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EDITORIAL

Dear readers!

The recent issue of the journal Corporate Ownership and Control pays attention to issues of corporate ownership and control and board practices. Corporate social responsibility, minority shareholder rights and corporate governance in Australia are also under the scope of researches. More detailed issues are given below.

Guido Stein and *Javier Capapé* order and classify the factors that lead to CEO failure into those a CEO can influence (endogenous) and those that are given (exogenous). The absence of unanimity in the literature leads them to conclude that insufficient attention has been paid to the main factor: the personal characteristics of CEOs. *Guido Stein* and *Salvador Plaza* made analysis which is focused on the role played by the independent director in the supervision and turnover of the chief corporate executive. In the process, they have carried out a comprehensive reflection on the independent director, consulting the latest literature and including the results of the most recent empirical evidence. They have also noticed that the role of the independent director often goes beyond the tasks that are usually considered specific to this function, namely, supervision of the company's senior management. *Mohammad Tareq, Sheila Bellamy, Clive Morley* investigates recent international reforms of minority shareholder rights (MSRs), and the relationship between those reforms and national legal systems. The study uses secondary data from 142 countries over a five-year period (2006-2010). The findings contribute to the current debate on the relationship of law to minority shareholder protection and will assist policy-makers in the area of investor protection reforms. *Timothy Wang, Mohamed Elsayed, Abdullahi D. Ahmed* state that many prior studies have investigated the nature of several corporate governance practices and mechanisms and how they exist to strengthen institutions, however, there have been questions related to the role of governance failures in preventing unethical behavior by top management. Authors analyse how effective the role of institutional shareholders is in corporate governance by examining the association between the different types of institutional shareholders and earnings management. *Helena Isidro* together *Liliana Gonçalves* investigates which managers characteristics are more likely to positively influence earnings management practices. Specifically, they study whether the CEO's age, education, expected tenure and duality of roles affects earnings management for a sample of listed Portuguese firms for the fiscal years 2005 to 2009.

The paper of *Mahmood Ahmed Momin* and *Mohammed Hossain* examines the extent of corporate social responsibility (CSR) Reporting by subsidiaries of multinational corporations in Bangladesh in two different steps. At the first step, their study explores the general trend of CSR Reporting in Bangladesh, and then examines in more detail: (a) CSR of subsidiaries of MNCs and (b) CSR of UK MNCs and their subsidiaries in Bangladesh. The paper of *Nguyen Huu Cuong* attempts to discover ethical responses to CSR from international organisations, companies, and individuals. Especially, each response is explained by different ethical theory.

Arifur Khan and *Paul Mather* examine the relation between managerial share ownership (MSO) and discretionary accruals in Australia. They find a positive relation between MSO and discretionary accruals up to a certain level of MSO followed by a negative relation (inverse U-shaped). *Jean M. Canil* with *Bruce A. Rosser,* using a unique data set, test theoretical propositions relating to grant size and exercise price in determination of optimal executive compensation.

We hope that you will enjoy reading the journal and in future we will receive new papers, outlining the most important issues and best practices of corporate governance!

CORPORATE OWNERSHIP & CONTROL

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SECTION 2. CORPORATE SOCIAL RESPONSIBILITY

The paper examines the extent of corporate social responsibility (CSR) Reporting by subsidiaries of multinational corporations in Bangladesh in two different steps. At the first step, the study explores the general trend of CSR Reporting in Bangladesh, and then examines in more detail: (a) CSR of subsidiaries of MNCs and (b) CSR of UK MNCs and their subsidiaries in Bangladesh. Content analysis has been used to capture the nature and quantity of CSR issues provided in the annual reports by the companies that were listed on the Dhaka Stock Exchange during the study. The paper suggests that CSR Reporting by MNCs subsidiaries in Bangladesh mainly means employee disclosure. CSR Reporting mostly consists of voluntary information with minimum level of mandatory disclosure. More importantly, subsidiaries disclose social and environmental issues more in line with Bangladeshi national companies than they do with their MNC parents. This highlights the fact that MNCs do follow different CSR Reporting strategy based on country of reporting.

Sustainability or sustainable development has become commonplace in the economic literature and become increasingly relevant to the academic literature and widely discussed by numerous of the researchers into social and environmental responsibility or corporate social responsibility (CSR), both from an economic and moral perspective. However, the thorough discussion of CSR under business ethics perspective in a broad view from the international or global context, to the organisational responses, and to individual attitudes does not exist in the current literature. This paper attempts to discover ethical responses to CSR from international organisations, companies, and individuals. Especially, each response is explained by different ethical theory.

SECTION 3. CORPORATE GOVERNANCE IN AUSTRALIA

We examine the relation between managerial share ownership (MSO) and discretionary accruals in Australia. We find a positive relation between MSO and discretionary accruals up to a certain level of MSO followed by a negative relation (inverse U-shaped). We suggest that these unique results are a result of certain Australian institutional features that are markedly different to those in the US and the UK and imply that the ownership-discretionary accruals relation is context specific with the wider corporate governance systems influencing the theorised incentive effects. We also posit that executive directors and independent directors have different ownership-discretionary accruals incentives and report results consistent with this proposition.

Using a unique data set, we test theoretical propositions relating to grant size and exercise price in determination of optimal executive compensation. For Hall and Murphy, pay-performance sensitivity does not behave as predicted with respect to CEO risk aversion and diversification, but the latter supports observed grant size while ATM grants exhibit positive abnormal returns as predicted. Consistent with Choe, exercise price is found inversely related to leverage. The unexpected positive relation between grant size and stock volatility is conjectured driven by CEOs' influencing large grants, which are found associated with weak corporate governance but ameliorated by outside directors.

РАЗДЕЛ 1
НАУЧНЫЕ ИССЛЕДОВАНИЯ И КОНЦЕПЦИИ

SECTION 1
ACADEMIC INVESTIGATIONS & CONCEPTS

FACTORS OF CEO FAILURE: MAPPING THE DEBATE

Guido Stein*, Javier Capapé**

Abstract

The failure of the CEO has been studied at great length in the literature. We order and classify the factors that lead to CEO failure into those a CEO can influence (endogenous) and those that are given (exogenous). The absence of unanimity in the literature leads us to conclude that insufficient attention has been paid to the main factor: the personal characteristics of CEOs. The agency approach and method are insufficient to understand leadership performance in organizations, due to the oversimplified view of human nature on which they are based and their heavy reliance on mathematical modeling.

Keywords: CEO, Corporate Governance, Board of Directors

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1. Introduction

"What do you mean by the 'failure' of a CEO?" When we tried briefly to explain this study to various managers of a large multinational, this was their first question. After all, can a CEO who leaves with a multi-million payoff be said to have failed? In this study we do not aim to cover every aspect of the issue of compensation. Our goal is to bring together, organize and classify the endogenous and exogenous factors that lead a top executive to lose the trust of the board of directors, shareholders, colleagues and subordinates, resulting in exit from the company (with or without compensation).

According to Dotlich and Cairo (2003), CEO failure is attributable to human behavior, i.e. to what CEOs are like and how they behave in certain circumstances (Charan, 2003).

One might obviously argue that CEOs tend to lose their job when their company performs badly and the directors (who are responsible for overseeing management), the shareholders (who will not receive the desired return) and the market as a whole (suppliers, creditors, customers, etc.) demand a replacement. This has been demonstrated empirically, particularly during the last quarter of

the 20th century.[1] And yet, according to Fredrickson et al. (1988), poor firm performance explains less than half the variance in CEO dismissals and CEO turnover. In other words, half of all CEO failures occur while the company is performing well. Clearly, there must be other factors at play.

This is a highly topical issue. A total of 524,000 jobs were lost in the United States in December 2008 and that included CEO jobs (*The Wall Street Journal*, January 13, 2009). In times of crisis, CEO turnover can double (Jenter and Kanaan, 2008). The recent announcement by the Obama administration of a cap on the pay of executives whose companies have been rescued with taxpayers' money (*Financial Times*, February 5, 2009) is a clear example of the level of interest in CEO performance in recent times. Similar reactions have been seen in many other developed countries.

According to Charan (2005), "CEO leadership must be treated differently because it is unique in scope and importance. The actions of CEOs determine the future of corporations, which collectively influence entire economies. Our quality of life depends on excellence at the top".

This interest has to do with the influence that multinational enterprises have on today's economy. The economic assets they manage are greater than the GDP of entire nation-states. The people who control them therefore probably have more power and influence than many heads of government (Cappelli and Hamori, 2004). It is therefore important to understand what CEOs are like and how they behave in order to understand the reasons why sometimes they fail.

We do not intend to focus on the causes of CEO failure in the present economic environment, however, but in an atemporal (though not static) perspective.

By our definition, a CEO has failed if he is unable to meet the expectations of the board of directors, the shareholders and the market, as manifested in the decision to press for the CEO's removal.

It is important to note that the literature we shall be reviewing presents the conclusions of studies using mainly United States samples. It therefore predominantly reflects the Anglo-Saxon model of corporate governance, centered on shareholder value creation (Rappaport, 1986). The shift from public to private ownership of large European companies over the last decade has resulted in steady cross-Atlantic convergence in corporate governance (Milne, 2009). Yet the Anglo-Saxon model retains certain distinctive features that need to be borne in mind when applying the conclusions found in the literature to European firms[2] (Gentry et al., 2007[a], and Russell Reynolds Associates, 2006a, 2006b).

In his historical study, Vancil (1987) concludes that 90% of CEO turnover is due to retirement, death or disability, i.e. factors that have nothing to do with firm performance. In other words, only 10% of CEO successions come about unexpectedly, as a result of a board decision prompted by the company's results, a change of ownership, a restructuring, a strategic change, or any of the other causes we shall be considering. In this article, therefore, we shall focus on the 10% identified by Vancil: the dismissals and voluntary departures. While other studies have taken a broader approach, our view is that this smaller group is the one that demands rigorous study, as these are the events that have most theoretical interest (Fredrickson et al., 1988). By examining the causes we will be able to determine why CEOs fail or at least shed some light on what leads to failure.

CEOs fail for a wide variety of reasons. Companies rarely disclose the reasons for dismissal or contract termination, or only in the vaguest terms (Cannella and Shen, 2002). It does not seem feasible to cover all the causes of failure and the interrelationships between them, but it is worth reflecting on the main causes that have been analyzed and studied in the international academic literature.

In this article we will try to weigh the academic contributions in light of the theory of human behavior put forward by Pérez López (1993)[3] and with reference to the new approaches that may come together to create an alternative paradigm (Pfeffer, 1993) to that of agency theory, one that has more precise explanatory power (Ghoshal, 2005).

First, we shall distinguish between endogenous factors (modifiable: the result of a function which the CEO himself can influence) and exogenous factors (beyond the CEO's control, i.e. given). As we shall see, the CEO can indirectly influence some

[1] James and Soref (1981), McEachern (1975), Salancik and Pfeffer (1980), Coughlan and Schmidt (1985), Warner et al. (1988).

[2] There is no unified European model (Guest, 2008). The model least like the Anglo-Saxon one is perhaps the German model. The main differences between the Anglo-Saxon and the German include: CEO remuneration (significantly higher in the United States); separation of CEO and Chairman roles (required by law in Germany, almost universal in the United Kingdom and less common in the United States); board representation (mainly the CEO and executives in the United States, equal presence of independents in the United Kingdom and considerable representation of the main shareholders in continental Europe); and employee participation in the selection of directors (in Germany, Austria and Denmark). See Krivogorsky (2006) and Russell Reynolds Associates (2006b).

[3] A theory built upon by, among others, Chinchilla (1997), Cardona and García Lombardía (2005), Argandoña (2007) and Rosanas (2008).

of the exogenous factors, so as to lessen their impact.

The endogenous factors include ownership of an interest in the company (Salancik and Pfeffer, 1980; Core and Larcker, 2002), compensation systems (Murphy, 1998), CEO origin (Puffer and Weintrop, 1995; Fredrickson et al., 1988; Warner et al., 1988), CEO capabilities (Dotlich and Cairo, 2003; Cappelli, 2008; Ciampa, 2005; Charan, 2005; Zajac, 1990, and Gentry et al., 2007b) and CEO involvement in selecting directors (Hermalin and Weisbach, 1998; Boeker, 1992). At the same time, there are conditioning factors external to the CEO that influence the exit decision: company size (Reinganum, 1985; Grusky, 1961), board composition (Weisbach, 1988; Hermalin and Weisbach, 1998; Bhagat and Black, 2002), the presence of institutional investors (Doidge et al., 2006), the actions of the CEO's predecessor (Conger and Nadler, 2004) and the existence of an incomplete succession plan (Kovach, 1986; Walter, 2002; Conger, 2004, and Watkins, 2004). This classification is not intended to be exhaustive, but singles out the factors we consider most relevant today (Table 1).

Table 1.

Factors in CEO failure*

Endogenous	**Exogenous**
Interest in the capital	CEO age and tenure
Compensation	Influence of predecessor
CEO origin	Company age and size
Selection of directors	Mergers and acquisitions
Competencies	Type of industry
	Board composition
	Directors' commitment
	Valid successor
	Industry regulation

* Source: compiled by the authors.

This classification is merely illustrative, as in practice the factors cannot be so neatly separated. An endogenous factor may be reinforced by exogenous factors. Tenure, for example (an exogenous factor insofar as it does not depend exclusively on the CEO himself) makes it more likely that a CEO will own stock in the company (an endogenous factor) and be able to influence the selection of directors (another endogenous factor), i.e. more likely that a CEO will be powerful enough to hold on to his job despite below-par performance.

This article is divided into four parts. In part two, following this introduction, we analyze the most important endogenous factors identified in the literature. In part three we describe the main contributions in the literature on exogenous factors. Lastly, we present our conclusions and outline directions for future research.

2. Endogenous Factors

In what follows we analyze the factors that have been identified in previous studies as possible causes of CEO failure. These are all factors the CEO can influence, although his influence is not always positive (in the sense that a CEO may effectively hasten his own departure). Given the lack of consensus in the literature, there is almost no positive statement to be made about how these endogenous factors affect CEO failure. As the statistical models lack explanatory power, we turn to competencies as a possible alternative.

As we said, in practice the causes of failure are not neatly separated. Nor does there appear to be a direct relationship between cause and failure taken in isolation. Some of the articles we review address the relationship between a particular cause and CEO failure; others group together two or three causes. As we describe in the section on competencies, we have not found a holistic model that combines quantitative and qualitative measures and achieves valid results. According to Kesner and Sebora (1994), research to date has omitted variables that influence CEO exit. The models used in much research omit qualitative variables because it is difficult to obtain homogenous, and therefore comparable, data.

2.1. Interest in the capital of the company. Compensation

Apart from the influence of personal characteristics (which we examine at the end of this section), there are other explanations for why a CEO remains in the position despite the company's having below-industry-average performance. One is the possession of an interest in the company's capital. According to Salancik and Pfeffer (1980), an increase in stock ownership is positively correlated with tenure; stock ownership gives CEOs an artificial defense against failure. This view presupposes power struggles in the company.

