderson *et al.,* 2004; Bushman and Smith, 2001). The main link between the board and the external auditors is the financial reporting process and the resultant financial reports, which then become the subject of audit. Since the Code expects better quality board oversight over financial reporting, board characteristics of greater independence, greater expertise and greater diligence may affect the amount of work performed by the external auditors as compared to the time period before the Code was enforced. Past studies have shown that director independence, diligence and expertise are key ingredients necessary for boards to effectively discharge their monitoring function effectively (Conger, Finegold and Lawler, 1998). Moreover audit committees can also help reduce the likelihood of misstatements arising from fraud or error (Beasley, 1996; Dechow *et al*. 1996; McMullan, 1996).

The Report of the Auditors

The auditors' attestation on the financial statements is documented in the Auditors' Report, which must accompany the financial statements sent to shareholders. The auditors' conclusion on the statements audited is in the form of an opinion. The opinion rendered on the accounts audited represents the culmination of the audit evidence accumulation process of several stages. At each stage evidence is aggregated and evaluated as to its adequacy and reliability to support assertions made by management (Blokdijk *et al.,* 2002). The auditors also state how the audit was planned and performed to achieve a reasonable level of assurance that the financial statements are free of material misstatements based on the evidence accumulated. The audit evidence accumulated is based on what auditors consider as nature, extent and timing of audit procedures. The planned level of assurance sought and the extent of

tests performed represent the effort expended by auditors to achieve the audit objective. To perform the evidence accumulation process from planning to testing and conclusion involves effort expended in the form of resources of audit personnel and time. The audit effort is also evidence of the auditors' reactions to client characteristics indicating the level of risk that financial statements may contain material misstatements. In this regard, the auditors play a critical role as they form a vital part of the checks and balances required for an effective governance structure. An understanding of the type of corporate governance in place is likely to help auditors assess various client risks and hence plan a more effective and efficient audit. The risks will indicate the probable source of misstatements and it is the identification of such sources that will determine where the audit effort should be focused.

Except for the literature on audit committees, the interest in audit in corporate governance is fairly recent (Goodwin and Seow, 2002). There is also little professional guidance on how auditors should consider corporate governance when formulating an audit strategy. In a good corporate governance environment, it is envisaged that a good monitoring system is in place and audit committees take responsibility for internal control and good financial reporting. A good internal control environment enables the external auditor to place reliance on it and subsequently reduces the extent of audit effort in performing substantive tests. A more accountable board, which is independent, expert and diligent, will set the tone at the top of the internal control environment. Such a control environment may indicate to the auditors a potential improvement in the financial reporting process. Hence a new tone of internal control could lead auditors to alter the amount of audit effort required to accumulate evidence and as a result the audit fees charged may also change. Empirical evidence shows that auditors do assess internal control risks and the outcome of such evaluation will in turn determine how much substantive work needs to be done subsequently (O'Keefe *et al*., 1994; Blokdijk *et al*., 2002).

Earlier studies on audit effort have not added the context of corporate governance as a package of variables in deciding whether to do more audit tests or not subsequent to the evaluation of internal controls (Blokdjik *et al.* 2002; Krishnamoorthy *et al.*, 1999; Davidson and Gist, 1996; O'Keefe *et al.*, 1994). The dependence of the nature, extent and timing of substantive audit procedures on the auditor's assessment of the client's internal control risk is a basic principle of auditing. An earlier study by O'Keefe *et al.* (1994), however, did not find any effect of internal control reliance on extent of audit effort because the authors attribute this to the one type of industry studied namely, the manufacturing and trade grouping.

In Malaysia, companies may view the Code as another form of compliance required by the regulatory authorities so whether there is any serious buy-in by management to introduce good corporate governance culture is an empirical issue. In this regard the number of resources committed by the auditor and hence the audit fees, in performing the audit, may depend on the auditors' assessment of the quality of the client's corporate governance structures. O'Sullivan and Diacon (1994) consider that auditors are uniquely placed to assess the quality of corporate governance in a company and the auditor's assessment is reflected in the audit fees charged. However, there are only some limited studies on audit and corporate governance in Malaysia (Mohd. 'Atef and Ayoib, 2002, Ayoib and Rezgalla, 2004). These studies have shown that choice of auditors and audit fees are related to some governance characteristics posited as best practice in the Code. Since the Code describes principles which are to be applied by corporations in a manner appropriate to the particular organization, and the listing requirements mandate a disclosure of how such principles have been applied, it is expected, therefore, that different firms will have different ways of applying the principles but the end results should be compliance with the principles enshrined in the Code. Together, the two modes of compliance will ensure the desired governance culture to be inculcated among Malaysian listed corporations.

Given that the Code has just been introduced and enforced via the Listing Requirements of Bursa Malaysia (BM) effective 2001, the requirement to comply with the Code's best practice adds a new dimension to the audit risk assessment. The impact of compliance with the Code's best practices on external audit effort has not been empirically examined. There is also little professional guidance as to how auditors should consider corporate governance when formulating an appropriate audit strategy. Research has shown that weaknesses in governance structures are often associated with lower financial reporting quality, earnings manipulation and even financial statement fraud (Dechow *et. al*, 1996; Beasley 1996; Beasley *et. al*, 2000). The effectiveness of a sub-committee of the board, the audit committee, in particular, has been identified as a critical factor in determining audit effort. Further, Krishnan (2001) documents an association between the quality of corporate governance structure of board composition and board sub-committee composition and the incidence of internal control problems. The quality of corporate governance structure may affect auditors' assessment of risk of misstatements. In addition, with the acceptance of risk- based auditing standard ISA 400 issued in 1998 and as big audit firms move towards an audit strategy that focuses on business process and business risk (Bell *et al.,* 1997), corporate governance could also affect audit program planning and allocation of staff on an audit job. Therefore audit

effort may change as a result of governance initiatives implemented by audit clients. Understanding the characteristics of corporate governance in place can, therefore, help auditors plan a more effective and efficient audit thereby improving the quality of audit. Increased risk could lead the audit firm to assign more experienced personal staff to the engagement (Asare *et al*. 2002). In the literature, only Cohen and Hanno (2000) report on the effect of corporate governance factors on the audit process. How governance affects auditor assessment of audit risk and if so which aspect of governance therefore warrants further study. This study contributes to the literature on audit risk and corporate governance and provides empirical evidence as to whether the external audit scope and role has been affected after the Code was implemented.

The external auditors are bound by the requirements of the profession to perform the audit in accordance with approved auditing standards. AI 400 "Risk assessment and internal control" issued by MIA requires the auditor to understand the accounting and internal control systems of clients so that the auditor can plan how to go about accumulating audit evidence in an effective and efficient manner. Three types of audit risk are identified in the standard: inherent, control and detection risks. Inherent risk is the risk of misstatement taking place assuming there were no related internal controls. Control risk is the risk of misstatement as a result of a weak internal control system. Detection risk is the risk that the auditors' work failed to detect material misstatements resulting in the issuance of an inappropriate opinion. The standard requires that auditors must first assess the level of inherent and control risk of their clients as a basis for setting the extent of substantive tests. Only after assessing the level of the inherent and control risks will the auditor determine the extent of substantive tests to be performed in order to achieve a reasonable level of audit assurance. Therefore the higher the inherent and control risks, the more work and effort have to be expended to arrive at a reasonable audit assurance level and the higher the audit fees. Studies by Cohen and Kida (1989), Krishnamoorthy *et. al* (1999) and Davidson and Gist (1996) have shown that auditors are sensitive to control system reliability in planning the extent of audit tests. Under corporate governance the additional monitoring in the form of independent and financially literate audit committees could enhance the internal control environment and better internal control could lead the auditor to perform less work substantively.

The control environment spans the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance to the company. A strong control environment will encompass functions of boards and directors and board committees, management's philosophy and style and the entity's organizational structure. Second, internal control relates to segregation of duties, documentation and authorization. By understanding the internal control systems the auditor will be able to identify where material misstatement s are likely to occur, consider the factors that affect the risk of misstatements and henceforth design the appropriate audit procedures. Part of the assessment of inherent risk relates to quality of management, in particular their expertise, experience and integrity. Paragraph 12 details many factors affecting the control environment such as experience, knowledge of management, capital structure and the existence of related parties. This becomes the basis for the audit plan. In a study by Blokdijk *et al.* (2002) on what determines the mix of audit procedures selected by auditors, it was reported that the level of substantive testing reduced when the quality of internal controls was assessed as good. This is in line with Paragraph 47 of the standard, which explains that higher control risk because of weak internal controls will lead the auditor to perform more substantive tests.

Auditing standard Al 240 on Fraud Assessment also iterates the importance of assessing management integrity. Furthermore AT5 on Guidance for Auditors on the Review of Directors Statement on Internal Control requires the auditor to review the said statement in connection with Para 15.24 of Bursa Malaysia Listing Requirements (BMLR) to assess whether it reflects the process directors have adopted in reviewing the adequacy and integrity of the system of internal control.

From the standards issued and described above it can be ascertained that the external auditors' sphere of judgment should include assessing the quality of the board of directors as part of the internal control assessment process. The standards place in the authoritative literature the implied assertion that corporate governance characteristics, in particular, board composition and board characteristics, are expected to have a significant relation to the quality of financial statements over which the auditors are going to attest. Since it is the financial statements and the financial reporting process that have been the domain of the external audit work, corporate governance characteristics have now become of direct concern to the auditors and form a new audit risk dimension in the overall audit risk model. If the requirement of the standard is implemented, then audit effort should reflect the auditors' response to governance environment of the client

The auditing profession has moved in tandem by revising the auditing standards, which in total significantly increase the responsibility of auditors. One such standard is ED /ISA 260: Communications of Audit Matters with Those Charged with Governance. Effective 1.1.2003 this standard specifically addresses the implications for audit when conducted in a corporate governance environment. It

defines what audit matters of governance interest are. Para 2 exhorts auditors to communicate audit matters of governance interest arising from the audit of financial statements to those charged with governance of an entity, Para 5 states that auditors should determine who are the relevant persons charged with governance and Para 11 identifies audit matters deemed of governance interest. However, Para 12 does caution the auditor that the audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. Hence the standard indirectly shows that a substantial portion of the audit of financial statements is interlinked with corporate governance. This new standard, therefore, extends the boundary of the statutory audit in relation to scope as well as reporting responsibilities beyond that specified in the Companies Act 1965. In extending the boundary of audit it is expected therefore that more audit will have to be performed and as such audit fees may increase.

Para 11 identifies eleven matters specifically related to the audit of financial statements. In essence the eleven factors singly or in combination could pose a potential source of misstatement. The standard focuses on accounting policies and its appropriateness, sources of risks, going concern uncertainties, internal control weaknesses and disagreements with management. Most of these matters have been addressed separately in other auditing standards but are presented together in this new standard because the standard anticipates that governance structures would be in place in audited organizations to which auditors can address governance issues. In accordance with the Code, all listed companies should have in place a governance structure which enables the Board of Directors to exercise objective judgment on corporate affairs, including financial reporting , independent in particular from management. The responsibility for oversight of financial reporting, external auditing and internal control lies with the audit committee. Hence an effective audit committee would put in place a strong internal control environment which ensures the integrity of a company's financial statements as a good control environment will be able to detect and prevent material misstatements from being reported in a company's financial statements. This is clearly spelt out in the Code.

Koh (2002) identifies the legal, regulatory and reporting framework which impinges on how companies operate in Malaysia as the pillars of the Malaysian corporate governance framework These requirements encompass the Companies Act 1965, the Securities Industries Act 1983, the Securities Commission Act 1993, the Malaysian Code on Takeovers and Mergers 1987, the BM Listing Requirements and Practice Notes, Guidelines on the Regulation of Acquisition of Assets, Mergers and Takeovers, the Financial Reporting Act 1997 and the Code of Corporate Governance 2001. These requirements appear as layers of forces that direct, shape and maintain standards of good corporate behavior. The Code is at the heart of the governance framework and in February 2001 Bursa Malaysia (BM) issued Practice Note 9/2001 explaining the contents of the Corporate Governance Statement, which must be included in a company's annual report. This statement must explain how the Principles in the Code have been applied and show the extent of compliance as detailed in the Best Practice section of the Code. The Corporate Governance Statement must be included in the annual report for financial year beginning July 1 2001. Clearly reforms in corporate governance are regulatory in nature.

From the above discussion, assessment of audit risk may be affected by the corporate governance structure, specifically that of the audit committee, of the corporation being audited. A strong monitoring function would provide greater assurance that controls are operating effectively which should reduce the assessed control risk as a more accountable board and effective audit committee can be a proxy for internal control strength (Collier and Gregory, 1996). There is also potential for a more efficient audit (less extent of tests of details) and more effective (greater assurance of the integrity of financial statements) audit (Goodwin and Seow, 2002). The auditor must therefore recognize and assess the strength of corporate governance and then use this as an input to the audit plans. Ultimately the planned extent, nature and timing of audit tests will affect the evidence accumulated and thus, the quality of the audit. The above changes to corporate governance framework also imply that change will be spread over a time frame. With more reporting standards being adopted, more frequent reporting and greater disclosures may increase the scope of the audit as well. This will lead to more audit effort being expended.

Goodwin and Seow (2002) examined the perception of directors and external auditors concerning the effect of certain corporate governance mechanism on financial reporting and audit quality in Singapore. Directors and auditors are seen to have considerable influence over the accountability of management and the integrity of financial management. In their study, directors are directly responsible for setting the tone at the top whilst auditors through their interaction with audit committees and client management are able to influence the quality of internal control and integrity of financial reporting. Both groups of directors and auditors participated in an experiment using two hypothetical cases and they perceived that the existence of internal audit and strict enforcement of code for directors had a significant impact on the company's ability to strengthen control, prevent and detect material misstatement and frauds. The results on the strength of the audit committee were mixed. A

strong audit committee was found to have a significant impact on audit effectiveness, on errors in financial statements and on the detection of management fraud. However it was not significant in relation to fraud prevention or strength of internal control.

Cohen and Hanno (2000) was the first study to focus on auditors' consideration of corporate governance and management control philosophy in preplanning and planning judgments. Like Goodwin and Seow's study, the authors used the experiment method of data collection. The study involved 96 auditors' responses to a fictitious case. The results suggest that auditors are more likely to reduce substantive tests in the presence of strong corporate governance. The study finds that companies with independent board of directors and having an audit committee were perceived by auditors to have lower audit risk and therefore will require less audit effort.

In an earlier study Hanno and Aggolia (1999) found that management and governance characteristics were considered by auditors to be the most important factors in the evaluation of the control environment. If the auditor seeks to reduce substantive testing, the level of control risk must be assessed, thus requiring the auditor to explicitly evaluate management and board characteristics. Cohen *et al.* (2002) conducted a semi-structured interview with 36 auditors on current audit practices in considering corporate governance in the audit process. The findings suggest that consideration of governance factors can affect the auditors' assessment of inherent and control risks levels, thereby affecting the nature and extent of audit testing, the audit effort. If the corporate governance quality is good, the auditors may subsequently reduce sample size and thus reduce the extent of costly substantive testing. When evaluating the strength of corporate governance, auditors looked at credibility of management and board characteristics as important determinants of the control environment.

O'Sullivan (2000) argues that in a good corporate governance environment, there is greater independent representation on boards of companies. Independent directors require more monitoring to demonstrate their commitment to shareholders and this drives the auditor to do more work. Independent directors will also enhance the auditors' independence because these directors will ensure that management does not restrict the work of the auditors and therefore the auditors are free to set the scope of their examination. De Angelo (1981) defines audit quality as the twin dimensions of the auditor's ability to detect material misstatements and having detected the misstatements, to be willing to report such misstatements. When auditors are free to set the scope of the audit, this increases the chance of detecting material misstatements, which therefore enhances the audit quality. In addition the study also included share ownership of independent directors as an additional measure of governance. Based on data of 402 UK companies, the study found that audit fees are negatively related to the proportion of equity owned by non-executive directors and that CEO/Chairman duality has a significant impact on audit fees.