How compensation influences failure depends, among other things, on the relative importance of each level of remuneration in total CEO pay. Theorists have

switched from studying total compensation to analyzing the structure of compensation (Mehran, 1995). Not all levels of pay influence CEO turnover to the same extent. As Murphy (1998) points out, annual or multi-year bonuses can generate perverse incentives for the company and, ultimately, for the CEO himself. In recent years we have seen cases of fraud in large companies (Satyam Computer Services in 2009, Parmalat in 2007, AIG in 2004, Enron and WorldCom in 2001). During the dotcom bubble both *Forbes* magazine and *MarketWatch* reported dozens of cases of accounting fraud in large organizations. If this behavior is repeated, more accounting fraud is likely to come to light in 2009.

Needless to say, the relationship between bonuses and stock options, on the one hand, and fraud, on the other, is not direct. Yet the motivation this kind of compensation plan generates can lead to other problems. As Murphy (1998) points out, when part of an executive's pay is linked to the achievement of personal targets, there may be a perverse incentive for the CEO to manipulate his results. A CEO whose performance exceeds the upper threshold for bonuses may work less hard, while one whose performance near year-end is below the threshold may be more inclined to make a special effort.

CEO performance is particularly difficult to assess if the assessment includes not only accounting measures but also measures of competencies and competency improvement (Dierdoff and Surface, 2008).

Stock options have also been criticized (Yermack, 1997). Numerous articles question the idea that stock options align the interests of executives and owners (Core et al., 2005). According to Bartol et al. (2008), any benefit from aligning interests is offset by the incentive to manipulate results. These authors also analyze the influence compensation systems have on the behaviors that lead to manipulation of revenues. They conclude that the likelihood of revenue manipulation increases with the amount of out-of-the-money options received and decreases with the proportion of capital owned by the CEO.

Bartol et al. (2008) consider that unethical CEO behavior, where CEOs manipulate revenue figures, is explained by Kahneman and Tversky's prospect theory (1979). According to prospect theory, the expectation of losses prompts individuals to make aggressive decisions that counteract or minimize the effect of any losses.

Tosi et al. (2000) conclude that 40% of the variance in CEO compensation is attributable to company size, while company performance explains only 5%. However, changes in compensation are equally sensitive to changes in size and performance.

Terviö (2007) concludes that the variable that best explains the level of CEO compensation is company size and that the distinctive qualities or talents of CEOs do not explain much of the variation in pay. Given the competitive balance in a market where CEO talent and CEO jobs are scarce, the added value that CEOs generate through their distinctive competencies has a weak effect on shareholder wealth.

The disparity of the findings (which is repeated throughout the literature on the factors considered in this article) supports Collins' (2001) conclusion that it is impossible to link any particular compensation model to firm or CEO success.

2.2. CEO origin: outsider or insider

Another relationship that displays empirical regularities is that between the decision to dismiss a CEO and the CEO's origin, i.e. whether the CEO is an insider or an outsider. Insider/outsider status has been defined in different ways: Weisbach (1988) defines an outsider as a manager who does not work for the company (i.e. who has no responsibilities in the company beyond board responsibilities) and who is not a former employee or a relative of a former employee, nor a lawyer, accountant, financial adviser or employee of any other company that has contractual relationships with the company in which he serves as a director. There is no generally accepted definition (Kesner and Sebora, 1994). This indeterminacy is one of the reasons for the diversity of results reported in the literature.[4]

Some researchers have found positive correlations between dismissal and outsider status. That is to say, all else equal, a CEO (or senior executive) promoted from inside the company has more chance of staying on than one brought in from outside. According to Collins (2001), 70% of successful companies have an insider CEO.

Agrawal et al. (2007) establish that the choice of an outsider CEO, effectively limiting existing employees' incentive to strive for the top job, has to do with organizational structure. Firms with a product-oriented structure, they suggest, tend to look for CEO candidates outside their own organization.

Zajac (1990) find that internal successors generate higher revenue, while Furtado and Rozeff (1987) find that they generate a higher share price. Given the variety of definitions (Kesner and Sebora, 1994), however, other researchers have concluded that having an outsider CEO correlates with improved company results (Reinganum, 1985, and Warner et al., 1988). For the latter authors,

[4] As we shall see later, in the wake of the Worldcom, Enron and Parmalat scandals regulatory bodies have defined more closely who qualifies as an outside director. For a description of the problems this issues has raised over five decades of research, see Karaevli (2007).

however, the positive correlation between hiring an outsider and subsequent results is very weak.

2.3. Membership of the board of directors

Boeker (1992) adds board membership as another field of analysis. As Mizruchi (1983) says, being a member of the board of directors gives a CEO greater influence. Boeker explains in his article that, where a firm is performing badly, the CEO is more likely to dismiss senior executives the less demanding the board of directors is in its monitoring of his activities. In other words, he will be inclined to blame outcomes on his senior executives and so save his own job.

This looser control is usually associated with a high proportion of internal, non-independent directors (Rostow, 1959; Fama and Jensen, 1983; Mizruchi, 1983; Weisbach, 1988; Fredrickson et al., 1988). Another stream of research, however, relates internal promotion to organizational success (Davidson et al., 1990; Zajac, 1990; Bower, 2007; Bhagat and Black, 2002). For Bower (2007), a successful CEO is an internal appointee who develops the capabilities and perspective usually attributed to outsiders. On this basis, we could infer that a mainly insider board would exercise stricter control over the CEO and be as demanding as outsiders are said to be.

If a CEO's main concern is to hold on to his position (Brady and Helmich, 1984), he will try to acquire the power to help him do so.[5] He will therefore try to influence those who may want him dismissed if the company's results deteriorate, namely the directors, who have the formal authority to dismiss him (Selznick, 1957), and the owners, who are directly affected by poor firm performance (Boeker, 1992). One way to reduce the amount of pressure from the board of directors is by becoming a director.

The CEO has a seat on the board when the roles of CEO and Chairman are combined. According to a study by Russell Reynolds Associates (2006b), there is a clear tendency, increasingly backed by the literature, to separate the two roles. The reason for this tendency is the increasing participation of directors in strategy formulation and the need for board independence to meet standards of good corporate governance. The figure of the CEO-Chairman persists, however. According to Russell Reynolds Associates (2006b), in 2005 the two roles were separate in only 29% of companies in the S&P 500.[6] Advocates of the combination of roles argue that having a CEO-Chairman reduces power struggles and facilitates succession. Survey respondents explain that the main reason for combining the roles is to have better chances of hiring an outside CEO, who will not find his authority within the company challenged.

Based on empirical data, Baliga et al. (1996) conclude that there is insufficient evidence to infer any negative impact of separating the CEO and Chairman roles. Brickley et al. (1997) also analyze the impact of separating roles using statistical methods and conclude that the costs are greater than the benefits.

2.4. Participation in the selection of directors

Shivdasani and Yermack (1999) introduce another explanatory variable: CEO involvement in selecting the members of the board of directors. There are those who argue that boards with a majority of independent directors exercise tighter control over CEOs (Hermalin and Weisbach, 1998; Weisbach, 1988; Jensen, 1993). A CEO may influence board supervision by influencing the selection of directors. Shivdasani and Yermack (1999) conclude that companies where the CEO has a say in selecting directors tend to select directors who exercise less control over the CEO. In these studies, as in those that analyze board composition, impact is measured by changes in the company's share price. Shivdasani and Yermack (1999) find a significantly higher impact in companies that appoint independent directors when the CEO has no part in selecting them. To explain this, they suggest that CEO participation signals to the market that the new director is less likely to exercise strict control over the CEO's activities. Klein (2002) likewise concludes that CEO membership of the nomination committee correlates with a smaller number of outsiders on the audit committee and higher CEO compensation, suggesting lax board supervision. In short, the empirical literature indicates a limited amount of value creation for companies when the CEO does not have a say in choosing directors.

With respect to CEO dismissal, Mace (1971) infers that CEO involvement in the director selection process limits board independence, as the chosen directors are likely to be personally close to the CEO. The board will be more tolerant of poor firm performance and less likely to dismiss the CEO. This increase in CEO power has been identified in the literature as a reflection of growing CEO stock ownership and tenure (Baker and Gompers, 2003).

Hermalin and Weisbach (1998) approach the question from a different angle. Rather than analyzing how boards behave depending on their

[5] Shleifer and Vishny (1989) explain that one way for a CEO to protect his job is by selecting projects that require specific human capital that cannot easily be transferred.

[6] In other indices the percentage varies: Nasdaq 100 (41%), Eurotop 100 (79%) and FTSE (93%). As we have seen, there is a clear difference between the United States and Europe on this matter.

insider or outsider composition, they argue that board behavior and board composition are related and united in the figure of the CEO. Although by law it is the shareholders that select the directors, they usually choose among pre-selected candidates. Overtly or covertly, depending on the extent of his influence, the CEO may have a hand in pre-selecting candidates. As Hermalin and Weisbach indicate, to understand corporate governance, the selection and performance of directors need to be considered simultaneously.

The studies we have mentioned can be summed up by the hypothesis that, all else equal, a CEO who has a say in selecting directors is less likely to be dismissed.

2.5. Competencies

Many authors consider the factors mentioned so far insufficient to explain CEO failure (Kesner and Sebora, 1994; Core and Larcker, 2002; Finkelstein, 2003; Shivdasani and Zenner, 2004; Cappelli and Hamori, 2004; Boone et al., 2007). In the literature, CEO failure has been attributed to a great variety of factors, yet lack of competencies, as one of those factors, has been underestimated due to the empirical difficulty of obtaining valid statistical evidence of competency. Fredrickson et al. (1988) attribute high explanatory potential to competencies, but they build their model of failure using empirically observable variables and fail to tackle the essential issue. Other authors have systematized competencies (Charan, 2005; Cardona and Wilkinson, 2009) or aimed for a deeper analysis (Kesner and Sebora, 1994).

The external factors we have considered so far fail to provide a valid explanation. That is why we consider it crucial to analyze CEO characteristics, or character, in more depth in order to understand CEO failure (Kesner and Sebora, 1994).

Many authors agree that lack of the necessary competencies is the main reason for CEO dismissal (Dotlich and Cairo, 2003;[7] Conger and Nadler, 2004; Cappelli, 2008; Charan, 2005; Gentry et al., 2007a and 2007b). In this section we discuss a number of characteristics that repeatedly emerge in CEO failure and propose that they be used as explanatory variables in a hypothetical regression aimed at explaining the dependent variable "CEO failure." This line of research is intended to remedy the shortage of qualitative analysis in the literature (Gentry et al., 2007b). CEO competencies may serve as a basis for future studies aimed at explaining the contradictions observed in CEO dismissals.

As the literature reveals, promotion on its own is not enough to ensure success. Kovach (1986) concludes that in many cases a brilliant career is not sufficient to guarantee talent. Many of the CEO failures we see nowadays are due at least in some measure to an inadequate career design that prevents the acquisition of management competencies (San Martin and Stein, 2008).

In Khurana's (2002) view, the pendulum of expected CEO capabilities has swung from professional excellence and honesty toward charisma and leadership ability. We may wonder whether this is a good thing. According to Susaeta et al. (2008), based on a survey of Spanish executives, credibility is the most highly valued quality in a CEO. Yet there are clear differences between industries. Neither ethics nor social or environmental responsibility feature among the top four reputational characteristics of CEOs in the financial industry.

We believe that this type of statistically valid empirical study should be encouraged in order to establish a proper model for explaining CEO failure in terms of these qualitative variables. We realize that there is a major problem of data collection. Bennis (1959) discusses the confusion that has arisen around this subject. Then, as now, the difficulty lies not in lack of evidence, but in the abundance of it and the contradictory conclusions it appears to support.

One method that might be useful would be interviews with, or surveys of, CEOs and the people around them, aimed at determining the influence of each of the characteristics we typically find in senior executives. This is the method used in demographic analyses of top management teams[8] and in books recounting the experience of top managers, as revealed in conversation (Finkelstein, 2003; Sonnenfeld and Ward, 2007; Dotlich and Cairo, 2003; Cardona and Wilkinson, 2009; and many others). According to Jensen et al. (2004), this type of qualitative analysis is more commonly used by executive search organizations (headhunters), so one may well ask what type of person would be the model for a CEO position.

Unless leaders find the happy medium in each competency, they may tend to an extreme. Maccoby (2000), for example, analyzes narcissism. The same competency can be a weakness when taken to excess, and a strength if kept within limits (Kets de Vries and Miller, 1985; Campbell et al., 2004). According to Maccoby (2003), however, it is difficult to draw the line between confidence and overconfidence. Narcissism is undesirable in many ways, but in some circumstances narcissists can be

[7] Dotlich and Cairo identify eleven defects that are found recurrently in CEOs that have failed. For each of the characteristics they study they identify an approximate threshold above which the characteristic becomes a defect that can increase the probability of failure.

[8] This article refers to several of these studies: Warner et al. (1988), Simons et al. (1999) and Miller et al. (1998). Authors that have analyzed these characteristics and their impact on corporate strategy include Iaquinto and Fredrickson (1997) and Jensen and Zajac (2004).

extraordinarily useful, or necessary even. Chatterjee and Hambrick (2007) find out that narcissistic leaders do seem to be more inclined to adopt dynamic, grandiose, alluring strategies (high risks, multiple acquisitions) that lead to extreme outcomes: huge success or catastrophic failure.

According to Collins (2001), who conducted an extensive field study on the success of United States public companies, it is impossible to simplify this complex process into a single function.

The question of CEO failure also goes beyond corporate governance, which does not consider the person as a whole nor attempt to grasp all the dimensions of a person. Just as a CEO who aims only to satisfy his subordinates' basic needs is doomed to failure (Pérez López, 1993), research into CEO failure that ignores the deeper question in the interests of statistically significant results is mistaken. However significant the results, if the variables are inadequate, the question will not be answered. This conclusion, though consistent with a deep view of management that is poorly represented in the literature, is in fact not new. As early as 1959 Bennis announced a fracture in organization theory: the transition from mechanistic models (free of friction with human emotions) to "human relations" models, which take account (or claim to take account) of the intuitions, beliefs, perceptions, ideas and feelings that inevitably interfere in employee decision making.

Nevertheless, we do not believe that the difficulties involved in studying the endogenous factors are impossible to overcome. In light of the risk of statistical oversimplification, we propose an advanced qualitative study (Kaplan et al., 2008) that will help today's CEOs to successfully meet the challenges of their position.

Table 2 shows the bibliographical references we have used to examine the endogenous factors. The divergence in the literature is clear. Only competencies are unanimously recognized by scholars.

Table 2.

Factor	Increases likelihood of staying on as CEO		Reduces likelihood of staying on as CEO		No clear effect on CEO failure / Other approaches to the factor	
Relation to failure	Author (year)	Contributions	Author (year)	Contributions	Author (year)	Contributions
Interest in the company *Greater share in the company's capital is associated with closer identification with shareholders' interests (in an agency perspective).*	Jensen and Meckling (1976)	Started agency theory.	Shivdasani and Zenner (2004)	Excessive stock ownership makes it less likely that a CEO will perform well.	Chung (2008)	Pay-performance sensitivity and independent directors are substitutes; they exert the same influence.
			McConnell and Servaes (1990)	Beyond a certain level the effect of stock ownership is reversed and becomes detrimental to performance.		
	Salancik and Pfeffer (1980) Morck et al. (1988) Core and Larcker (2002)	A CEO who holds a higher percentage of capital is more likely to act in the shareholders' best interests and to survive.	Morck et al. (1988)	Rewriting contracts entails an excessive cost for companies. With suboptimal contracts, interests are not aligned.		
			Hermalin and Weisbach (1991)	Increases in stock ownership (above 1%) entail better firm performance.		
Compensation *Like the factors linked to stock ownership, compensation has in many cases been studied as a way of aligning interests.*	Jensen and Murphy (1990) Coughlan and Schmidt (1985)	Interests are aligned by increasing the proportion of variable pay (linked to firm performance).	Kahneman and Tversky (1979)	The prospect of losses (out-of-the-money options) leads people to make aggressive decisions to counteract or minimize losses.	Yermack (1997)	Anticipating bull markets, CEOS increase the proportion of stock options in their contracts.
					Tosi et al. (2000)	Around 40% of the variance in CEO compensation is attributable to company size. Firm performance explains only 5%.

	Crawford et al. (1985)	In deregulated industries CEOs receive more performance-related pay, resulting in better firm performance.	Jensen (2004) Ghoshal (2005) Argandoña (2007)	Optimal remuneration may mitigate agency costs, but it cannot eliminate them completely.	Collins (2001)	The complexity of a CEO's tasks makes it impossible to design an ideal compensation system.
			Bartol et al. (2008)	The incentive to manipulate accounting ratios offsets the beneficial effect of alignment of interests.	Terviö (2007)	CEO compensation is explained by firm size.
			Taleb (2009) Murphy (1998)	Compensation linked to stock performance may encourage CEOs to take unjustified risks.	Core et al. (2005)	The increase in total compensation is explained by the growing risk entailed in stock-based compensation.
Outsider CEOs *The indeterminacy of the term "outsider" and the disparity of the research findings makes it impossible to determine the impact of outsider status on CEO failure.*	Weisbach (1988) Reinganum (1985) Warner et al. (1988)	Outsider CEOs enable the companies they lead to perform better.	Collins (2001)	Only 30% of the companies that go from "good to great" do so with an outsider CEO.	Kesner and Sebora (1994) Karaevli (2007)	The absence of a common definition of the term "outsider" is an obstacle to the study of this variable.
			Furtado and Rozeff (1987)	Outsider CEOs generate less revenue than insiders.		
	Dalton and Kesner (1983, 1985)	Smaller companies with average profitability are more likely to hire outsider CEOs.	Kets de Vries (1989)	Internal succession is beneficial in large, complex companies because it eliminates structural friction.	Agrawal et al. (2007)	Selection of outside candidates reduces employees' incentive to make the necessary effort to reach the position.
			Zajac (1990)	An outsider CEO is unlikely to succeed if the company wants continuity rather than a strategic break.	Kaplan et al. (2008)	CEOs are hired based on talent, not origin.

Outsider CEO (continued) *The indeterminacy of the term "outsider" and the disparity of the research findings makes it impossible to determine the impact of outsider status on CEO failure.*			Bower, (1992) Davidson et al. (1990) Bhagat and Black (2002)	Internal promotion is positively correlated with improved firm performance.		
			Cannella and Shen (2002)	Outside CEOs develop weaker social networks and lack the support of top management.		
			Brady and Helmich (1984)	Outside CEOs have shorter tenure if the object of the succession was to achieve stability and continuity.		
			Ocasio (1994)	Outsider CEOs have less chance of institutionalizing their power.		
Participation in the selection of the board of directors *The literature is practically unanimous on this point: participation is seen as a CEO defense mechanism that reduces shareholder value.*	Mace (1971)	CEO involvement in the selection process limits board independence.				
	Weisbach (1988) Wade et al. (1990) Jensen (1993) Hermalin and Weisbach (1998) Shivdasani and Yermack (1999)	Companies in which the CEO has a say in selecting directors tend to select directors who exercise less control over the CEO.				
	Klein (2002)	CEO membership of the nomination committee correlates with a smaller number of outsiders on the audit committee and higher CEO compensation.				
Board membership. **CEO-Chairman role** *Both institutional and agency theory agree that combining the two roles aids CEO survival, but with opposite consequences.*	Baliga et al. (1996)	There is not enough evidence to infer that combining the CEO-Chairman roles results in worse firm performance.	Selznick (1957)	The board of directors has the formal power to dismiss the CEO. CEO board membership may affect the board's performance of this function.	Brady and Helmich (1984)	A CEO's primary concern is to hold on to power. CEO board membership may be interpreted as a attempt to

						prolong his mandate.
	Brickley et al. (1997)	Empirically, the costs associated with separation of the roles are greater than the benefits.	Mizruchi (1983)	Increases the CEO's influence.	RRA (2006b) MacAvoy and Millstein, (2003)	Executives prefer that the roles of CEO and Chairman not fall upon the same person.
	Lorsch and Zellecke (2005)	Avoidance of power struggles and smoother successions.	Boeker (1992)	Increases the CEO's ability to attribute his own mistakes to other executives.	Finkelstein and D'Aveni (1994)	Distinguish between the institutional and agency approaches in the literature.
			Rechner and Dalton (1991) Pi and Timme (1993)	Companies that have separated the two functions achieve better results.		
Competencies *Competencies have increasingly been seen as a fundamental factor in CEO failure. Authors agree on their importance for avoiding CEO failure.*	Kesner and Sebora (1994)	To study CEO failure properly, it is necessary to study each CEO's competencies.			Pérez López (1993)	The study of management must take into account the three types of motivation inherent in any human action.
	Conger (2004)	An incomplete succession plan increases the probability of failure.			Groysberg et al. (2004)	Talent declines abruptly when a CEO switches company. This indicates that there are factors that reinforce a CEO's capabilities: firm resources, systems and processes, internal networks, etc.

	Gentry et al. (2007a and 2007b)	CEOs who have a more inflated view of their own capabilities are more likely to fail.			Khurana (2002)	Nowadays, firms seek competencies that are closely related to short-term results, namely CEOs with charisma and leadership quality in preference to professional excellence and honesty.
	Cappelli and Hamori (1994)	The perception of capabilities varies over time: today firms seek younger CEOs with a shorter track record who have been educated in the public education system.			Fich (2005)	Companies want to retain highly qualified human capital.
	Core and Larcker (2002) Finkelstein (2003) Shivdasani and Zenner (2004)	The reach of the studies focused on searching for empirical patterns has proven inadequate.			Boone et al. (2007)	Financial economists have reached few conclusions regarding the forces that determine board composition. The motivations of a director cannot be reduced to an arbitrary number of years in the company.
					Terviö (2007) Gabaix and Landier (2008)	Legal restrictions on compensation may result in labor market inefficiencies, as they prevent the signaling of the most efficient managers.

	Cappelli (2008) Charan (2003) Dotlich and Cairo (2003) Charan (2005) Cardona and Wilkinson (2009)	Systematization of CEO characteristics and analysis of the influence of each characteristic.			Kaplan et al. (2008)	Executive capabilities are more closely related to success than interpersonal capabilities. First systematic study of the impact of CEO skills and characteristics, based on interviews carried out over four years.
	Kovach (1986) Walker (2002) Watkins (2004) San Martin and Stein (2007)	Rapid career progression entails a lack of leadership training.				
	Kets de Vries and Miller (1985) Maccoby (2000, 2003) Campbell et al. (2004) Chatterjee and Hambrick (2007) Friel and Duboff (2008)	Narcissism may prevent business leaders from acquiring leadership capabilities.				
	Bennis (1959) Jensen et al. (2004) Sonnenfeld and Ward (2007) Susaeta et al. (2008)	Competencies determine CEO reputation.				

3. Exogenous Factors

So far we have examined the exogenous factors that can lead to CEO failure. These are variables the CEO himself can influence. For example, the CEO can choose whether or not to hold an interest in the company's capital, or whether or not to take part in selecting directors or his successor; and he can choose to develop the leadership competencies required of a CEO.

His efforts in this direction may be frustrated, however, by other factors. Parrino (1997) identifies several of them and examines the influence the presence of a qualified outside successor can have on the decision to dismiss a CEO. Others include board composition, board control, and industry type. We shall also consider the effect of CEO age and tenure, regulatory framework, multiple directorships ("busy boards") and firm size.

It is reasonable to assume that the main exogenous causes of CEO dismissal are poor firm performance (D'Aveni and Hambrick, 1989) and failure to achieve targets. As we said, however, these do not provide sufficient explanation (Fredrickson et al., 1988). Moreover, defining a measure of firm performance is by no means a trivial task. In fact, the variety of measures actually used by boards to measure their firms' performance indicates an absence of agreement as to the relative merits of accounting and market variables (Brickley, 2003).

3.1. Demographic factors

Age deserves serious consideration. In most empirical studies it is used as a control variable. In the studies discussed below it is used mainly to exclude departures for retirement from departures that need explaining.

Some authors have tried to relate age to CEO failure. Morck et al. (1988), for instance, note that organizations with young CEOs have higher rates of CEO turnover. According to Weisbach (1988), Barro and Barro (1990), Murphy and Zimmerman (1993) and Goyal and Park (2002), however, age and turnover are positively correlated.

Vancil (1987) introduces age as an explanatory variable for CEO turnover and concludes that an outgoing CEO's choice of successor is influenced by the successor's age insofar as the CEO will try to choose a successor who has at least 10 years to retirement at the time of succession.

Brickley (2003) suggests that age has not been studied in depth and asks how retirement age affects or is related to the choice of successor.

Hambrick and Mason (1984) created "upper echelons theory," which claims that observable demographic characteristics of senior executives, such as diversity of age, education or background, influence organizational outcomes. Attempts have been made to relate such diversity to innovation, diversification and firm performance (Kisfalvi and Pitcher, 2003). The theory suggests that diversity of perspectives on the strategic environment propitiates a more effective, more rational response (Simons et al., 1999). Like large boards, however, diversity can generate conflict (Ocasio, 1994, and Pfeffer, 1981), hamper decision making and prevent consensus on strategy (Kisfalvi and Pitcher, 2003).

Another exogenous factor considered in the literature is the characteristics of the CEO's predecessor (Reinganum, 1985; Fredrickson et al., 1988; Cannella and Shen, 2001; Conger and Nadler, 2004). Fredrickson et al. describe four ways in which the characteristics of the predecessor make it more likely that his successor will be dismissed: a) job tenure: for the reasons already stated, regarding board loyalty and possible comparisons between the two CEOs; b) the reasons for the predecessor's departure: the incoming CEO will be under more pressure if his predecessor was fired than if he left to head another company and the board understands that the job they are offering has been considered inferior; c) continued presence of the predecessor in the company (either as a director, as a consultant, or in some other capacity): the newcomer will be under close scrutiny and the market does not react favorably to such successions (Reinganum, 1985); and d) the predecessor's having been the founder of the company: the previous three influences will be combined, thus augmenting the CEO's chances of being dismissed.

3.2. Company size and age

Numerous articles have been written on the impact of CEO succession on shareholder wealth. Reinganum (1985) is a classic example, pointing to an association between succession and return on equity. The author signals the need to establish certain control variables for company size, successor origin and the measures taken by the outgoing CEO.

He finds that in large companies CEO succession has no statistically significant impact on stock price (Reinganum, 1985). In small companies, however, he finds an "abnormal cumulative return".[9] Combined with the above, Reinganum's findings imply that the CEO of a small company is more likely to be dismissed if he has been promoted from within. According to Cappelli and Hamori (2004), these two factors (small company and internal promotion) are unlikely to occur simultaneously, as

[9] This term is commonly used to explain the impact a certain event has on a variable. In our case, Reinganum studies the impact that succession announcements have on stock prices. For an explanation of event study, see MacKinlay (1997).

small companies increasingly tend to hire CEOs from outside.

There is no agreement in the literature as to the impact of firm size on CEO turnover. Boeker (1992), who defines size in terms of company sales compared to industry average sales, concludes that size may affect turnover because in larger companies routines become institutionalized, increasing the number of dismissals. Using a sample of the smallest and largest *Fortune 500* companies, Grusky (1961) finds that large companies have higher CEO turnover.

Others, such as Brady and Helmich (1984), find no significant impact of company size on CEO dismissal.

Miller et al. (1982) argue that size has an inertial effect on CEOs in that as corporate processes entail stricter monitoring of, or limitations on, management, larger organizations will tend to have higher CEO turnover.

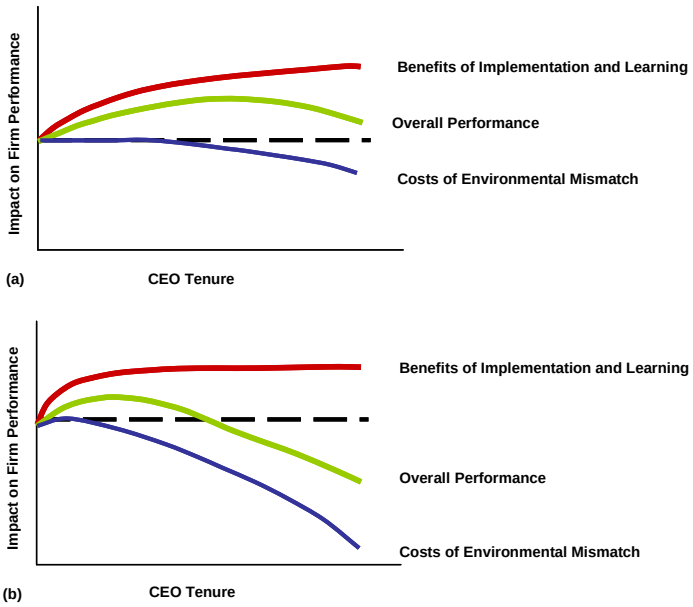
With respect to company age, the most recent studies note a growing correlation between company age and number of outside directors (Boone et al., 2007; Coles et al., 2008; and Linck et al., 2008). As we shall see, the relationship between majority outside boards and CEO turnover is one of most fiercely debated issues in the literature. Therefore, there is no conclusion to be drawn as to how company age affects CEO failure.

3.3. Industry type

According to Fredrickson et al. (1988), industry type can affect CEO turnover through three channels: the level of development of the industry, the diversity of financial performance, and the number of companies. Level of development is found to have a range of contrasting effects. In young industries there is no benchmark for CEO or firm performance (Pfeffer and Moore, 1980), as industry knowledge is limited (Porter, 1980). This can increase CEO turnover for two reasons: divergence of interests among the directors of these companies can make the CEO more vulnerable and at the same time prevent consensus (inside and outside the company) on dismissal. Henderson et al. (2006) suggest that CEOs in fast-growing industries can contribute strategic value to their companies intensely but for a short period. In contrast, stable industries (the authors cite the United States food industry) provide an environment in which CEOs can improve their companies' performance over a longer period, albeit less dramatically.

The two charts in Figure 1 show the trend reported by Henderson et al. (2006, p. 450) in the impact of the CEO on company earnings (a) in stable industries and (b) in fast-growing industries.

Figure 1.