Prior studies measure attributes of good governance in several ways: using board characteristics of size, composition in terms of proportion of independent directors on the board, share ownership pattern, CEO duality, multiple directorships and financial or accounting knowledge and diligence of audit committee members. All these characteristics are similar to those described in the Code to achieve board effectiveness. With the exception of Carcello's (2002) and Abbot et al (2003) s' study, the rest only measured the existence or otherwise of audit committees as another governance variable. Both empirical evidence and prescriptive literature concur that corporate governance characteristics set the tone at the top for internal control for audit clients. These characteristics provide cues to auditors as to the reliability of the internal control system in place in an organization. The auditor's assessment of the corporate governance characteristics will determine the amount of evidence to be accumulated to achieve the planned level of assurance and thus the quality of audit. Hence if listed corporations put in place the principles of good governance, greater accountability is achieved, leading to better internal control environment and therefore less audit risk and less audit fees.

Based on the literature above, the research questions are:

What aspects of corporate governance do auditors think of when they are asked about corporate governance? How do auditors incorporate corporate governance in the planning and conduct of audit? How does it vary across different engagements? How important is audit committee?

Results and discussion

Research question 1: What aspects of corporate governance do auditors think of when they are asked about corporate governance?

In response to this question, all partners agree that the structure, in particular, the lines of authority and functions are at the heart of governance and this is where auditors focus their risk and plan. Highest level of authority in particular, the aspects relating to the financial reporting process sets the tone at the top. "Many times we consider the qualifications and character of the audit committee chairman as very important". Despite the Code's Best Practice guide which requires non-executive directors to be a majority of audit committee members, most listed companies are relatively homogenous in structure in complying with the form of audit committee independence. Hence a discriminating factor is

therefore the personality of the audit committee chairman.

Research question 2: How do auditors incorporate corporate governance in the planning and conduct of audit?

Assessment in the initial stages is made using a checklist drawn up based on the Code. Where the initial risk assessment indicates poor governance audit response is to require greater sample size and thus increase the scope of audit work subsequently to reflect greater skepticism. Corporate governance is explicitly considered throughout the audit but for different purposes. At the beginning of the audit partners say it is important to assess engagement risk of accepting client in the first place. Partners agree that assessment is made throughout the audit.

"We certainly constantly review throughout the audit and a revisit is made at the final stage of the audit."

Research question 3: How does it vary across different engagements?

Partners comment that different engagements have different governance strength. However, an important factor acknowledged is that certain more regulated industry requires a greater emphasis on good governance as part of audit risk assessment especially public listed companies under the purview of Bank Negara.

Research question 4: How important is audit committee?

Partners feel that it depends on who sits on it. In the early years "they allow the CEO to respond now audit committees are more conscious of their duties". Partners are of the view that it depends on the approach/stance taken by audit committee.. A good independent audit committee is an important pillar, supported by executive committee. The most important factor is the CEO.

Some partners consider audit committees very important saying that the power and personality of chairman sets the tone. To be effective, partners feel that audit committee must think of interest of minority shareholders as well.

Research question 5: Has corporate governance made any significant impact on audit process?

Almost all partners said yes. On the positive side it helps mitigate risk exposure of auditors and indirectly helps auditors to do a more effective audit. Corporate governance is seen as the cornerstone and is most important and a significant input in the audit process. There is now more communication and dialogue with directors.

A dissenting voice feels that the level of corporate governance in Malaysia is still low as middle management is still not conscious of the importance of corporate governance.

Conclusion

This paper reports on how Malaysian auditors perceive the impact of governance on the audit process of listed Malaysian companies. Based on interviews with audit partners the study finds that corporate governance assessment is incorporated very early in the process of accumulating audit evidence, when partners assess the risk of accepting a particular client. The audit risk model is versatile enough to enable auditors to incorporate assessment of governance throughout the audit. The audit committee may be the single most important aspect of internal control provided it has the characteristics of independence and competence. Partners agree that corporate governance has an impact on the efficiency and effectiveness of audit more so for highly regulated sectors of finance and insurance. Future studies may consider examining how auditors interact with audit committees and make judgements as to whether audit committees contribute to reducing audit risk.

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FIRM SIZE, CORPORATE LEVERAGE AND CORPORATE DIVIDEND: EVIDENCE FROM KOREAN BANKING INDUSTRY

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Abstract

This paper examines how the dividend policy of banks is associated with the level of safety of the banks. As the proxy for the safety of the bank, we employ the asset size and leverage measures. Considering that the explicit protection system of deposit insurance backing up the banking industry is prevailing and implicit forbearance policy practiced by the banking regulators generally would not allow the failure of especially large banks, the banks with larger asset size, other things being equal, would be considered safer than smaller banks. Also, following the implications of finance literature, higher leverage is believed to represent higher riskiness and the firms in higher leverage positions would have greater risk-taking incentives to maximize potential upward gains from high profit. From the panel data of Korean banks during 1994-2005, we find that the banks in a safer position significantly pay more dividends. That is, the banks with larger asset size and lower leverage tend to pay more dividends. In the tests employing partitioned samples and interaction variables for risk characteristics, we find more transparent and consistent results.

Keywords: Leverage, Asset size, Dividend policy, Banking industry, Bank risk

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I. Introduction

Dividend policy determines the allocation of the firm's cash flows between the funds that are flown to investors as the reward for their investment and the funds that are retained by the firm for future investment. This decision affects firm value, and therefore, optimal dividend policy should be made to maximize the firm value. Dividend can also provide valuable information to the investors in capital market regarding the firm's past and future expected performance. This mechanism is referred to as a signaling effect of dividend policy. The signaling effect gives the managers the pressure that they are under the supervision of capital market, and therefore, they have to pay optimal amount of dividend to investors. The effectiveness of dividend policy on firm value has been examined by many researchers. Many of these were interested in identifying the factors affecting the dividend policy of firms. Rozeff (1981) finds that dividend payout ratio is negatively related to all the factors such as the growth rate of sales, insider ownership, and the beta of the firm. Crutchley and Hansen (1989) find that the dividend payout ratio is positively related to the size of the firm and the risk of the firm's operation, but negatively related to the cost of capital. Jensen, Solberg and Zorn (1992) find that the dividend payout ratio is positively related to the level of profit, but negatively related to the level of insider ownership, the growth rate of the firm, and the level of investment.

This paper continues the previous line of research by employing the data on a very special type of industry, and tries to add additional evidences and investment strategies regarding dividend policy to the previous researches that examined mostly non-financial firms. This paper employs the data on Korean banking industry, and examines how the dividend policy of Korean banks is associated with the banks' asset size and level of leverage. Considering that the explicit protection system of deposit insurance backing up the banking industry is prevailing and implicit forbearance policy practiced by the banking regulators generally would not allow the failure of especially large banks, the banks with larger asset size, other things being equal, would be considered safer than smaller banks. Also, following the implications of finance literature, higher leverage is believed to represent higher riskiness and the firms in higher leverage positions would have greater risk-taking incentives to maximize potential upward gains from high profit. From the panel data of Korean banks during 1994-2005, we find that the banks with larger asset size and lower leverage pay significantly more

dividends. In the tests employing partitioned samples and interaction variables for risk characteristics, we find more transparent and consistent results.

II. Sample and Data

The sample for this paper consists of all the commercial banks in Korea from 1994 to 2005: 24 banks in 1994, 25 banks in 1995 and 1996, 26 banks in 1997, 20 banks in 1998, 17 banks in 1999 and 2000, 15 banks in 2001, and 14 banks from 2002 to 2005. Over the period 1994-2005, for each bank, we collect the data such as total asset, equity capital, fixed asset, dividend payout ratio, nonperforming loans and return on asset. These variables are obtained from the Statistics of Bank Management for each year published by the Korean Financial Supervisory Service.