Source: Henderson et al. (2006).

Another influence on CEO turnover is disparity of earnings within an industry (as explained by Fredrickson et al.). Boards of directors use not only their own company's past performance but also the performance of rival firms as an indicator of their company's performance. Heterogeneity of performance in emerging industries can create incentives in either direction (Parrino, 1997).

Fredrickson et al. identify a final source of influence: the number of companies in an industry. This last variable does not alter the effect of the

previous two and correlates highly with industry age and disparity of earnings.

3.4. Board composition

Board composition, especially the proportion of executive and non-executive directors, can be expected to have a major impact on the likelihood of CEO dismissal (Boeker, 1992). According to Shivdasani and Zenner (2004), few issues find such consensus in academia: board decisions are generally thought to be better for shareholders when the board has a majority of non-executive directors. Even so, there are those who deny any such relationship between outside directors and company performance.

Weisbach (1988), for example, argues that boards are, for shareholders, the first line of defense against incompetent management and concludes that, where outsiders are a majority,[10] the stock price is positively correlated with CEO succession. This means that a change of CEO is a signal to the market that the change will generate value for the company. This result is explained by there being a majority of outside directors.

Having a majority independent board may therefore be a good explanatory variable for CEO dismissal in the event of poor management performance (Shivdasani and Yermack, 1999). Fama and Jensen (1983) note that, in order to preserve their reputation as directors, outside directors will work to eject under-performing CEOs and thus signal their decision monitoring capability to the market.

The literature argues in favor of majority outside boards on the understanding that insiders are less likely to dismiss a CEO to whom they owe their position (Fama, 1980).

However, non-executive directors could be expected to exercise more effective control and monitoring of CEO decisions (Shivdasani and Zenner, 2004; NYSE, 2003; Fama and Jensen, 1983), as they are good advisers and have a "wealth of experience," so CEOs would make fewer mistakes and give fewer signals to the market (e.g. declines in earnings) that might spark a chain of decisions leading to CEO dismissal. In other words, CEOs in companies with majority outside boards should be replaced less frequently.

Other researchers, question the importance of board composition. Longstreth (1995) is skeptical of any correlation between board composition and firm performance. He also contends that directors' management oversight role may detract from their advisory role, which may be neglected if directors habitually adopt an attitude of confrontation with management. For Tobin (1994), who analyzes the issue from a legal perspective, the link between the number of outside directors and board independence is weak. In his view, many inside directors with an interest in the company would set more ambitious goals and ask more searching questions. He therefore considers "independence" to be just one of the many characteristics of the "ideal" director (Faulk, 1991).

Despite the theoretical consensus (with the noted exceptions), the empirical findings disagree (Mehran, 1995; Coles et al., 2008). Hermalin and Weisbach (1991) conclude that board composition and firm performance are unrelated. They acknowledge that their findings contradict the literature and argue in favor of the beneficial effects of insider boards, which understand the company's day-to-day operations (Mace, 1971, and Vancil, 1987) and the succession process (Mace, 1971). This positive assessment of the contribution of insider directors is shared by Coles et al. (2008) and Berry et al. (2006).

Bhagat and Black (2002) study firm profitability in relation to board composition. They conclude that companies with majority independent boards are no more profitable than those with a majority of executive directors.

The solution, therefore, would seem not to be more regulation (MacAvoy and Millstein, 2003) or "more independent" boards, nor power sharing between the board of directors and the management team (led by the CEO). Rather, the aim should be to strike a delicate balance, so that board and management join forces to grow the company in the long run (Canals, 2008).

3.5. Board size and commitment

According to Fredrickson et al. (1988) CEO turnover is higher in companies with large boards of directors. Where there is a large number of directors, there are more likely to be different interest groups; any policy the CEO adopts is more likely to be criticized from different angles; and CEO decisions supported by one group of shareholders are more likely to be rejected by another group. This disparity may result in higher CEO turnover.

Iaquinto and Fredrickson (1997) conclude that companies with more cohesive top management teams achieve better results. These authors also explore the direction of causality and find that cohesion among the top management team modifies firm performance, not vice versa. In addition, they find that firm size (which is reflected in board size) is positively correlated with diversity of views among members of the top management team.

[10] As we have said, there is no unanimity in the literature on what is meant by "outside." Since 2002, following the Enron and Worldcom scandals, the NYSE and Nasdaq determined a majority of outsiders on the boards of publicly traded companies and audit committees. The Sarbanes-Oxley Act defined more clearly what constitutes an outsider for both bodies.

This size-related diversity has been found to have a delaying effect on CEO dismissal due to the difficulty of reaching consensus (Lipton and Lorsch, 1992; Jensen, 1993; Monks and Minow, 1995; Yermack, 1996; and Eisenberg et al., 1998). The costs of coordination and the presence of free riders make it likely that large boards will perform their CEO monitoring role less effectively (Lehn et al., 2003).

Fan et al. (2007) find no significant relationship in their study using a relatively small sample of Chinese companies.

Coles et al. (2008) find a U-shaped parabolic relationship between firm performance (measured by Tobin's Q) and board size. In other words, there is a certain optimum at the two extremes: small boards and large boards regularly achieve better results than medium-sized boards. This pattern holds for complex industries, whereas in simpler companies an increase in number of directors is associated with a decrease in Tobin's Q.

Dalton et al. (1999) and Shivdasani (2004), in their bibliographical reviews, conclude that scholars disagree as to the impact of board size on corporate governance. The optimal size for any given company is not easy to determine and it does not seem useful to prescribe an ideal board size for all companies.

Directors' commitment

Using Core et al.'s (1999) definition of "busy directors" (those with three or more directorships if still working, or six or more if retired), Fich and Shivdasani (2005) introduce another factor that influences board effectiveness. According to their research, the number of busy directors is inversely related to CEO monitoring. Beasley (1996) and Perry and Peyer (2005) also find a decrease in monitoring capacity due to multiple directorships. Thus, the more busy directors there are on a board, the lower the level of board control and, all else equal, the lower the probability of CEO dismissal even if the firm performs badly.

However, there is a strand in the literature that sees a positive in this: the experience gained on multiple boards adds value to the company (Pritchard et al., 2003), so there is no reason to set a limit to the number of directorships.

3.6. Valid successor and succession plans

Hermalin and Weisbach (1998) consider that a CEO has a better chance of staying on if there is no obvious successor in the organization. A CEO who has a hand in the succession process therefore faces a conflict of interests: if he selects a brilliant candidate, he will soon be replaced, whereas if he chooses a less capable candidate, he will have no immediate rival (Fredrickson et al., 1988). This interpretation of succession is inconsistent with the value creation arising from internal succession (San Martín and Stein, 2008; Bower, 2007).

Greenblatt (1983) argues that senior managers' perceptions of the CEO affect CEO turnover. CEOs considered irreplaceable ("Rebecca Myth") are better able to hold onto their position (Kets de Vries, 1988).

Cannella and Shen (2001) suggest that the presence of an heir is determined by the interaction of three parties: outside directors, the outgoing CEO and the successor himself. The authors conclude that an heir succeeds (i.e. becomes CEO) if he has experience in the company, the environment is favorable (independent directors tend to back the heir in order to limit the incumbent CEO's power), the outgoing CEO does not control the process (scant stock ownership, short tenure) and the heir has strong leadership qualities.

According to Fredrickson et al. (1988), CEO turnover increases once an industry has matured and shareholders are able to make comparisons and accurately assess CEO performance. In these cases, the board has access to a talent pool, thus reducing the CEO's bargaining power.

Behn et al. (2005) find that the market reacts favorably to CEO succession when a succession plan has been established and there is a publicly identified heir apparent.

According to Conger (2004), an incomplete succession plan entails a direct increase in the probability of CEO failure. An employee who has risen too quickly may not be a good replacement, as he may well not have acquired the necessary leadership competencies (Kovach, 1986). As Pérez López (1993) puts it, an executive who has climbed too fast will not have acquired the necessary personal experience to learn to lead. Walker (2002) highlights the importance of competencies when he notes that people who are used to relying on their own capabilities are slow to discover new roles, such as promoting growth in others, delegating, or building effective teams. Watkins (2004) offers recommendations to new leaders to help avoid failure in the transition period. In his view, failure early on in the CEO's tenure results from failure to understand the new situation or lack of the necessary competencies and flexibility to adapt to it. Premature failure is sometimes related to the narcissism of CEOs who think they can do everything on their own, spurning the support of their predecessor (Friel and Duboff, 2009).

3.7. Mergers and acquisitions: institutional factors

One exogenous reason for CEO turnover often cited in the literature is the merger or acquisition of the CEO's company (Grossman and Hart, 1980; Daines

and Klausner, 2001; Offenberg, 2009; Netter et al., 2009). However, this factor correlates very closely with poor organizational performance. Most acquisitions come in the wake of a period of below industry average results (Martin and McConnell, 1991). Like firm performance, therefore, this factor has limited power to explain CEO failure (Fredrickson et al., 1988).

Martin and McConnell distinguish between disciplinary and synergistic mergers and acquisitions. Synergistic M&As generate gains by combining the resources of the acquirer and the target. In these cases, there is little change in CEO turnover. In disciplinary M&As, however, CEO turnover increases significantly. Martin and McConnell consider an acquisition or merger to be disciplinary when the target is performing poorly. The acquisition of the poorly performing target and the replacement of its top managers effectively disciplines management inefficiency. The possibility of becoming a takeover target is an incentive to change inefficient behavior and brings the interests of management into line with those of shareholders. According to Short and Keasey (1999), in economies where there are few defense mechanisms against hostile takeover, this market discipline (Jensen, 1988) is efficient.

Institutional factors

According to Geddes and Vinod (2002), regulatory changes in an industry influence CEO survival. Their direct conclusion is that CEOs in deregulated industries have shorter tenure. Indirectly, these changes influence CEO turnover because deregulation generates at least two contrasting effects for CEOs. On the one hand, Geddes and Vinod observe that deregulation is linked with smaller boards and a smaller proportion of outside directors. On the other, there is insufficient evidence to be able to state unequivocally that deregulation influences the proportion of outsiders. Therefore, deregulation has opposite effects on CEO turnover. Smaller boards and fewer outsiders are indicators of lower CEO turnover,[11] but the lack of statistically significant evidence means that the proportion of outsiders cannot be said to favor turnover. The aggregate effect is ambiguous and requires further research.

As regards the effect that deregulation has on individual industries, Crawford et al. (1995) and Hubbard and Palia (1995) examine the United States banking industry. Hubbard and Palia find that a deregulated sector is associated with greater pay-performance sensitivity. They also find that deregulation entails higher rates of CEO turnover. In their view, these results are consistent with the idea that legal restrictions on CEO pay reduce labor market efficiency: standardization of pay prevents the market from signaling the most efficient managers. This lower CEO labor market efficiency has been studied in a theoretical framework by Gabaix and Landier (2008) and Terviö (2007). In their models these authors attempt to assess the effect that CEO talent has on company earnings and, consequently, the optimal level of additional compensation.

The growing importance of capital markets in recent years has also affected CEOs' decisions. Vancil (1987) correctly predicted growing pressure on CEOs from the capital markets. He foresaw that the market (seeking to maximize shareholder wealth) would be an impartial judge of CEO's decisions and would ultimately determine CEO survival. Vancil's predictions were accurate (Guerrera, 2009). However, this demand for short-term results can also undermine the longer-term development of a company and its professionals, which are essentially what will enable the company to survive over the medium to long run (Canals, 2008).

As with the endogenous factors, the results of our review of the literature on the exogenous factors of CEO failure are summarized in a table (Table 3).

[11] In parts of the literature analyzed in this article, the relationship described here is seen as being the reverse: small boards tend to make faster decisions, resulting in higher CEO turnover.

Table 3.

Factor	Increases likelihood of staying on as CEO		Reduces likelihood of staying on as CEO	No clear effect on CEO failure / Other approaches to the factor		
Relation to failure	Author (year)	Contributions	Author (year)	Contributions	Author (year)	Contributions
CEO age (older) *Are older CEOs more likely to be dismissed?*	Morck et al. (1989)	Younger CEOs have higher turnover rates.	Weisbach (1988) Murphy and Zimmerman (1993) Goyal and Park (2002)	Empirical evidence shows a significant negative relationship between age and dismissal.	Brickley (2003)	Insufficient empirical evidence to draw conclusions.
Long tenure *A long-serving CEO is less likely to be dismissed than a shorter-serving one.*	Pfeffer (1981)	Theory of the institutionalization of power.	Selznick (1957) Michels (1962) Pareto (1968)	Theory of the circulation of power: time generates conflicts between elites.		
	Fredrickson et al. (1988) Wade et al. (1990)	Loyalty of board members hired during CEO's tenure.				
	Boeker (1992) Ocasio (1994) Lehn and Zhao (2002) Cannella and Shen (2002) Baker and Gompers (2003)	Greater CEO influence.	Vancil (1987)	After 10 years CEOs start to be worn down.		
	Henderson et al. (2006)	In stable industries CEOs can learn more. The impact of CEOs' decisions on the environment allows 10-15 year tenures.				
Greater demographic diversity *Does greater demographic diversity (education, age, origin) in top management teams promote CEO survival?*	Simons et al. (2001)	Diversity of approaches to the environment propitiates a more appropriate strategic vision, which helps the CEO to improve the company's performance.	O'Reilly et al. (1984)	The greater the demographic diversity of the top management team, the greater the threat to CEO survival.	Hambrick and Mason (1984)	Started the study of demographic factors: Upper echelon theory.

	Kisfalvi and Pitcher (2003)	Laxer monitoring of the CEO due to diversity of board opinion.			Lieberson and O'Connor (1972) Hannah and Freeman (1977) Salancik and Pfeffer (1980)	Strategy (as a source of CEO failure) is determined by the environment: it is an inertial response to the environment.
	Finkelstein and Hambrick (1990)	Longer-serving top management teams obtain above-average results.			Jensen and Zajac (2004)	The agency view does not include these demographic factors.
Outgoing CEO *The activity of the outgoing CEO may facilitate the decisions of the incoming CEO.*	Vancil (1987)	Facilitates the transition and the incoming CEO's first decisions	Helmich (1977)	Outgoing CEOs leave behind an image created over a long period.	Fredrickson et al. (1988)	Succession is influenced by the outgoing CEO's tenure, reasons for exit, active presence in the company after leaving the CEO position, and company founder role
			Pfeffer (1981) Cannella and Shen (2002) Conger and Nadler (2004)	The loyalty of old directors makes succession more difficult.		
			Reinganum (1985)	Succession is less successful if the outgoing CEO remains in the company.		
Company size *The bigger the company, the smaller the probability of CEO dismissal.*	Reinganum (1985)	If the CEO is an insider, a statistically valid pattern is observed: in small companies, CEO turnover is higher.	Grusky (1963)	Large companies have higher turnover.	Cappelli and Hamori (2004)	The two characteristics are unlikely to occur simultaneously. There is insufficient evidence to determine the direction of the effect.
			Miller et al. (1982) Boeker (1992)	In larger companies CEO monitoring processes are more likely to be institutionalized, leading to higher CEO turnover.	Brady and Helmich (1984)	There are no empirical differences based on company size.
					Tosi et al. (2000)	CEOs try to increase company size because in doing so they increase their own compensation.