III. Testable Hypotheses and Testing Models

To examine how the dividend policy of the banks is related to the bank's level of leverage and asset size, we estimate the following pooled time-series/cross-sectional regression equation over the period 1994-2005.

$$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage})_{i,t} + \beta_2(\text{Operational leverage})_{i,t} + \beta_3(\text{Log of asset size})_{i,t} + \varepsilon_{i,t} \quad \text{-----(1)}$$

In the estimation equation for the bank's dividend policy, we employ two leverage measures; financial leverage and operational leverage, and asset size as the explanatory variables. Financial leverage is measured by the bank's ratio of equity capital to total asset. Operational leverage is measured by the ratio of fixed asset to total asset. As mentioned above, higher leverage is believed to represent higher riskiness and the firms in higher leverage positions would have greater risk-taking incentives to maximize potential upward gains from high profit t: The higher the financial leverage (or, the lower the ratio of the equity capital to total asset), the riskier the firm is and the greater risk-taking incentives the firm has, because of both leverage effect and the moral-hazard-incentives of stockholder associated with limited liability. The firm with a lower financial leverage or higher capital ratio has obviously a lower possibility of bankruptcy when the firm's asset value declines. Furthermore, limited liability gives the firm's stockholders more incentives to expropriate wealth from creditors by increasing risk to maximize the potential upward gains. Operational leverage is agreed to act in an analogous fashion to financial leverage in increasing firm risk. To better capture the above implication that higher leverage represents higher risk, financial leverage is measured by the negative value of the capital ratio. So, the higher the financial leverage, the lower the capital ratio, which represents higher risk. Also, the higher the operational leverage, the higher the ratio of fixed assets to total assets, which represents higher risk. Other things being equal, we could hypothesize that the safer banks in terms of financial, operational conditions and asset size would be able to pay more dividends. Then, the sign of the coefficient β_1 and β_2 would be negative, and β_3 would be positive in equation (1).

IV. Empirical Results for Regression Analysis

IV-1. Correlation Test

Table 1 presents the Pearson correlations among the variables of the banks. It is shown that the dividend payout ratio is negatively correlated with both financial leverage and operational leverage. Also, it is positively correlated with asset size. These results are consistent with our expectations that the banks with safer characteristics would pay more dividends. The two leverage measures are positively correlated. It is shown in the table that the multicollinearity problem does not appear to exist in the regression estimation that uses these variables as independent variables.

-Insert Table 1 approximately here-

IV-2. Regression tests: Full Sample and Partitioned Sample

Table 2 shows the regression results for estimating the equation (1). It is shown that the coefficient on the financial leverage is significantly negative, and the coefficient on the asset size is significantly positive. Therefore, the safer banks such as with lower financial leverage and larger asset size tend to pay more dividends. The coefficient on the operational leverage is also negative, however, it is not statistically significant.

-Insert Table 2 approximately here-

To further examine the relationship between the level of leverage, asset size and dividend policy of the banks, we partition the full sample into two groups for each risk characteristic variable; higher financial leverage group vs lower financial leverage group, higher operational leverage group vs lower operational leverage group, and larger asset size group vs smaller asset size group. Firstly, in table 3, we partition the full sample into the two groups at the median value for financial leverage; higher financial leverage group and lower financial leverage group. Each year, the bank with lower financial leverage (those whose capital ratio is higher than the median for that year) takes the value of 1 and 0 otherwise.

Then, we multiply that dummy variable to each of the three independent variables, and estimate the following regression equation.

$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage})_{i,t} + \beta_2 D\times(\text{Financial leverage})_{i,t} + \beta_3 (\text{Operational leverage})_{i,t} + \beta_4 D\times(\text{Operational leverage})_{i,t} + \beta_5(\text{Log Asset size})_{i,t} + \beta_6 D\times(\text{Log Asset size})_{i,t} + \varepsilon_{i,t}$

Therefore, the coefficient on the dummy interaction variable (β_2, β_4, and β_6) indicates how the relationship between each independent variable and dividend payout ratio for the group of bans with lower financial leverage is different from the group of banks with higher financial leverage. The results are presented in table 3. It is shown that the coefficient on D×(Operational leverage) is significantly negative, indicating that the tendency of the banks with lower operational leverage to pay more dividends is more clearly observed in the group of the banks with lower financial leverage or higher capital ratio.

-Insert Table 3 approximately here-

Similar partition is made in table 4 with respect to operational leverage. The bank with lower operational leverage (lower ratio of fixed asset) is assigned the value of 1 and 0 otherwise. Then the dummy variable is multiplied to each of the three independent variables. The estimation results are presented in table 4. It is shown that the coefficient on D×(Operational leverage) is significantly negative, and that on D×(Log Asset size) is significantly positive, indicating that the tendency of the banks with lower operational leverage and larger asset size to pay more dividends is more clearly observed in the group of the banks with lower operational leverage.

-Insert Table 4 approximately here-

Table 5 presents the results for the test where the dummy variable for larger asset size is multiplied to each independent variable. The coefficient on D×(Financial leverage) and D×(Log Asset size) is negative and positive, respectively, at the significant level of about 15 percent.

-Insert Table 5 approximately here-

Overall, the above results in table 2-5 show that the lower the level of financial and operational leverage and the larger the asset size, the greater the dividend payout ratio the bank has. These results are more clearly confirmed in the partitioned sample tests.

IV-3. Further Tests

We presume that one of the most convincing reasons for the banks with lower leverage and larger asset size to pay more dividends is that the banks with these characteristics are safer. To examine this hypothesis further, we run the regression for dividend payout ratio against the interaction variables between the three explanatory variables and the more transparent proxy variable for the safety of the bank. Firstly, the safety of the bank is measured by the ratio of nonperforming loans to total asset, and we estimate the following regression equation.

$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage} \times \text{Nonperforming loans})_{i,t} + \beta_2(\text{Operational leverage} \times \text{Nonperforming loans})_{i,t} + \beta_3 (\text{Log Asset size} \times \text{Nonperforming loans})_{i,t} + \varepsilon_{i,t}$

The results are shown in table 6. The coefficient on (Log Asset size× Nonperforming loans) is significantly negative. This result is believed to confirm our presumption. The significantly negative coefficient on the interaction variable indicates that the larger the asset size and the lower the nonperforming loans (and therefore, the lower the interaction variable of these two), the greater the dividend payout ratio the bank has.

-Insert Table 6 approximately here-

In table 7, we run one more regression employing another proxy for the safety of the bank, return on asset. It is shown that the coefficient on (Log Asset size× ROA) is significantly positive, indicating that the larger and the safer (greater ROA), the greater the dividend payout ratio the bank has. This result confirms our presumption, too. We find another consistent result from the coefficient of interaction variable between financial leverage and ROA. The coefficient is negative as expected, which is significant at the significant level of 10.6 percent.

V. Concluding Comments

This paper examines how the dividend policy of banks is associated with the level of safety of the banks. As the proxy for the safety of the bank, we employ the asset size and leverage measures. Considering that the explicit protection system of deposit insurance backing up the banking industry is prevailing and implicit forbearance policy practiced by the banking regulators generally would not allow the failure of especially large banks, the banks with larger asset size, other things being equal, would be considered safer than smaller banks. Also, following the implications of finance literature, higher leverage is believed to represent higher riskiness and the firms in higher leverage positions would have greater risk-taking incentives to maximize potential upward gains from high profit. From the panel data of Korean banks during 1994-2005, we find that the banks in a safer position significantly pay more dividends. That is, the banks with larger asset size and lower leverage tend to

pay more dividends. In the tests employing partitioned samples and interaction variables for risk characteristics, we find more transparent and consistent results.

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Table 1. Correlations

This table shows the Pearson correlations among the risk-characteristic variables for the sample banks. The first number is the correlation for the pre-reform period (1994-1997); the second in the correlation for the post-reform period (1998-2005). One, two, or three asterisks indicate statistical significance at the 10, 5, or 1% significance level, respectively.

	Payout ratio	Financial leverage	Operational leverage	Asset size
Payout ratio	1	-0.2512***	-0.0939	0.0669*
Financial leverage		1	0.1986*	0.0937
Operational leverage			1	-0.0041
Asset size				1

Table 2. Regression results

$$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage})_{i,t} + \beta_2(\text{Operational leverage})_{i,t} + \beta_3(\text{Log Asset size})_{i,t} + \varepsilon_{i,t}$$

This table shows the panel regression results. One, two, or three asterisks indicate statistical significance at the 10, 5, or 1% significance level, respectively.

	Coefficient	t-value	p-value
Constant	-5.5939**	-2.05	0.0413
Financial leverage	-50.1436***	-4.21	3.95×10^{-5}
Operational leverage	-0.0009	-0.68	0.4956
Log Asset size	1.1198**	2.34	0.0203
Adjusted R^2	0.08		
Number of observations	225		
Standard error of regression	3.6875		
F-statistic	7.08***		

Table 3. Regression results

$$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage})_{i,t} + \beta_2 D\times(\text{Financial leverage})_{i,t} + \beta_3(\text{Operational leverage})_{i,t} + \beta_4 D\times(\text{Operational leverage})_{i,t} + \beta_5(\text{Log Asset size})_{i,t} + \beta_6 D\times(\text{Log Asset size})_{i,t} + \varepsilon_{i,t}$$

This table shows the panel regression results. One, two, or three asterisks indicate statistical significance at the 10, 5, or 1% significance level, respectively. D=1 if the bank belongs to lower financial leverage group, and 0 otherwise.

	Coefficient	t-value	p-value
Constant	-2.1615	-0.82	0.4096
Financial leverage	-35.5535	-1.55	0.1223
D × Financial leverage	3.5353	0.12	0.9045
Operational leverage	-0.0007	-0.51	0.6093
D × Operational leverage	-0.0431***	-2.62	0.0093
Log Asset size	2.6240	1.01	0.3151
D × Log Asset size	0.4237	1.39	0.1642
Adjusted R^2	0.1		
Number of observations	225		
Standard error of regression	3.6477		
F-statistic	4.92***		

Table 4. Regression results

$$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage})_{i,t} + \beta_2 D\times(\text{Financial leverage})_{i,t} + \beta_3(\text{Operational leverage})_{i,t} + \beta_4 D\times(\text{Operational leverage})_{i,t} + \beta_5(\text{Log Asset size})_{i,t} + \beta_6 D\times(\text{Log Asset size})_{i,t} + \varepsilon_{i,t}$$

This table shows the panel regression results. One, two, or three asterisks indicate statistical significance at the 10, 5, or 1% significance level, respectively. D=1 if the bank belongs to lower operational leverage group, and 0 otherwise.

	Coefficient	t-value	p-value
Constant	-7.2653**	-2.35	0.0194
Financial leverage	-77.5338***	-4.12	5.2×10^{-5}
D × Financial leverage	33.0679	1.51	0.1303
Operational leverage	0.0001	0.07	0.9408
D × Operational leverage	-0.0356**	-1.93	0.0544
Log Asset size	1.1660**	2.06	0.0409
D × Log Asset size	0.4721**	2.16	0.0319
Adjusted R^2	0.09		
Number of observations	225		
Standard error of regression	3.6568		
F-statistic	4.71***		

Table 5. Regression results

$$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage})_{i,t} + \beta_2 D\times(\text{Financial leverage})_{i,t} + \beta_3(\text{Operational leverage})_{i,t} + \beta_4 D\times(\text{Operational leverage})_{i,t} + \beta_5(\text{Log Asset size})_{i,t} + \beta_6 D\times(\text{Log Asset size})_{i,t} + \varepsilon_{i,t}$$

This table shows the panel regression results. One, two, or three asterisks indicate statistical significance at the 10, 5, or 1% significance level, respectively. D=1 if the bank belongs to larger asset size group, and 0 otherwise.

	Coefficient	t-value	p-value
Constant	10.0157***	2.65	0.0085
Financial leverage	-37.9675***	-3.14	0.0018
D × Financial leverage	-41.8296	-1.41	0.1592
Operational leverage	-0.0087	-0.87	0.3821
D × Operational leverage	0.0082	0.81	0.4141
Log Asset size	-2.1114***	-2.79	0.0057
D × Log Asset size	0.3857	1.36	0.1721
Adjusted R^2	0.19		
Number of observations	225		
Standard error of regression	3.4551		
F-statistic	9.65***		

Table 6. Regression results

$$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage} \times \text{Nonperforming loans})_{i,t} + \beta_2(\text{Operational leverage} \times \text{Nonperforming loans})_{i,t} + \beta_3(\text{Log Asset size} \times \text{Nonperforming loans})_{i,t} + \varepsilon_{i,t}$$

This table shows the panel regression results. One, two, or three asterisks indicate statistical significance at the 10, 5, or 1% significance level, respectively.

	Coefficient	t-value	p-value
Constant	3.7324***	9.21	2.46×10^{-17}
Financial leverage × Nonperforming loans	-0.6428	-0.52	0.5973
Operational leverage × Nonperforming loans	3.78×10^{-5}	0.48	0.6308
Log Asset size × Nonperforming loans	-0.0554***	-4.31	2.43×10^{-5}
Adjusted R^2	0.07		
Number of observations	225		
Standard error of regression	3.6908		
F-statistic	6.93***		

Table 7. Regression results

$$(\text{Payout ratio})_{i,t} = \beta_0 + \beta_1(\text{Financial leverage} \times \text{ROA})_{i,t} + \beta_2(\text{Operational leverage} \times \text{ROA})_{i,t} + \beta_3(\text{Log Asset size} \times \text{ROA})_{i,t} + \varepsilon_{i,t}$$

This table shows the panel regression results. One, two, or three asterisks indicate statistical significance at the 10, 5, or 1% significance level, respectively.

	Coefficient	t-value	p-value
Constant	2.5781***	10.29	1.49×10^{-20}
Financial leverage × ROA	-5.3720	-1.62	0.1061
Operational leverage × ROA	-0.0001	-0.57	0.5640
Log Asset size × ROA	0.0983***	3.64	0.0003
Adjusted R^2	0.09		
Number of observations	225		
Standard error of regression	3.6562		
F-statistic	8.46***		

DISCLOSURE OF EXECUTIVE REMUNERATION IN LISTED PUBLIC UTILITY COMPANIES

Simona Franzoni*

Abstract

This paper aims to examine disclosure about listed companies' executive remuneration, investigating particularly the rules and recommendations adopted in industrialized countries (European countries: France; German; Italy; Spain; United Kingdom; and non-European countries: Canada; Japan; Russia; United States) and to verify if effective communication behaviours adopted in Italy and in foreign countries by listed public utility companies match cognitive and evaluation stakeholders' expectations and rules and existing specific recommendations. Disclosure of the remuneration is necessary to offer each stakeholder to understand if the amount of compensation paid and its composition is adequate to avoid potential excesses that could compromise the process of value generation by the enterprise. This is an important topic, considering also potential conflicts between form, structure and level of executive directors' remuneration (fixed and variable elements, stock options, total estimated value of non-cash benefits, remuneration paid to directors in connection with the termination of his activities during that financial year, etc.) and corporate performance optimization in the long term.

Keywords: Executive remuneration, Disclosure, Public utilities sector

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1. Introduction

Over the last years, the issue regarding the remuneration systems of executive board members has become increasingly relevant, especially, in the current national and international context, characterized by globalization of markets, financial scandals, frequent separation of the corporate ownership from the management and more exposed to information, so that to lead to a greater awareness about the implementation of evaluation processes.

The definition and implementation of corporate objectives need consistent interaction and communication between shareholders and directors. Nonetheless, directors, considering their mandate, can determine the evolution of the company.

Reconciliation of interests and adequate remuneration of the corporate governance boards are, therefore, relevant variables of corporate responsibility and accountability.

Adequate remuneration paid for the implemented business activity, on the basis of professional skills and performance, is the main source of consensus among corporate managers and requires that individual economic interests are satisfied in the respect of corporate cost-revenue balance.

A remuneration policy correctly formulated could, therefore, induce management behavor in the long-term to privilege a sustainable corporate development rather than short-term performance, which is relevant but featured by uncertain sustainability, and lead to a greater consensus and confidence in the corporate strategic projects, in particular, in its different implementation actions.

The remuneration system is not the only factor, but it definitely has a decisive impact, both on motivation to better performance and on the development of a performance-oriented culture based on the ability to attract and retain the best resources.

Remuneration systems concur in orienting behaviour and meeting the expectations of directors and managers and induce, as incentive, effectiveness implementation of governance systems to the end of value generation and sustainable development in the long term.

Meanwhile, the fact that remuneration systems influence corporate behaviour significantly implies some risks that could have important consequences on corporate effectiveness: executive directors, in order to reach their goals, could act favouring short term results by maximizing turnover and revenues, that is, behave in an opportunistic way in relation to stock option plans by manipulating shares' values.