Company age *High correlation with company size: older companies can be expected to dismiss fewer CEOs than younger ones.*					Boone et al. (2007) Coles et al. (2008) Linck et al. (2008)	Correlation between company age and proportion of independent directors. Impact on CEO turnover is indeterminate.
Board composition *Having a majority of outsider directors implies stricter supervision of CEO activities.*	Mace (1979)	Insider directors contribute value to the CEO with their advice and knowledge of daily operations.	Rostow (1959)	Outsider directors monitor CEO decisions more rigorously.	Demsetz (1983)	Dispersion is linked to weaker control.
	Vancil (1987)	Insider directors facilitate smooth succession.	Jensen and Meckling (1976)	Independent directors, who are not influenced by the CEO, can help to minimize agency costs.	Hermalin and Weisbach (1991)	There is no empirical relationship between CEO turnover and board composition. There may be no real relationship; or insiders may be the same as outsiders.
	Faulk (1991)	Independence should not be the only factor considered.	Fama (1980) Fama and Jensen (1983)	Independent directors' desire to cultivate their reputation in the senior management market makes them more demanding of CEOs.	Agrawal and Knoeber (1996)	Board supervision must be considered in conjunction with other variables, such as the presence of institutional investors or the dispersion of capital.
	Tobin (1994)	Insiders set more ambitious goals than outsiders because they have closer ties with the company	Mizruchi (1983)	Identifies independence with outside, non-executive directors. Concludes that the capacity to dismiss the CEO is dependent on the presence of outside directors.	Bhagat and Black (2002)	There is no enough statistical evidence to state that outsider boards obtain better results than insiders.
	Longstreth (1995)	Excessive concern for supervision is detrimental to the board's advisory role. The merit of independence needs to be proven.	Weisbach (1988)	Independent directors are the first line of defense of shareholders' interests.	Canals (2008)	Rather than a power struggle, it would be better to find a balance that allows insiders and outsiders to combine forces.
	Mehran (1995)	There are no empirical data to compare this logical consequence with agency theory.			Guest (2008)	Identifying independence with better supervision is an oversimplification.

	Coles et al. (2008)	Better firm profitability with more outside directors on the board in R&D-intensive industries .	Friedman and Singh (1989) Boeker (1992) Jensen (1993) Borokhovich et al. (1996) Agrawal and Knoeber (1996)	Greater probability that succession will not be initiated by the CEO.		
			Shivdasani and Yermack (1999)	The market does not value the inclusion of independent directors when the CEO sits on the nomination committee.		
			Shivdasani and Zenner (2004)	A majority of articles stress the importance of outside supervision.		
Board size *How does board size influence the decision to replace the current CEO. Board size has been associated with fragmentation of views.*	Chaganti et al. (1985)	Successful companies have larger boards than unsuccessful ones.	Fredrickson et al. (1988)	In larger boards, rival groups are more likely to form. If the CEO identifies with any of these groups, there may be confrontation with the others.	Selznick (1957)	Merely having worked together on the board for a long period does not necessarily mean that directors are united in their views
	Lipton and Lorsch (1992) Jensen (1993) Monks and Minow (1995) Yermack (1996) Eisenberg et al. (1998)	The diversity of large boards leads to laxer monitoring of CEO activities. Coordination costs lead to dilution of board monitoring of management.	Helmich (1980)	Higher CEO turnover in companies with large boards and below-average performance.	O'Reilly et al. (1984)	Board members tend to come to share the same values over time. The impact on CEO turnover is unclear.
					Dalton et al. (1999) Shivdasani and Zenner (2004)	There is no unanimity in the literature on the impact of board size.
			Iaquinto and Fredrickson (1997)	Top management team cohesion results in better firm performance: large boards prevent such cohesion, as they increase the likelihood of	Fan et al. (2007)	No relationship has been found between CEO turnover and board size.

				divergence of opinion.	Coles et al. (2008)	Complex organizations perform better (as measured by Tobin's Q) when they have large boards.
	Lehn et al. (2003)	Coordination costs and the greater probability of having ineffectual directors on the board dilutes board control				
Board commitment *Multiple directorships may enhance supervision (broader, more diverse experience) or they may decrease it (difficulty of advising appropriately).*	Beasley (1996) Perry and Peyer (2005) Fich and Shivdasani (2005)	Busy boards are less able to supervise the CEO effectively.	Pritchard et al. (2003)	Boards whose members have experience from multiple directorships have access to best practices and are better able to monitor the CEO.	Fich and Shivdasani (2005)	Companies whose reputation is damaged by irregular activities do not have higher board turnover, but they do have fewer directors who also sit on other boards.
Type of industry *Do younger, more innovative industries with higher R&D spending have higher CEO turnover?*	Fredrickson et al. (1988) Parrino (1997)	CEOs less likely to face dismissal in young industries with large numbers of companies (disparity of results) and no generally accepted criteria for assessing CEO performance.	Fredrickson et al. (1988)	Boards in mature industries may place higher demands on CEOs, due to the relative ease of achieving good performance.	Coles et al. (2008) Berry et al. (2006)	Boards in R&D-intensive industries have a higher percentage of insider directors. There is no empirical evidence that this higher percentage of insiders has any impact on CEO turnover.
	Henderson et al. (2006)	CEOs learn more in stable industries. The impact of their decisions on the environment allows 10-15 year tenures.	Henderson et al. (2006)	In nascent industries there is more statistical noise and boards' decision-making capacity is more limited.	Linck et al. (2008)	There is a positive correlation between R&D investment and the proportion of outsider directors. The effect of this circumstance is unclear.
Valid successor *Companies need to establish succession plans. Divergence of interests may disrupt such plans.*	Fredrickson et al. (1988)	The CEO has incentives to appoint less capable successors and so reduce the pressure of succession.	Hermalin and Weisbach (1988)	In the short term, succession has a positive impact on stock price.	Greenblatt (1983)	In the event of succession, top managers may see the successor as a Messiah (putting the incumbent under greater pressure) or they may succumb to the Rebecca Myth (comparing the successor unfavorably with his predecessor).
	Hermalin and Weisbach (1988)	A CEO's jobs is safer when there is no clear successor within the company.	Cannella and Shen (2001)	A CEO is more likely to be replaced when the company is performing well, the CEO has little influence over the choice of successor and there is a successor with leadership capabilities.	Behn et al. (2005)	The return to shareholders improves if the heir is announced publicly.

			Bower (2007) San Martín and Stein (2008)	CEOs have incentives to make their succession a success.		
Institutional factors. Mergers and acquisitions *Having a market that disciplines inefficient management puts pressure on CEOs to perform well.*	Vancil (1987)	The capital market, which performs the monitoring tasks described by Jensen (1988), provides an incentive for better management performance.	Grossman and Hart (1980) Jensen (1988) Daines and Klausner (2001)	Mergers and acquisitions can help to protect shareholders, as they monitor and replace inefficient executives.	Geddes and Vinod (2002)	The effects found in the empirical comparison (of regulated and unregulated industries) do not indicate causal relations.
	Martin and McConnell (1991)	Mergers and acquisitions may be synergistic or disciplinary. Synergistic M&As may strengthen the position of the target company's CEO.	Crawford et al. (1995) Hubbard and Palia (1995) Offenberg (2009) Netter et al. (2009)	Empirically, companies involved in M&A processes have higher CEO turnover.	Rosen (1982) Ortín and Salas (1997)	The labor market may generate hierarchical assignment of talent within companies. The influence on CEO survival will depend on the effectiveness of the market assignment.
			Gabaix and Landier (2008) Terviö (2003)	Based on theoretical models, caps on CEO pay distort the labor market and reduce the pressure to perform optimally.	Short and Keasey (1999) Daines and Klausner (2001) Stout (2002)	Managers may develop defense mechanisms that discourage M&A processes.
					Canals (2008)	Market supervision of corporate governance may be excessively biased toward the short term and may undermine the longer-term development of companies and their employees.

4. Conclusions

We find no consensus in the literature as to the factors that lead to CEO failure. We therefore cannot draw valid conclusions on how to model failure. Given the disparity of the statistical results, it is impossible to design a single model that satisfactorily explains CEO failure. We have analyzed the various factors that may contribute to CEO dismissal, but the conclusions are unclear, and there is a considerable temptation to relate the variables (Kesner and Sebora, 1994), with the result that no practical consequences follow.

In view of the absence of unanimity on the causes of CEO failure and the unsatisfactory nature of the explanations backed by powerful statistical methods, we conclude that the most decisive and informative variable, namely CEO characteristics, has not been sufficiently studied. CEO characteristics (not only competencies) may be the area of greatest interest for research into CEO failure.

We believe that the complexity of the task carried out by CEOs calls for a set of qualitative explanatory variables of such depth that the process most likely cannot be modeled (Ghoshal, 2005; Hayek, 1989). Attempts to answer this question statistically have produced no satisfactory results.

We have probably reached a point of diminishing returns in *logit* models focused on the correlation between CEO turnover and firm financial performance. To improve our understanding of these complex processes we need to explore other, less well trodden paths (Brickley, 2003). The search must continue, perhaps using innovative methods with a greater emphasis on qualitative analysis and within a new theoretical framework.

Firm profitability is significantly negatively correlated with CEO succession, yet it still does not satisfactorily explain CEO failure. The criteria used to measure firm performance are disparate (accounting performance, market share, industry-weighted, etc.), so the results depend on the sample and the criteria used. As we announced at the beginning of this study, the relationship between firm performance and CEO failure is widely acknowledged (and seems common sense), but it is not a sufficient explanation.

We have analyzed the influence of CEO stock ownership on CEO turnover. The two seem to be inversely related: the higher the CEO's interest in the firm's capital, the lower the probability of CEO dismissal.

This conclusion fits with Jensen and Meckling's (1976) agency theory, which argues that stock ownership aligns managers' interests with those of shareholders and so reduces agency costs. Nevertheless, numerous authors attribute a perverse effect to stock-based pay, in that it can encourage CEOs to act unethically and even manipulate their companies' accounts, thus effectively increasing their chances of failure.[12]

Although this is a central question for corporate governance, there is no consensus, in theory or practice, as to how CEO stock ownership affects either firm performance or CEO succession.

Another much debated variable in relation to CEO failure is board composition. Despite general agreement on the desirability of majority independent boards, we believe that this issue has been oversimplified in the literature and in regulation, while the value of executive directors has been underestimated. In fact, Bhagat and Black (2002) find no statistically significant evidence that companies with majority independent boards perform better than those with majority non-independent boards. The preference for independent directors is too closely linked to agency theory (Ghoshal, 2005) and is not based on a rigorous analysis of directors' personal qualifications or a precise definition of "independent" (Shivdasani, 2004).

Financial economists have reached few conclusions regarding the forces that determine board composition (Boone et al., 2007).

Two factors favor CEO survival: CEO membership of the board of directors and CEO participation in selecting directors. Both increase job stability in the short term, but if the CEO's decisions are self-interested, both may also be detrimental to the company (the value of its shares) and prove harmful in the medium term.

A universal definition of failure would allow the various aspects analyzed here to be brought together in a general framework. Studies refer variously to CEO turnover, CEO dismissal, involuntary departure, retirement, decease, etc. This disagreement over the dependent variable makes it difficult to draw any overall conclusions and results in a loss of relevant information.

In most of the samples analyzed in the literature, the possibility of survival bias is not considered. Yet when analyzing time series or panel data from different industries, we find a clear survival bias. This entails a loss of relevant information, as company failure will have a high correlation with CEO failure.

There is a serious bias in the samples used in field studies of CEO competencies. In our view, the information that is not obtained, due to questions not being answered in interviews, represents a significant loss, as non-response and worse performance may be correlated.

To illustrate this lack of unanimity in the literature, below are the profiles of two types of

[12] The subprime crisis seems sufficient evidence of this.

CEO that the research we have analyzed would consider to be at risk of losing their jobs. In some respects the profiles are opposites and yet the literature comes to the same conclusions about both. This suggests that "to date, many different and mutually exclusive theories have sought to study the same phenomenon" (Ghoshal, 2005, quoted in Rosanas, 2008).

CEO A. This CEO is not a member of the board of directors and does not have a say in the selection of directors. He has not been in the company for long and a successor is ready and waiting. He comes from outside the firm and the industry and does not hold many shares in the company. Also, the board of directors is large and has a majority of independent directors, most of whom do not serve on other boards. The company operates in a highly deregulated industry.

CEO B. This CEO (also close to dismissal) has been with the company for many years and holds a substantial proportion of the company's stock. The company's board is small and consists mainly of insiders, who have no other directorships. The company is large and operates in a deregulated sector, where it is subject to share price pressure.

Ghoshal asks why there has not been a fundamental rethink in corporate governance. His answer like that of Hayek (1989) is crucial: the honest answer is that such a perspective cannot be elegantly modeled we don't have the mathematics to do it (at least not yet).

We consider that the main avenues for future research in this area are as follows: a) exploration of the differences between industries as regards CEO failure, so as to remove industry bias; b) further in-depth study of CEO competencies as an endogenous cause of failure, using statistically valid qualitative analysis; c) study of the impact of the stock market on the monitoring of CEO decisions; d) assessment of the increase in performance-related pay at all levels of the company (Hall and Murphy, 2003) and of whether agency theory's prediction of greater alignment between employees and shareholders is accurate; e) development of a comprehensive definition of failure, distinguishing between voluntary and involuntary departure, so as to allow more valid conclusions to be drawn and a more holistic basic model to be built; and f) exploration of new approaches, based on recognition of the inability of the existing literature to explain CEO failure, perhaps less dependent on statistics and built on new theoretical foundations (*The Economist*, 2005), moving toward a theory that acknowledges the complexity of human motives in decision making in corporate governance, thus breaking the hold of agency theory (Pérez López, 1993; MacAvoy and Millstein, 2003; Ghoshal and Rocha, 2006; Rosanas, 2008).

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THE ROLE OF THE INDEPENDENT DIRECTOR IN CEO SUPERVISION AND TURNOVER

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Abstract

A considerable amount of research has been done on the figure of the CEO, approaching it from many angles. Our analysis focuses on the role played by the independent director in the supervision and turnover of the chief corporate executive. In the process, we have carried out a comprehensive reflection on the independent director, consulting the latest literature and including the results of the most recent empirical evidence. We have noticed that the role of the independent director often goes beyond the tasks that are usually considered specific to this function, namely, supervision of the company's senior management. However, the directors' independence cannot be built by requirements. It is a personal quality of the individual that transcends the various problems raised by agency theory. We believe that correct CEO supervision can only be effectively undertaken if the independent directors have these personal qualities. It seems that companies with a larger number of independent directors are more likely to replace the CEO when performance is not as expected. This can only happen if the independent directors enjoy effective independence.

Keywords: Board of Directors, Independent Director, CEO Supervision and Turnover

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1. Introduction: Why has the independent director appeared?