In order to limit significantly the risk directors may expose companies to, by manipulating information at their own advantage, the existence of a disclosure system of remuneration, able to ensure the implementation of fair remuneration practices, is particularly important.

Top managers should display transparency as far as the disclosure of remuneration by specifying its entity and elements, so as to enable shareholders and other investors to control the destination of the value generated by the company.

Information transparency on remuneration systems should, therefore, facilitate the understanding of:

- the policies adopted to motivate executive directors, on which basis, a noteworthy part of remuneration might be correlated to the achievement of specific corporate or individual objectives, that is the criteria directors' remuneration systems are based on providing for a coherent relation between remuneration and specific objectives/parameters to achieve;
- the wealth generated by the corporate business and its allocation among who manage the company, to the end to check the effective costs and benefits obtained by performance, that is, the value of remuneration paid to executive directors and its effects on corporate economic results.

Remuneration transparency, as a key factor suitable to acquire consensus and confidence, is even more necessary in the current historical context, considering also the late scandals related both to the pursuit of individual interests by several directors and to reticent behaviour in corporate disclosure, in extreme situations where even legal boundaries have been overcome.

The effectiveness of disclosure of remuneration mechanisms is directly related to substantial, comprehensive, fair and exhaustive answers to the cognitive/assessing demands arising from different social players and to the predisposition to receive positively the messages coming from the environment.

The situation of insatisfaction at an international level, mentioned above, has led to the general consensus on the need of recovering the value of transparency in order to assign the necessary features of efficacy to communication, generally speaking, and in particular, to the disclosure of remuneration. Communication systems are actually a precondition to obtain resources for business development and to grant stakeholders acknowledgement and consensus in a global context where communications flows before every thing.

The necessity to prevent other phenomena, potentially prejudicial to the social welfare, is inducing national and international institutions to the introduction of direction rules towards efficacious behaviour by operators. The importance of the topic on remuneration and disclosure tools is also shown by several interventions by international organizations such as: OECD, ON, IOSCO etc. and European institutions, in particular, the EU intervened with Recommendation 2004/913/EC: "The disclosure of accurate and timely information by the issuers of securities builds sustained investor confidence and constitutes an important tool for promoting sound corporate governance throughout the Community. To that end, it is important that listed companies display appropriate transparency in dealings with investors, so as to enable them to express their views" (2004/913/CE, 3).

2. Theoretical framework

In listed companies, the disclosure of remuneration has recently attracted particular attention, especially with regard to remuneration of individual directors of the company, executive and non-executive or supervisory directors.

As regards communication and transparency on remuneration systems, the European Commission intervened with the Action Plan (COM 2003 – 284), in order to initiate a process of harmonisation of the regulatory provisions in the Member States about company law and corporate governance. In particular, as far as remuneration schemes, the Commission adopted in December 2004 Recommendation 2004/913/EC, to be implemented by the Member States by 30 June 2006, concerning the promotion of a regime aimed at regulating the remuneration system of directors and chief executive officers (in circumstances where they are not members of the administrative, managerial and supervisory bodies of a listed company), as a tool able to promote confidence of the public and to reinforce the culture of transparency in companies operating in stock markets.

Therefore, stakeholders, in order to have an effective opportunity to express their views and debate about remuneration policies on the basis of adequate information, "should be provided with a clear and comprehensive overview of the company's remuneration policy" (2004/913/EC). Such disclosure would enable shareholders to assess a company's approach to remuneration and strengthen a company's accountability to stakeholders. Adequate transparency should also be ensured in the policy regarding directors' contracts. This should include the disclosure of information on issues such as notice periods and termination payments under such contracts which are directly linked to directors' remuneration. Shareholders and stakeholders should also be provided with the information on the basis of which they can hold individual directors accountable for the remuneration they earn or have earned, and in particular, share-based remuneration. "Disclosure of the remuneration of individual directors of the company, executive and non-executive or supervisory directors, in the preceding financial year is therefore important to help them appreciate the remuneration in the light of the overall performance of the company" (2004/913/EC).

The research was based on the analysis of the

mandatory and voluntary regulations on disclosure of remuneration systems in the in the major industrial countries - G8 Countries whose remuneration and governance systems are presumed among the most developed in the European context (Canada, France, Germany, Japan, Italy, Russia, United Kingdom, United States) and Spain (considering its late economic growth) - on the purpose to assess the dominant trend in each of these countries and comparing the regulations and guidelines in force in non-European Countries with those adopted by the European Union.

The comparison was developed by setting appropriate framework, which items were defined considering the European Recommendation, and then, grouped under the following three subjects (which represent the three sections provided in the recommendation 2004 /913/EC): remuneration policies; remuneration of individual directors and share-based remuneration.

The analysis clearly shows that the United Kingdom is the European country with the widest range of regulations on directors' and top management' remuneration, substantially in line with the provisions of the European Recommendation. Even before the European recommendation, since 1995 with the Greenbury Code, based on the principle comply or explain, and later, through a specific law in 2002 "Directors' Remuneration Report Regulations" on the purpose to amend the Companies Act 1985, the United Kingdom had a set of rules aimed at promoting the disclosure of remuneration systems by listed companies, both as regards the policy of remuneration definition and total/individual remuneration of executive directors, non-executive directors and top managers.

Undoubtedly, the discrepancies found in the regulatory approaches reflect the different ownership structures: the problem of remuneration is, in fact, definitely more relevant within the systems where ownership is fragmentized.

However, the results also highlight that the differences, within the changed international scenario, are getting increasingly dwindled.

As regards the four non-European countries (Canada, Japan, Russia, United States), the research highlights, in the first place, a strong difference in the type of rules adopted concerning the disclosure of remuneration systems: on the one hand, a substantial and articulated regulation adopted by the Supervisory Exchange Commission of the United States and Canada (SEC and Canadian Securities Administrators), with particular attention to equity-based incentive plans; on the other, a definitely more limited regulation in force in the other two countries under examination, Japan and Russia. Regulations in the United States and Canada require that listed companies provide the market with detailed information on the remuneration of ex executive officers and directors, in tabular and descriptive form; on the contrary, the provisions in force in Japan and Russia require from listed companies summary information and do not provide for a model of reference on disclosure for companies to comply with.

In general, it seems possible to assert the existence of a common approach between the regulatory framework in the American countries and the contents of the European recommendation, but not in the provisions of the remaining countries (Japan, Russia).

From the analysis of regulations in the countries mentioned above the first aggregated groups are based on the rules consistency level:

- United States, Canada and United Kingdom have adopted "strict" rules;
- Germany, Japan and Russia have provided for "general" instructions;
- Spain, France and Italy are in an intermediate position.

In the Anglo-Saxon world the practice of adopting transparent remuneration systems undoubtedly derives from the typical features of the outsider system, in which there is a net separation between ownership and company control: the former is fractioned and widespread, the latter is held by managers.

Where an adequate information system can be identified, the market works as a regulator favoring the replacement of managers unable to turn shareholders' equities to better account. Therefore, in the outsider systems, it is possible to have more stable director commitment, liability and impartial judging due to effective information disclosure, resulting like this in obvious broader benefits to stakeholders.

United States, Canada and Great Britain were the first countries to discuss about regulating support information in economic reporting between companies and the environment, contributing in this way to essential regulations and promoting disclosure.

The foundation of public companies in Great Britain and big corporations in the United States has also stressed the necessity of protection of shareholders and stakeholders' specific interests related to corporate performance.

In Germany and Japan, the great importance investing majority shareholders, along with the absence of a solid board of directors, has generated scarce attention to performance and effective remuneration systems disclosure. This is ultimately proved by the fact that, both in Germany and Japan, stock options were considered illegal until the end of the '90s. Russia's situation, pursuant to privatization, is marked by companies that are mostly controlled by an only shareholder or a little group of shareholders.

The *insiders'* authority and the weak protection of external investors and shareholders have widely compromised the development of stock markets and tolerated, instead, less transparent information.

As far as Continental and Latin Europe's countries are concerned, based on *insider systems*, financial markets are less active or developing, ownership is concentrated and stable, and there are impressive equity and financial connections between companies and banks.