In recent decades, the world economy – and the financial markets in particular – has undergone an unprecedented globalisation process. The presence of international investors in companies' equity has required the convergence of certain criteria that enable the investor to compare and evaluate the enormous variety of financial assets and instruments using reliable information. Globalisation and the opening of capital markets, together with the growth of a middle class with investing capacity, have given rise to another highly significant phenomenon – the fragmentation of corporate equity ownership and the emergence of a large number of small investors. One direct consequence of this process has been to widen the gap between corporate ownership and corporate management.

The problems generated by the separation between the ownership and management of large corporations have been extensively discussed in the literature (Berle and Means, 1932; Jensen and Meckling, 1976; Fama and Jensen, 1983). This article focuses on the control that the Board of Directors must exert on the performance of the CEO and the executive team, highlighting the role played by the independent director[13]. This issue offers considerable current interest. The accumulation of power in the hands of some CEOs, to the detriment of the role that should have been played by the Board of Directors in its supervisory function, has led to undesired effects, such as those observed in the recent bank crisis.

Since the Cadbury Report was published in 1992 in the United Kingdom, many countries have adopted codes of good corporate governance with the goal of satisfying these needs and addressing the situation created by the new phenomena. The codes of good governance are aimed at protecting shareholders' interests. According to the Olivencia Code, conflicts of interest are those in which the company's interests conflict (directly or indirectly) with the director's personal interests. It is in this type of situation that the independent director must perform his role, contributing an objective criterion that is bereft of any outside influence, for the benefit of the shareholders as a whole.

The codes of good governance have provided valuable recommendations for improving «effectiveness, responsiveness, responsibility and transparency in the governance of the companies that turn to the financial markets»[14]. It seems logical that it is the listed companies that have been under greatest pressure to implement the recommendations proposed by the various codes, as

[13] The Webster's Dictionary defines "independent" as "free from the influence, control, or determination of another or others". Depending means being influenced or determined by something else.

[14] Olivencia Report, 1998.

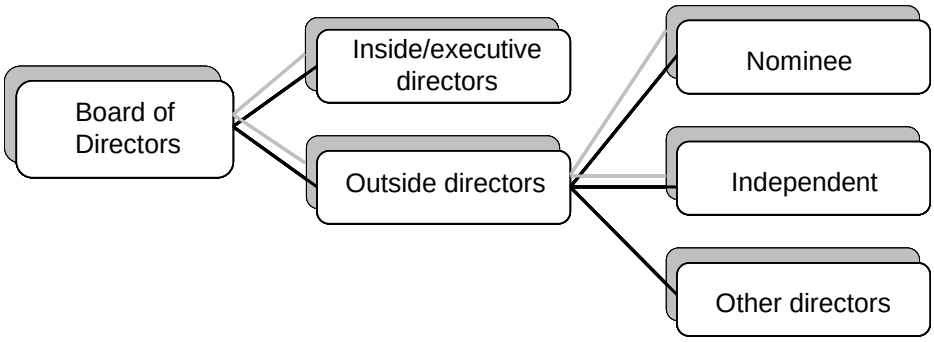
these have the greatest capitalization and shareholder fragmentation.

Our paper has been structured as follows: First, we define the terminology used in Spain when referring to corporate directors. Second, we discuss the influence of legislation and the main codes of good governance. We also devote a section to the distinctive qualities that must predominate in the independent director. This is followed by a review the independence criteria established by the unified code of good governance. In the following section, we compare the features and requirements attributed to the independent director in the leading international codes. The core of this paper is the chapter on the role of the independent director and the supervisory function he must perform on the CEO. We close with the conclusions.

2. Director typology

Before discussing the influence of legislation and the role of the codes of good governance on membership of the Board of Directors, it would be wise to first clarify a series of definitions concerning director typology. Boards of Directors are mainly composed of inside directors and outside directors. The terminology used in Spain is translated in Figure 1.

Figure 1.



Source: Authors.

Executive directors: These are directors who perform senior management functions or are employees of the company in question. It is they who manage the company's day-to-day affairs and who are best qualified to report to the other Board members on the company's progress. The Unified Code of Good Governance (UCGG) recommends that the number of executive directors be the least necessary to cover reporting and coordination requirements.

Outside directors: These are directors who are not employed by the company nor do they have any type of professional relationship with the company, except the directorship. There are three types of outside director: nominee, independent and other.

Nominee directors: These are directors with a shareholding equal to or greater than that legally considered significant or who have been appointed directors by virtue of their shareholder status. Nominee directors are also considered to be those who represent significant shareholders. A director is also considered to be a nominee director if he is a senior executive or director of any of the company's parent companies.

Independent directors: These are directors appointed for their personal and professional qualities, who can perform their functions without being conditioned by relationships with the company, its significant shareholders or its managers.

Other directors: These are directors who cannot be considered nominee or independent directors.

The definition of "other directors" is often given to a director previously classified as an executive, nominee or independent director but who now no longer meets one or more of the requirements specified for these categories. The presence of this type of director can be justified because it is considered necessary that they remain on the Board of Directors (because of their experience and knowledge). For example, executives who cease to perform management duties due to retirement would be classified as "other directors".

3. Influence of legislation and codes of good governance

In Spain, the laws governing listed companies are the Public Limited Companies Act and the Stock Market Act. According to the Stock Market Act, all listed companies must approve and publish an annual corporate governance report (art. 116) in which they give account of their compliance with the recommendations proposed by the Unified Code of Good Governance. Although it is not obligatory to implement the recommendations of the codes of good governance, it is considered that compliance with these recommendations contributes to improving the company's performance by helping

the Board of Directors to carry out its duties in the best interest of the shareholders (*Combined Code on Corporate Governance*).

Considering the different business realities that exist, it may happen that good governance can be achieved by means other than those proposed by the codes of governance. Accordingly, the laws governing the functioning of listed companies provide for the application of the *Comply or Explain* criterion[15], in which listed companies are required to state in their annual corporate governance report the degree to which they follow the recommendations proposed by the currently valid code of governance[16]. According to this criterion, if a company does not apply any of the recommendations, it must explain the rationale which has led it to decide not to comply with the recommendations proposed. Thus, it is left to the market to judge whether the conducts followed are justifiable on the basis of the information provided.

When one talks of the *composition* of the Board of Directors, normally one is referring to the nature of the directors who are its members. There is a general consensus among the codes of corporate governance that the number of outside directors should be sufficient to maintain the Board's independence and, consequently, should be in a majority with respect to the executive directors. Depending on the weight of the various shareholders, there should also be an appropriate ratio between nominee and independent directors, so that the representativeness criterion stipulated in the Public Limited Companies Act is met. In the case of Spain, the UCGG provides that independent directors must represent at least one third of the total Board membership (Recommendation 13).

Appendix 1 lists a series of recommendations given in the leading codes of good governance concerning membership of the Board of Directors and the presence of independent directors.

4. Qualities of the independent director

There is an abundant literature on the skills that managers must have. In this section, we will focus on those skills in which the independent director must excel, commenting on those that are directly mentioned in the legislation and the codes of good governance (Figure 2). With the goal of including recent empirical evidence, we will also refer to some of the most significant research work.

Independent judgement

The ultimate purpose of the independent director is to objectively safeguard the interests of the shareholders (and specifically those holding floating equity[17]) on the Board of Directors. This purpose is fulfilled in different ways but perhaps the most important is to provide an impartial, professional opinion on the decisions that must be made by the Board. This is the main quality that the independent director must have: independence and impartiality in his decision-making.

Many interests are represented within Boards of Directors: senior executives, institutional investors, shareholders with large holdings in the company's equity, and minority shareholders. In principle, all should wish the best future for the company but it is also possible that conflicts of interest may arise. The independent director plays a fundamental role in neutralising these conflicts. By having no ties with the managers and representative shareholders, he should be able to give a truly objective opinion for the benefit of the company.

Loyalty

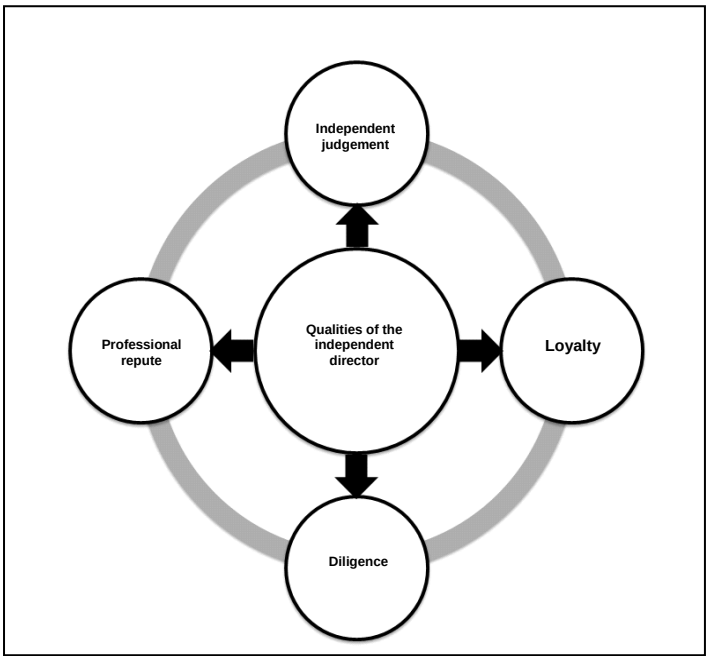
Article 127 (ter.) of the Public Limited Companies Act provides that company officers *must act as loyal representatives*. This duty may seem overly abstract and confusing. In legal terms, the duty of loyalty implies carrying out all the activities that may be required to achieve the company's corporate purpose. With the goal of increasing effectiveness of the duty of loyalty, the Aldama Report gives more precise recommendations: a loyal director must avoid conflicts of interest between the company officers or their direct family and the company, reporting the existence of such conflicts (if they arise) to the Board of Directors. A loyal director must not hold any position in companies that are competitors of the company he is a director of. Under no circumstances must he use confidential company information for private purposes. And he must not make any inappropriate use of the company's assets or use for his personal advantage the business opportunities that come to his knowledge by virtue of his directorship.

[15] In the case of Spain, the Comply or Explain criterion is defined in Article 116 of the Stock Market Act.

[16] In the case of Spain, this is the Unified Code of Good Governance (UCGG), 2006.

[17] The term floating equity refers to the shares in a company that can be routinely traded on the stock market. This term is used in contrast to captive equity, which are strategic equity holdings held by significant shareholders and members of the Board of Directors.

Figure 2. Qualities of the independent director



Source: Authors.

Diligence

It is stated that «*company officers must perform their duties with the diligence of an ordered business person and a loyal representative*»[18]. As is the case with the duty of loyalty, the concept of diligence, as it is defined in the Act, is rather confusing. Consequently, the Aldama Report provides a series of criteria to help give it more substance.

First of all, a diligent director must make sure that he can effectively devote the necessary time and effort to perform the tasks that behove to him as an officer of the company. His involvement in the Board of Directors must be active, saying whatever he considers to be best for the company's interests. In order to achieve this goal, he must not spare effort in obtaining the information he needs and, if he considers it appropriate, he should not hesitate to ask for any advice he considers appropriate.

Keeping well-informed on the company's affairs depends on each director's attitude. Therefore, it is important to have a particularly active attitude, so that the information obtained is as thorough and accurate as it can be. It is vital that the director have the best information available if his opinions are to be truly impartial and independent.

Professional repute

The Board of Directors must be considered as a single body, in spite of the possible internal conflicts that may arise. Accordingly, independent directors should be appointed applying a team approach. It is the Board of Directors as a whole that must pool the knowledge and skills that will enable it to direct and supervise the company in the best way. The Board of Directors' qualities and effectiveness are the product of the aggregate qualities of the individual directors. The independent directors must contribute a series of skills to the Board that will enable the best team to be formed. A diversity of knowledge and skills that complement each other gives added value to the Board's work. The basic requirement is professional repute and it is common for Boards of Directors to include representatives from the academic world, people who have held senior positions in the Civil Service and professionals who have worked in industries that are very different from the company's. To illustrate the varied background of independent directors, the table below summarises the results obtained by the consultancy firm Spencer Stuart in 2009 in its Boards of Directors Index.

Among other factors, professional repute is determined by past performance and results. Gupta et al. (2008) studied the quality of new independent director appointments in the United Kingdom. The authors conclude that the quality of a new directorship correlates positively with the results achieved by the company where the director was

[18] Public Limited Companies Act, article 127.

previously employed. To put it another way, the results that have greatest impact on achieving a higher quality directorship are those that are closest in time to the present.

Table 1.

Habitual professional activity of the independent director	Ibex 35
Activities related with the business world	83%
Academics	11%
Civil Service	6%
Retired executives	16%
Runs own businesses	16%
Independent professionals (lawyers, tax consultants, etc.)	16%
Executive presidents in another company	10%
Non-executive chairmen	8%
CEOs	6%
COOs	5%
Other type of manager	4%
Employers (large companies)	3%

5. Independence criteria defined in the Unified Code

Section III, point 5 of the Unified Code provides a series of criteria whose purpose is to safeguard the directors' independence. These criteria refer to circumstances that it is considered could give rise to conflicts of interest and, consequently, could induce the director to make a decision that is not in the best interests neither of the company nor of the shareholders. It is ultimately the company, through its decision-making bodies, that is responsible for certifying that these requirements are effectively met.

Previous employees or executive directors of other group companies cannot be considered independent directors until at least three to five years have passed since termination of the professional relationship. This is a reasonable requirement as anyone who has worked in a company for any period of time may have developed some kind of link or relationship with other employers or managers that could interfere with their work as independent director (overriding the independence of judgement). Likewise, directors receiving from the company any money other than the compensation agreed for performance of their directorship cannot be considered independent directors. When there is a financial tie between the company and the director, and this tie can be broken unilaterally by the company, this creates incentives that may interfere with the director's independence.

Partners of the external auditor or officers responsible for drawing up the audit report cannot be appointed independent directors (unless three years have passed since they held this position). People who have or have had (during the last year) any significant business relationship with the company must also be ruled out as independent directors. Spouses and relatives (to the second degree) of executive directors or senior managers of the company are also ruled out. All of these cases refer to situations in which it is obvious that the director's independence is in doubt. These are circumstances in which there is a real risk of decisions being made that do not represent the company's best interest.

The Unified Code introduces a novelty by stating that no director can be considered independent if he has not been proposed by the appointments committee. The appointments committee must be composed of outside directors, which in theory qualifies it to choose directors who are independent from the executive team. This measure, together with the other criteria mentioned, does not guarantee the director's independence. For this reason, as we have pointed out at the beginning of this section, it is the company, with its Board of Directors, that must determine its directors' independence.

6. The features and requirements of the independent director in leading codes

In order to analyse the figure of the independent director from a general viewpoint, we have compared the features and requirements of the independent director in the leading codes of good governance. The purpose of this analysis is to identify those recommendations for which there is most consensus. The results obtained are shown in Table 2.

Table 2.