The greatest risk in these environments regards minority shareholders: top managers pursue and defend, first of all, and, often acting partially, the interests of majority members.

Appropriate information disclosure can obviously strengthen the protection of minority groups, enhancing investor confidence and market forces.

France, Spain and Italy belong to this category as well, and, as a response to requirements of greater information transparency imposed by internationalization processes, are getting more and more involved in enlarging their provisions about disclosure and satisfying, like this, stakeholders' assessment needs.

Regulations in the Anglo-Saxon countries, directed to empower information in remuneration institutions, are also coming up in Continental Europe's countries. The phenomenon refers, anyway, to recent times in a context characterized by undeveloped financial markets, in which small and middle dimension companies prevail.

The present impulse to corporate structural and dimensional change is also favoring the adoption of further provisions on disclosure, as well as harmonization with European directives on remuneration systems disclosure (Recommendation 2004/913/CE).

In short, shareholders and investors should own sufficient information to be able to appropriately assess costs and benefits and the relation between company performance, on the one hand and the level of executive remuneration, on the other. In this respect, *disclosure* of executive directors' remuneration allows stakeholders to assess the fairness of individual remuneration considering liability and/or performance of directors.

In each country enable companies to have a regulatory framework (briefly described above), so this research shows the analysis of the practical accomplishment of institutional provisions on compensation systems disclosure, by a homogeneous group of listed companies, on the purpose to assess if the companies surveyed behave in conformity with transparency provisions and assure information completeness, regardless the mandatory and voluntary regulations on disclosure of remuneration systems.

3. Methodology and Research Design

This research, carried out on a group of listed companies in European and non-European markets, is intended to review at what level companies, operating in the public utilities sector, behave in conformity with transparency rules and assure completeness of information, regardless the Regulations.

The decision of focusing on companies operating in the public utilities services is based on the importance of disclosure in this sector: the protection of public interests related to the nature of the services they offer and the owners' position, from the one hand; the entrepreneurial independence and the ability to create value in the interest of the totality of stakeholders, from the other.

This research is therefore intended to review in what proportion public utility companies adopt transparent and coherent behavior towards shareholders' interests and users expectations, and how appropriate is this behavior in light of the protection of all other stakeholders' interests.

On the whole, there are 70 listed companies taken under examination in this survey, selected with reference to the existence of a segment or Stock Exchange index dedicated to public utilities or to energy, gas and water sectors in the 9 countries considered: Canada, France, Germany, Japan, Italy, Russia, Spain, United Kingdom and United States.

Tab. 1. European Companies Surveyed - 2007

Country	Company	Total
France	*Areva, Chauf.Urb, Edf, Edf Energies Nouvelles, Gaz de France, GPE Group, Rubis, Sechiellinne Sidec, Suez, Theolia, Veolia Environnement.*	11
Germany	*EnBW, E.ON, MVV Energie, RWE.*	4
Italy	*Acea, Acegas, Acque, ACSM, Actelios, AEM (A2A since 2008), Ascopiave, ASM (A2A since 2008), Edison, Enel, Enertad, Eni, Enia, Gas Plus, Gruppo Hera, Iride, Mediterranee, Snam Rete Gas, Terna.*	18
Spain	*Agbar, Enagas, Endesa, Enersis, Fersa, Gas Natural, Iberdrola, Red Eléctrica, Union Fenosa.*	9
United Kingdom	*Centrica, Dee Valley, British Energy, Drax, International Power, Novera, Kelda, National Grid, Northumbrian water, Pennon Group, Severn Trent, United Utilities.*	12
	Total	54

Tab. 2. Non-European Companies Surveyed - 2007

Country	Company	Total
Canada	*Cnrl (Canadian Natural Resources Limited), Encana, Nexen, Talisman Energy.*	4
Japan	*Chubu Electric Power, Okinawa Electric, Osaka, Tokio Gas.*	4
Russia	*GazProm, Lukoil, Surgutneftegas, Tataneft.*	4
United States	*Central Vermont, Northeast Utilities, Peoples Energy, Wisconsin.*	4
	Total	16

In particular, the analysis has taken under examination 54 European companies representing all the listed companies with reference to the Stock Exchange segment of "Public utility" based in the European countries surveyed: the remaining 16 companies have been selected random among the ones belonging to the Stock Exchange segment of "Electricity, gas, waters and multi-utilities" in each of the non-European countries: Canada, Japan, Russia and United States.

The research method adopted is empirical/inductive and is based on the analysis of mandatory documents (balance sheet and consolidated balance sheet, annual reports, proxy and circular statements, corporate governance reports, remuneration report, etc.) and voluntary documents (social and environmental reports, etc.) available on the official websites of the respective companies surveyed, where relevant elements for reviewing the effectiveness of remuneration systems disclosure can be found. This analysis is, therefore, carried out with reference to corporate documents, available on their official websites, over the period of September – November 2007.

The comparison has been made by presetting appropriate tables, whose items have been defined considering the rules, codes and guidelines issued by each country on remuneration disclosure, and then grouped on the basis of the following three subject areas: (which, on turn, represent the three sections provided in Recommendation 2004/913/EC):

- remuneration policies;
- executive directors' remuneration;
- equity-based compensation.

The aim of this survey is to examine the adjustment level of the companies to specific reference rules and offer an overview of the main results coming out from the research, by comparing, at a general level, the different procedures of remuneration systems disclosure adopted by the 54 European companies versus the ones adopted by the other 16 non-European companies surveyed.

Besides, the comparison is made on the basis of further aggregation, pursuant to the provisions consistency level and the reference context, grouping the companies taken under examination in the following categories: "Anglo-Saxon" companies (Great Britain, Canada and United States, equal to 20), "German-Japanese and Russian" (Germany, Japan and Russia, equal to 12) and "Latin" (France, Italy and Spain, equal to 38).

4. Discussion of Findings

Considering the survey items, some noteworthy elements concerning the following areas are to be underlined:

a) remuneration policies;
b) directors' remuneration;
c) equity-based compensation.

a) Remuneration policy

From the overall analysis carried out on remuneration policy statements in listed companies, this practice is effective only for a definitely low percentage of companies: in fact, only 28,57% of the companies considered disclose their remuneration policies by means of an "independent" statement or part of other documents, such as: the corporate governance report, the annual report, the annual information circular, etc.

Tab. 3. Remuneration statement

	European companies		non- European companies		Total	
	n.	%	n.	%	n.	%
Existence of a remuneration statement.	12	22,22	8	50,00	20	28,57

By distinguishing companies according to their reference context, it clearly comes out that companies presetting a remuneration statement, both European or non-European, belong only to the Anglo-Saxon world (table 4).

Tab. 4. Remuneration statement

	"Anglo-Saxon" companies		"German-Japanese" companies & Russia		"Latin" companies		Total	
	n.	%	n.	%	n.	%	n.	%
Existence of a remuneration statement.	20	100,00	0	0,00	0	0,00	20	28,57

The information confirm once again that the Anglo-Saxon system is the only one, at present, offering the most structured information system.

In this regard, it is opportune to underline that transparency oriented remuneration systems, although affected by the typical features of the outsider system, are based anyway on broad and detailed regulations on this subject.

This statement is confirmed by the results deriving from the analysis concerning the other countries, where companies, in absence of specific regulations, pay no attention to their own remuneration policy disclosure.

Anyway, regardless mandatory provisions, it is to be remarked that accessibility of the necessary information about the policy adopted by the company to motivate executive directors and top managers is of fundamental importance to stakeholders in order to understand the measure of correlation between director remuneration and company goals and results achieved or individual objectives.

The result emerging from table 5, instead, is satisfying; it concerns the existence of a remuneration committee, operating in many of the companies surveyed (78,57%).

Tab. 5. Remuneration Committee

	European companies		non-European companies		Total	
	n.	%	n.	%	n.	%
Existence of a Remuneration Committee	45	83,33	10	62,50	55	78,57

The data show that listed companies, European or non-European, often make use of a similar board, in order to determine remuneration systems. In particular, it is to be remarked that the remuneration committee operates in all the Anglo-Saxon companies surveyed (table 6) and in the majority of the "Latin" ones (81,58%); definitely inferior is the number of companies belonging to the group "Germany, Japan and Russia" (33,33%).

Tab. 6 Remuneration Committee

	"Anglo-Saxon" companies		"German-Japanese" companies & Russia		"Latin" companies		Total	
	n.	%	n.	%	n.	%	n.	%
Existence of a Remuneration Committee	20	100,00	4	33,33	31	81,58	55	78,57

b) Executive directors' remuneration

As far as disclosure of the individual executive directors' remuneration is concerned, the overall data show that 60% of the companies surveyed make a similar complete report available. The data represent the general context and differ very little among European and non-European companies.

Tab. 7. Remuneration Report

	European companies		non- European companies		Total	
	n.	%	n.	%	n.	%
Existence of a Remuneration Report	32	59,26	10	62,50	42	60,00

Tab. 8. Remuneration Report

	"Anglo-Saxon" companies		"German-Japanese" companies & Russia		"Latin" companies		Total	
	n.	%	n.	%	n.	%	n.	%
Existence of a Remuneration Report	20	100,00	6	50,00	16	42,11	42	60,00

Once again, Anglo-Saxon companies are the only ones fully satisfying regulation requirements: in fact, all the companies surveyed provide for a remuneration report.

As far as the report contents and the information reported in the analyzed documents (table 9) are concerned, the overall results coming out from the survey show that most of the companies under examination specify individual director remuneration and its related elements (78,57%). Definitely lower is the number of companies providing with a remuneration comparison over different fiscal years (44,29%) and even lower is the percentage of companies specifying the criteria used to determine the variable part of performance-based remuneration (35,71%) and the performance indicators values (12,86%).

In particular, all the Anglo-Saxon companies surveyed offer highly detailed information regarding executive director and top management remuneration, specifying individual remuneration and its elements and comparing remuneration paid over different financial years.

Yet, it is to be remarked how, although 95% of Anglo-Saxon companies disclose the criteria used to determine variable remuneration, only 45% of these companies specify the performance indicators values. Outcome values are only related to the achieved outcome, without providing for the forecasted results.

Tab. 9. Contents of Directors' remuneration Report

	European companies		non- European companies		Total	
	n.	%	n.	%	n.	%
Individual executive directors' remuneration.	47	87,04	8	50,00	55	78,57
Elements of executive directors' remuneration (fixed, variable part, benefits, …).	47	87,04	8	50,00	55	78,57
Comparative table on remuneration over consequent financial years.	23	42,59	8	50,00	31	44,29
Adopted criteria in defining variable performance-based remuneration.	17	31,48	8	50,00	25	35,71
Specification of performance indicators values in order to easily understand paid variable remuneration.	6	11,11	3	18,75	9	12,86

The percentage of companies belonging respectively to the "German-Japanese" and Russia group and to the "Latin" one, offering such information details, is definitely lower and variable depending on the elements considered, as shown in table 10.

Tab. 10. Contents of Directors' remuneration Report

	"Anglo-Saxon" companies		"German-Japanese" companies & Russia		"Latin" companies		Total	
	n.	%	n.	%	n.	%	n.	%
Individual executive directors's remuneration.	20,00	100,00	4	33,33	31	81,58	55	78,57
Elements of executive director's remuneration (fixed, variable part, benefits, …).	20,00	100,00	4	33,33	31	81,58	55	78,57

Elements: Table on remuneration over consequent financial years.	20,00	100,00	4	33,33	7	18,42	31	44,29
Adopted criteria in defining variable performance-based remuneration.	19,00	95,00	2	16,67	4	10,53	25	35,71
Specification of performance indicators values in order to easily understand paid variable remuneration.	9,00	45,00	0	0,00	0	0,00	9	12,86

c) Equity-based compensation

Considering the data available, it is evident that equity-based middle/long term incentive plans are not so frequent today in listed companies, or they are poorly disclosed. In particular, Equity-based Remuneration Plans are adopted only by 33 companies over the 70 companies surveyed (table 11). The existence of Equity-based Remuneration Plans has been assessed for almost the totality of the "Anglo-Saxon" companies surveyed (95%); the percentage of the other companies is lower instead and, in any case, lower than 30%.

Tab. 11. Stock options and Stock grants plans

	European companies		**non- European companies**		**Total**	
	n.	%	n.	%	n.	%
Existence of a Stock options or Stock grants plan or Equity-based long term incentive plans.	24	44,44	9	56,25	33	47,14

Tab. 12. Stock options and Stock grants plans

	"Anglo-Saxon" companies		**"German-Japanese" companies & Russia**		**"Latin" companies**		**Total**	
	n.	%	n.	%	n.	%	n.	%
Existence of a Stock options or Stock grants plan or Equity-based long term incentive plans.	19	95,00	3	25,00	11	28,95	33	47,14

As far as plans are concerned, information provided is generally detailed and a high number of companies specify in detail: the number of stock options granted or shares assigned, the number of options exercised during the year, the number of options unexercised, the exercise price, the exercise date and the conditions for exercising rights.

With reference to table 13, the overall percentage of the listed companies considered providing with the above information is around 80% of the total sample survey, though it can be noticed a remarkable difference between European (nearly 75%) and non-European companies (50%). In particular, it is to be highlighted that information details are reported by all the Anglo-Saxon companies surveyed; definitely lower is, instead, the percentage of "German – Japanese", Russian and "Latin" companies providing for a similar analysis level (table 14).

Tab. 13. Information in a Stock options plan

	European companies		**non- European companies**		**Total**	
	n.	%	n.	%	n.	%
Number of Stock options granted or equities assigned by the company.	19	79,17	8	50,00	27	81,82
Number of Stock options exercised during the financial year.	18	75,00	8	50,00	26	78,79
Number of options unexercised, exercise price, exercise date and conditions of rights exercise.	18	75,00	8	50,00	26	78,79

Tab. 14. Information in a Stock options plan

	"Anglo-Saxon" companies		"German-Japanese" companies & Russia		"Latin" companies		Total	
	n.	%	n.	%	n.	%	n.	%
Number of Stock options granted or equities assigned by the company.	19	100,00	2	66,67	6	54,55	27	81,82
Number of Stock options exercised during the financial year.	19	100,00	1	33,33	6	54,55	26	78,79
Number of options unexercised, exercise price, exercise date and conditions of rights exercise.	19	100,00	1	33,33	6	54,55	26	78,79

5. Conclusion

From this analysis it firmly stands out that the level of corporate remuneration systems disclosure, strictly connected to the provisions system in force is more satisfying where the reference rules are structured and detailed. In fact, with reference to several elements analysed, where specific legal provisions are lacking, information provided by companies is brief or even missing.

This leads to ponder about the importance of adequate regulations, able to assure an effective response to transparency needs and protection to all social stakeholders, in light of the present global arena, as well.

It is, therefore, desirable the achievement, at an international level, of representation models containing uniform and comparable information, both in form (tabular and narrative), and contents. Besides, it is evident the need for easily accessible information, avoiding its fragmentation in different documents and concentrating it in a specific report, or report section on corporate governance.

An important step in this direction has been taken by the European Union by favoring the process of provisions alignment of each country member, in order to facilitate comparability among different companies and, most of all, to allow any subject to get the necessary information for the assessment of the transparency level of communications, even by comparing the data of companies coming from the same sector.

The existence of bodies which promote this process, at an international level, would spur further towards the creation of a system able to assign a higher value to the regulations of each country and to current corporate best practices. Regulations, where necessary, would be more adequate orienting like this corporate behavior towards more transparency.

In this way, executive directors and top managers are expected to behave in a transparent way regarding remuneration disclosure, by making clear its value and elements, so that to allow shareholders and other investors to monitor from outside the destination of resources that would be difficult to deduce, otherwise, from other documents.

The shareholders and investors should own sufficient information to be able to appropriately assess costs and benefits and the relation between company performance, on the one hand and the level of executive remuneration, on the other.

In this respect, director and executive remuneration *disclosure* allows stakeholders to assess the fairness of individual remuneration considering liability and/or performance of directors and can positively influence the achievement of consents management concerning the distribution options of the generated value and the mechanisms through which companies pursue the harmonization of different interests, ethical and not opportunistic behaviour and the research towards continuity.

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