		ANALISYS OF THE QUALITIES AND REQUIREMENTS OF INDEPENDENT DIRECTORS IN THE CODES OF GOOD GOVERNANCE														
			Represent the floating equity's interests	There must be no l ink with the management team	Integrity, experience, expertise and professional repute	Supervisory function	Broaden the Board's "vision". Strategic contribution	Contribute impartial, objective judgement	Independent from shareholders' monitoring groups	Classified by the Board as independent	Proposed by the appointments committee	Exclusion of former executives or employees**	Exclusion of senior managers' relatives	Exclusion of financial ties with the company	Not be a director of another listed company that has nominee/outside directors in the company in question	Limitations on equity holdings***	Exclusion of auditors, consultants or other professionals having a previous relationship with the company
CODES	SPAIN	Olivencia Report (1998)	x	x	x	x	x	x	x			x	x	x		x	x
		Aldama Report (2003)	x	x	x	x		x	x		x	x	x	x	x		x
		Unified Code of Good Governance (2006)		x	x				x		x*	x	x	x	x		x
	INTERNATIONAL	Cadbury Report (1992) United Kingdom		x	x	x	x	x		x	x		x	x			x
		Higgs Report (2003)		x	x	x	x	x	x	x	x	x	x	x			x
		NYSE 303A Corporate Governance Standards (2003) United States		x						x		x	x	x			x
		European Commission Recommendation (2005/162/CE)	x	x		x		x	x			x	x	x			x
		Combined Code on Corporate Governance (2008) United Kingdom		x	x			x	x	x		x	x	x	x		x
		Code de Gouvernment d'entreprise des sociétés cotées (2008)	x	x	x				x	x		x	x	x	x	x	x
		Deutscher Corporate Governance Kodex (2009)		x	x	x			x			x	x	x			x
		Hong Kong Code on Corporate Governance (2004)		x	x		x	x	x	x		x	x	x		x	x

*Almost all the codes of good governance recommend selecting independent directors by means of a formal selection process supervised by the appointments committee. The Unified Code of Good Governance specifies as a criterion of independence (and not as a mere recommendation) that the candidate be proposed by the appointments committee.
** Most codes of good corporate governance do not allow appointment of former employees as directors until a period of 3-5 years has elapsed.
***Normally, independent directors are not forbidden from holding shares in the companies, although a maximum limit is stipulated in order guarantee effective independence.

Most of the requirements given in the codes of good governance refer to circumstances that can potentially give rise to conflicts of interest between the director and the company. Thus, we see that the variables that are stressed most are those that refer to ties between the director and the company (ties with the management team, independence from controlling shareholding groups, exclusion of former executives, exclusion of relatives of the management team, exclusion of financial ties with the company and exclusion of auditors and consultants). Particular emphasis is also given to the recommendations concerning the independent director's integrity, experience, expertise and professional repute.

Considering the variables analysed and the fact that our study is focused on the independent director, the most comprehensive codes in this respect are, in our opinion, the Olivencia Report, the Aldama Report, the Higgs Report, Le Code de Gouvernment d'entreprise des sociétés cotées, and the Hong Kong Code on Corporate Governance.

7. Independent directors: CEO supervision and turnover

As has been pointed out, the equity of listed companies has become increasingly fragmented in the hands of shareholders with small holdings. Many people hold small portfolios containing shares of different companies. The company is owned by the shareholders as a whole. As the number of shareholders with small holdings in listed companies increases, shareholders are forced to delegate administration, management and supervision of the company to third parties, widening the gap between company ownership and management. The Board of Directors is responsible for performing administration and supervision functions on behalf of the shareholders. The shareholders need independent directors who represent their interests, unaffected by any conflict of interests or influence by significant shareholders.

Arguments for and against

The figure of the independent director is a major area of focus for academics specialised in the governance of listed companies. Study of the independent director has taken on increased importance in the aftermath of the corporate scandals that have emerged in recent years (Enron, Worldcom, Parmalat, etc.). These scandals have been related with conflicts of interest between the companies' managers and their shareholders; for example, short-term compensation of the chief executive versus the company's long-term, sustained performance. Within this context and from the perspective of agency theory, the independent director has been highlighted as a basic governance instrument for neutralising problems between the principal (shareholders) and the agent (managers). As shown in Table 3, this is not the only reason justifying the existence of independent directors. There are other reasons that appear recurrently in the various codes of good governance. In addition to the function of correcting possible conflicts of interest and safeguarding the corporate interest in the decisions that must be made by the Board of Directors, there is also the function of improving the quality of the company's governance and ensuring effective supervision of the executive team. When discussing the qualities in which the independent director must excel, we have already mentioned professional repute. This quality is crucial for improving the quality of governance. Likewise, only a person who is completely dissociated from the management team can provide effective supervision.

Table 3.

Reasons supporting the existence of the independent director	Main arguments against the independent director
1. Correct potential power inblanaces and conflicts of interest.	1. The CEO controls membership of the Board of Directors.
2. Safeguard the company's interests in the decisions made by the Board of Directors.	2. He has no incentive to go against the executive team.
3. Improve the quality of the company's governance.	3. He is not in touch with the organization's day-to-day affairs. Information costs.
4. Provide effective management supervision.	4. The fact that he receives compensation negates his independence.

Source: Authors.

However, in spite of the many arguments in favour, a number of criticisms have been made of the independent director. The reasons given to back such opinions seek to refute the independent director's true independence or his ability to provide an impartial perspective in decision-making. One of the more prevailing theses, supported by several research papers, states that the

CEO controls membership of the Board of Directors through his influence on the selection of outside directors. Thus, Shivdasani and Yermack (1999) say that when the CEO is a member of the appointments committee or when this committee does not exist, companies tend to hire less independent directors and more "gray" directors[19] with conflicts of interest. Nowadays, thanks to the recommendations made in the codes of good governance, this situation usually does not arise. As a general rule, compensation and appointments committees are usually composed solely[20] of outside directors and their chairmen are independent. However, there is a risk of formal compliance with the requirements while ignoring the legislator's "spirit", with the result that it is the CEO who effectively exerts power and his influence pervades all areas of the organization. It seems that this view has some following among the more critical sectors.

CEO control in the choice of Board members is not the only criticism made against independent directors. They are also accused of not having any incentive to go against the management. According to the critics, an independent director will never effectively supervise those very people who have put him where he is. This argument is used jointly with that of the compensation of the independent directors. If the company's management is involved directly or indirectly in the selection process and, at the same time, it is able to weigh on the various committees, it does not seem unreasonable to think that any outspoken disapproval of the executive team may endanger the independent director's continued tenure. If such views were to be true, it would follow that the independent director's supervisory role would be effectively invalidated and, furthermore, it would become apparent that an independent director stands to lose much more than he could gain if he chooses to take a critical stance towards the company's management.

The third argument against the independent director focuses on the level of knowledge about the organization that an independent director can have. According to this thesis, independent directors are unable to make decisions that can have a positive influence on the company's performance since they are not involved in the company's day-to-day affairs. Although it is true that the independent director is usually not familiar with the problems that may arise routinely in the company to the same level of detail as the executives, it can also be argued that his function is different from that of other employees of the company. The independent directors contribute value to the company through their knowledge of the industry, their strategic vision, by supervising the executives' work, safeguarding the company's general interest, etc. It is true that they are not aware of the minutiae of the organization's functioning to the same degree as a manager. But this cannot be used as an argument against them, since their job is different. In any case, when faced with any important decision, it is the independent director's obligation to examine in detail all possible consequences and implications in each area of the company. Therefore, the level of knowledge of the company will depend on the director's personal area of responsibility and one neither can nor should generalise that independent directors lack the necessary knowledge to make the organization's important decisions.

On some occasions, as some academics have pointed out, obstacles may arise in obtaining information about the company. Lee et al. (1992) warn that another way in which the CEO can control the Board of Directors is through the information provided to the outside directors. As Jensen (1993) points out, the CEO almost always decides the agenda and the information provided to the Board. Thus, independent directors may find themselves in the situation that the CEO does not provide them with quality information or directly omits significant information on his management. Jensen (1993) concludes that this information constraint limits the ability – even of the most talented directors – to make an effective contribution to control and appraisal of the CEO, and to the company's strategy.

When faced with this type of situation, the director can publicly disclose this fact or resign from the Board. The latter option, resignation, conveys information that the markets usually do not view positively (Gupta and Fields, 2009). Indeed, if an independent director resigns due to the circumstances described above, this can have a very negative effect on the share price of the company in question, forcing the company's management to make the necessary changes to regain the correct course. Thus, an independent director's resignation may be an effective control mechanism in specific situations.

The study performed by Duchin et al. (2010) highlights the importance of information in guaranteeing the independent directors' effectiveness. The authors state that the independent directors' effectiveness depends on the cost of obtaining information from the company. When the cost of obtaining information is low, the company's performance improves when outside directors are added to the Board of Directors. However, when the cost of obtaining information is high, its performance deteriorates when outside directors are added.

[19] The expression "gray directors" is used in the academic world to refer to those directors who, even though they may be classified as outside or independent, have some type of relationship with the company that may lead to conflicts of interest.

[20] Recommendation 44, Unified Code of Good Governance.

There is a fourth criticism that is made of independent directors. As there will be a specific section on the compensation of independent directors, we will leave discussion of this point for a later stage. We will simply mention here the two-fold problem raised by the compensation of independent directors: 1. Beyond what salary level can the directors' independence be at risk? 2. How can you be independent from the people who pay you? It is not possible to find a solution for these two problems without considering each director's personal qualities and traits.

Analysis of the role of the independent director

As Bhagat and Black (2002) point out, the literature presents two different models for analysing the independent director's role in businesses' performance. The first model examines directly the relationship between the Board's membership and the company's performance. The second model studies the relationship between membership of the Board of Directors and its response to specific situations such as, for example, replacing a CEO, rewarding executives with golden parachutes, buying other companies and defending against takeover bids.

In the following pages, we analyse the major contributions to the literature on the subject, taking into account the two models generally used. There will also be an additional section devoted to analysing the papers that have made significant contributions in various areas and a further section on the compensation of the independent director.

Company valuation and performance

The idea that relates independence of the Board of Directors with improved performance by the firm is widely held both among the academic community and among reformers. However, in spite of being a widely held idea, there is no clear consensus in the literature on the relationship between improved performance and a greater presence of independent directors on the Board of Directors. There are authors who say that they have found positive relationships between the study variables (Baysinger and Butler, 1985; Pearce and Zahra, 1992; Rosenstein and Wyatt, 1990; De Andrés and Vallelado, 2008; Krivogorsky, 2006); others, however, maintain that the relationship is negative (Shivdasani and Yermack, 1999; Agrawal and Knoeber, 1996; Klein, 1998). There are also authors who have not found any statistically significant relationship between the variables (Bhagat and Black, 2002; Hermalin and Weisbach, 1991; MacAvoy et al., 1983).

As Dalton et al. (1998) point out, these conflicting findings may be due to the nature of the various performance indicators used by the authors. First of all, the question arises of the repercussion of the decisions made by the Board of Directors and by the management team. To what extent can these decisions affect accounting or market-based financial indicators? The fact is that there is no generalised agreement on this issue. The use of accounting criteria has been criticised because they are susceptible to tampering, systematic understatement of assets' true value, distortions arising from different depreciation criteria, different account consolidation criteria, etc. Significant objections can also be made to market-based measures, as they are beyond managers' control. In spite of these criticisms, the use of market-based indicators also has some positive attributes: risk-adjusted results, not affected by different industrial and multinational contexts, greater ease in comparing companies in different contexts, etc. Other factors that account for the lack of homogeneity in the results arise, for example, from sampling differences and lack of consensus in the definitions of the variables used.

The relationship between a larger number of independent directors and improved performance is grounded on two main reasons: 1. Greater management supervision implies that managers will work harder and better in favour of the interests of the shareholders as a whole. 2. The independent directors' experience and professional repute may contribute notably to the company's strategic decisions.

However, this issue cannot be reduced to mere numeric requirements; it is more complex than that. From the information contained in the study performed by Duchin et al. (2010), we have drawn up a table that summarises the three different visions of this issue. This approach focuses attention on the CEO's ability to choose the new directors and the Board of Directors' membership before the changes are made.

The first vision, advocated mainly by those who are sceptical about good governance reforms, is the so-called "window-dressing" approach. This view maintains that increasing the number of independent directors on the Board of Directors has no effect whatsoever on the company's performance, as the CEO controls the candidate selection process and uses it to put his allies on the Board. In this case, the directors play a decorative role, far removed from any supervisory task, helping the CEO to strengthen his position in the company. Following this reasoning, the recommendations contained in the codes of good governance that specify certain percentages are futile, as the CEO can choose directors who are independent under the terms of the law but are actually dependent upon him on a personal basis.

The "consolidating" vision, argued mainly by those who support the good governance reforms,

maintains that any increase in the Board of Directors' independence has beneficial effects. The reasoning behind this thesis is that managers do not like independent directors and will try to avoid their supervision. Market forces are insufficient in themselves to establish an optimal number of independent directors on the Board, which is why the various recommendations and improvements that have been implemented by the codes of corporate governance are effective. Legislation is an obstacle that cannot be readily sidestepped by the CEO and his team, which is why the new directors' independence should be effective, increasing and guaranteeing supervision of the company's executives.

The third vision, called "optimising", states that the additional independent directors who have been appointed as a result of the good governance reforms may have adverse effects on companies' performance. This idea is grounded on the perception that companies structure their Boards of Directors in the best manner possible. The baseline position would be an optimal point from which any change that might be made would give rise to a less efficient suboptimum. It is true that each director typology has its own particular features; each one has its strengths and weaknesses. Hence the dilemma of having to choose between one or the other. This problem is solved by the company itself with experience and the various significant events that shape its functioning. However, the changes brought about by new legal requirements may have adverse effects. This view may also explain why there is such a divergence of results in the studies that have sought to relate the appointment of independent directors with improved performance. The addition of an independent director would be beneficial for a given company if its Board membership started from a point that was not optimal. Otherwise, the effect will be negative.

Leaving to one side the various technical aspects that work against homogeneity of the results, a greater presence of independent directors on the Board of Directors cannot be justified by a supposed relationship between the Board's independence and improved performance. The lack of consensus in the literature and the scientific evidence lead one to doubt the veracity of this type of statement.

Table 4. Effects of appointing independent directors to the Board

Vision	Window-dressing	Consolidating	Optimising
Who advocates it?	Sceptics about the reforms	Reformists	Some academics
Main arguments	Setting goals by regulating the number of independent directors does not improve companies' governance. The executive team can choose directors who are "independent" according to legal requirements but disposed favourably to management.	Executives do not like independent directors. The management team tries to evade their supervision. Market forces are insufficient to establish an optimal number of independent directors. The management team cannot easily sidestep legislation and, consequently, the new directors' independence will be effective.	Boards of Directors are formed in such a manner that they maximize the company's value. The executive team finds itself in a dilemma when it has to choose between executive directors or independent directors; each one has different strengths and weaknesses
Effect of increasing the number of independent directors on the company's performance	**It has no effect at all**. The CEO uses the figure of the independent director to put his allies on the Board.	**Positive**. An increased number of independent directors on the Board increases supervision of the management team.	**Negative**. Adding independent directors may lead to a suboptimal composition and, therefore, may detract from the company's performance.

Table obtained from the information given in Duchin et al. (2010).

Replacement of the CEO, takeover bids and MBOs

Unlike the situation with the studies mentioned in the previous section, the literature shares a broad consensus when it comes to analysing situations in which the Board of Directors has to make specific decisions. A large number of articles have been published documenting evidence of specific situations in which companies with Boards of Director with a majority of independent directors are able to create higher value for the shareholder.

Of particular interest are the contributions made to the supervision of the chief executive. Membership of the Board of Directors, particularly the proportion of outside and inside directors, should have a significant impact on the likelihood of deposing the CEO (Boeker, 1992). To a certain extent, this is because the Board of Directors is the shareholders' first line of defence against incompetent managers (Weissbach, 1988). Consequently, when faced with inappropriate management, the Board of Directors is the body responsible for vetoing the management and facilitating a change of leadership.

A number of studies have been performed that highlight the relationship between poor performance and CEO turnover (Coughlan and Schmidt, 1985; Warner et al., 1988). However, these studies do not address the possible effects that a higher number of independent directors on the Board may have on the turnover of chief executives. Within the decisions that are included in the supervision function, one of the most important tasks is the replacement of the CEO when he does not adequately perform his role. Following the theses proposed by agency theory, a Board of Directors can only be objective in its decisions when it is independent (Fama, 1980). Accordingly, from the purely conceptual viewpoint, the Boards with a majority of independent directors would be more likely to replace the CEO when his management is not obtaining the required results.

One of the most heatedly debated papers in this line of research is that of Weisbach (1988). This author includes the Board's independence as one of the model's variables. The results obtained describe a positive correlation between CEO resignations/stand-downs and the evolution of the share price when there is a majority of independent directors on the Board of Directors. Based on unexpected share returns on the day when the resignations are announced, the author concludes that the directors create value for the company when they remove poor-performing managers. Fama and Jensen (1983) suggest that an outside director will try to preserve his human capital as a successful director and will therefore move for the removal of the inadequately performing CEO, thereby signalling to the market that he has a high capacity to act as a "decision controller".

As regards the selection of a new CEO, Borokhovich et al. (1996) argue that when the chief executive is dismissed, the likelihood that the Chairman will be an outsider increases proportionately to the percentage of outside directors in the company's governing body.

Other leading researchers have studied what happens when an independent director enters or leaves a company. Gupta and Fields (2009) warn that the resignation of an independent director sends a negative signal to the market. This information is less negative when the Board of Directors has a sufficient proportion of independent directors before the resignation. Another study that addresses the exit of independent directors has been published by Farrell and Whidbee (2000). The authors find a higher likelihood of turnover for those independent directors who show a greater degree of alignment with the outgoing CEO. Hsu-Huei et al. (2008) analysed the market reactions in Taiwan when new appointments of independent directors are announced and identified a positive correlation between the two factors. As the presence of independent directors on Taiwanese Boards of Directors is not addressed in the legislation, they conclude that the appointment of independent directors has more beneficial effects in those countries with less effective mechanisms for good governance.

The chief executive's salary has also been addressed from the viewpoint of independent directors. For example, Ryan and Wiggins (2004); Mishra and Nielsen (2000); Hooy and Tee (2010), document positive relationships between a performance-based compensation for the CEO and the presence of independent directors on the Board of Directors. Similarly, Mayers and Smith (2010) find evidence for a relationship between a higher number of independent directors and the part of managers' salaries that is performance-indexed. The authors point out that executives' salaries are more sensitive to changes in the ROA when the proportion of independent directors on the Board of Directors is higher.

Another highly prolific field of research has been that which has sought to relate independent directors with various variables that come into play when a takeover bid occurs. Byrd and Hickman (1992) find that when a company makes a takeover bid and at least 50 percent of its Board membership includes independent directors, the unexpected share returns on the same day of the announcement are much higher. However, the relationship they describe is not linear, which suggests that it is also possible to have too many independent directors.

The study by Cotter et al. (1997), which analyses the situation from the viewpoint of the

target company of the acquisition, concludes that the presence of independent directors increases the gains of the shareholders of the acquired company, and that companies with a majority of independent directors are more likely to implement defence measures (poison pills, etc.) to increase the shareholder's wealth. Furthermore, when a takeover bid is not well received by the market and the share prices of the target company fall considerably after announcement of the bid, the operation is less likely to go through in the case of those companies with a greater presence of independent directors (Paul, 2007).

In the case of independent directors and MBOs[21], Lee et al. (1992) suggest that shareholders of companies with Boards controlled by independent directors obtain greater returns than other companies in management buyouts. Given the nature of this type of operation, the likelihood of conflicts of interest arising between the management and the shareholders is much greater. In their desire to obtain control of the business, managers may have incentives to make decisions that have a negative impact on the share price, thereby reducing the operation's cost. However, the management team has the obligation to safeguard the shareholders' interests. If they buy the business, this obligation becomes a duty to obtain the best possible price for the shareholders. If the management does not possess the necessary ethical standards and the company lacks defence mechanism, the problem worsens considerably. In this type of situation, the role that must be played by the independent director becomes vitally important. The results obtained by Lee et al. indicate that this role is by no means trivial since, as has been pointed out, the shareholders of companies with a larger number of independent directors receive more value in this type of operation.

Other factors

The influence of the independent director has also been studied on a broad range of variables that are of great importance for companies. For example, evidence has been found that the presence of venture capital firms as equity holders correlates positively with the presence of independent directors on the Board of Directors (Baker and Gompers, 2003).

Musteen et al. (2010), analysing a sample of 324 companies included in the *Forbes* list of most admired US companies, identify that companies with a larger number of independent directors (together with the Board size variable) have a better reputation.

Studying S&P 500 companies with founding family shareholders, Anderson and Reeb (2004) state that the highest valued listed companies are those in which the presence of independent directors balances that of family representatives on the Board.

The independent director and strategy

Recent empirical evidence enables us to gain a better understanding of the reality underlying the figure of the independent director. The results obtained lead us to think that, on many occasions, the role of the independent director goes beyond the relationships and tasks stipulated in legislation and in the codes of good governance.

It may be interesting to ask ourselves again exactly why do companies appoint independent directors. The obvious answer has been discussed in previous sections: there are regulations and a series of recommendations that stipulate their presence on the Boards of Directors of listed companies. However, this answer does not seem to reflect what is actually happening on the supervisory bodies of large companies.

In a study of the 1,000 largest listed companies in Japan, Miwa and Ramseyer (2005) find that appointment of independent directors is not a random process. According to the results obtained by the authors, each appointment is for a specific reason. For example, companies that need to borrow heavily or have less mortgageable assets are more likely to recruit directors from the bank industry. Likewise, companies in the construction industry with significant sales to the public sector are likely to recruit directors belonging to the Civil Service and the Government. This latter factor has been studied in depth (for the Korean case) by Kim and Lim (2008), who identify a positive relationship between a company's valuation and the proportion of directors with prior experience in Government positions.

Likewise, the study performed by Bhagat and Black (2002) reveals important information about the behaviour of large companies in the appointment of independent directors. The results obtained help us gain a better understanding of the rationale underlying this type of decision. According to the authors, companies with low or negative returns tend to contract more independent directors with the aim of improving their situation. It seems that the Boards of Directors, with their decisions, support and follow the convention that a higher number of independent directors on the Board helps improve companies' performance. However, the authors point out that there is no evidence that this strategy actually works. Indeed, the information obtained by Bhagat and Black

[21] Management Buyout. A MBO is a type of operation in which a given company's management team takes control of the company by buying the shares held by the other shareholders.

suggests the complete opposite of what common sense would dictate, i.e., companies with more independent directors do not perform better than the others.

The results obtained by these authors indicate that, while they accept legal requirements and the recommendations of the codes of good governance, companies choose members for their Board of Directors on the basis of their specific needs. Accordingly, it seems that what really matters in an independent director is not his independence, but his contacts and possible strategic contributions arising from his knowledge of a particular industry. Thus, the independent director may become a significant strategic tool for the company.

To conclude this section, Table 5 summarises the main contributions made by the leading authors on the subject of independent directors.

Table 5. Main contributions on the role of the independent director

Factor	Authors	Contributions
Compensation of independent directors and personal profile	**Linn and Park (2005)**	Companies with better investment opportunities compensate their independent directors more generously.
	Marchetti and Stefanelli (2009)	Companies compensate more generously those directors who are better known.
Independent directors and strategy	**Kim and Lim (2008)**	There is a positive relationship between a company's valuation and the proportion of directors with prior experience in Government positions.
	Miwa and Ramseyer (2005)	Appointment of independent directors is not a random process. Companies appoint independent directors on the basis of their needs (contacts with banks, with the Government, etc.).
Independent directors and performance	**Agrawal and Knoeber (1996)**	A higher holding by "insider" directors in companies' equity relates positively with better performance, while more independent directors on the Board, more financing via debt and a higher involvement in control activities relate negatively with performance.
	Baysinger and Butler (1985)	Companies with a higher percentage of independent directors obtain better results. The beneficial effects are seen on Boards of Directors with low levels of independence.
	De Andrés and Vallelado (2008)	Membership and size of the Boards of Directors of banks show an inverted U-shaped correlation with the company's performance.
	Duchin et al. (2010)	Outside directors' effectiveness depends on the cost of acquiring information from the company.
	Hermalin and Weisbach (1991)	It seems that there is no relationship between membership of the Board of Directors and corporate performance.
	Klein (2002)	There is a negative relationship between Board independence and abnormal returns.
	Krivogorsky (2006)	The results obtained show a marked positive relationship between the proportion of independent directors on the Board of Directors and a number of profitability ratios.
	Pearce and Zahra (1992)	The presence of independent directors on the Board is associated positively with financial return indicators.
Entry and exit of independent directors	**Shivdasani and Yermack (1999)**	Appointment of an independent director has less impact on the share price when the CEO is involved in the selection process.
	Hsu-Huei et al. (2008)	Appointment of an independent director has a positive impact on the market.
	Bhagat and Black (2002)	Low-performing companies tend to increase the independence of their Boards of Directors. However, it cannot be said that this strategy works. Companies with more independent directors do not perform better.
	Farrell and Whidbee (2000)	A higher turnover is more likely for those independent directors who are more aligned with the outgoing CEO.
Entry and exit of independent directors	**Gupta and Fields (2009)**	The resignation of an independent director sends a negative signal to the market. This information is less negative when the Board of Directors has a sufficient proportion of independent directors before the resignation.

	Hermalin and Weisbach (1991)	It is more likely that additional independent directors will be appointed when companies' performance deteriorates. Boards of Directors tend to lose independence as the CEO grows in his career.
	Rosenstein and Wyatt (1997)	The market responds positively when companies appoint independent directors.
CEO replacement	**Boeker (1992)**	The CEO is less likely to stand down when the company's shareholding structure is more fragmented and the company's Board of Directors has a higher percentage of executives as members.
	Borokhovich et al. (1996)	When the chief executive is dismissed, the likelihood of the Chairman being an outsider increases with the percentage of outside directors on the company's Board.
	Fama and Jensen (1983)	An outside director will try to preserve his human capital as a successful director. He will therefore move for the removal of a bad CEO.
	Hermalin and Weisbach (1991)	CEO turnover correlates negatively with companies' performance. This correlation increases when the Board of Directors has greater independence.
	Weisbach (1988)	There is a greater likelihood of resignation among those CEOs whose companies are performing poorly and their Boards of Directors have a majority of outside directors.
CEO compensation	**Hooy and Tee (2010)**	Sensitivity of the CEO's compensation to performance is higher in those companies with more than 50% of independent directors.
	Mayers and Smith (2010)	There is a positive relationship between the structure of the Board of Directors and the extent to which executives' compensation is performance-linked. Compensation is more sensitive to the ROA when the percentage of outside directors is high.
	Mishra and Nielsen (2000)	There is a positive relationship between the percentage of independent directors and the sensitivity of the CEO's salary to performance.
	Ryan and Wiggins (2004)	Compensation in the form of stock is higher for those managers whose companies have a higher number of independent directors.
Takeover bids	**Byrd and Hickman (1992)**	Companies making a takeover bid and which have at least 50% of independent directors obtain significantly higher abnormal returns on the day of the announcement than the companies with less independent directors. When the Board of Directors is independent, the acquisition premium, the premium revision, and the shareholder gains during the tender period are higher. When a takeover bid is not well received by the market and the share price of the target company falls considerably after announcement of the acquisition, the operation is less likely to go through in the case of companies with a greater presence of independent directors.
MBOs	**Lee et al. (1992)**	The results suggest that companies with Boards controlled by independent directors obtain higher returns than other companies when they are bought by the management.
Other factors	**Anderson and Reeb (2004)**	The companies with founder family equity holdings with the highest net worth – included in the S&P 500 index – are those in which the presence of independent directors balances family representatives on the Board.
	Baker and Gombers (2003)	Companies backed by venture capital firms have less inside directors and more independent directors.
	Musteen et al. (2010)	Companies with large Boards of Directors with a higher proportion of outside directors have a better reputation than companies with small Boards and high proportions of inside directors.

Compensation of the independent director

One of the critical problems involving the independent director arises from the compensation they must receive. The salary of directors given the attribute of independent must be balanced if it is wished to guarantee their independence. There are no precise criteria for identifying high compensations that could imperil the directors' independence. However, if the income from the directorship represents a high percentage of the director's salary, his criterion may lose a certain degree of independence from the person or committee who has appointed him to this position.

The opposite case also causes problems. If the salary received is too low, the company may have difficulties in finding qualified directors willing to take on the dedication and responsibility required by the position. Consequently, the appointments committee faces a major dilemma when determining the compensation of independent directors.

The problem of independent directors' compensation has not been studied by the academic community with the depth at which the various systems of executive compensation have been approached. Neither does legislation or the codes of good governance address this problem to any significant degree. The Unified Code of Good Governance confines itself to recommending *«that the compensation of outside directors be that required to reward the dedication, qualification and responsibility required by the position; but not so high as to compromise their independence»*[22]. The EU recommendation of 30 April 2009 on compensation schemes of listed companies provides a series of principles which should be taken into account when drawing up compensation schemes for directors. Given their content, these principles may be very useful for creating compensation schemes for independent directors.

First of all, the compensation scheme for directors should foster the company's *long-term* sustainability. Furthermore, compensation should be tied to the company's results. This second point implies that the variable part of the salary should be linked in some way to performance criteria (quantifiable, established beforehand and not just financial). In order to guarantee that the decisions made by the directors are the most favourable for the company in the long term, it is proposed that part of the variable performance-linked salary be deferred. This would enable the results obtained to be checked against the goals proposed. If the pre-established requirements are not met, the director will receive the part corresponding to his fixed compensation, losing the variable part. Stock options are excluded from any possible compensation of independent directors, as they endanger his effective independence.

Although compensation schemes for independent directors have not been studied in depth, this is not the case of the possible relationships between the compensation of independent directors and other variables. Thus, Marchetti and Stefanelli (2009) study whether there is any relationship between the compensation of independent directors and their personal profile. The results obtained indicate that companies compensate more generously those directors who are more widely known.

Linn and Park (2005) assure that the compensation of independent directors is related with the company's investment opportunities. In other words, the companies with more investment opportunities compensate their independent directors more generously than those with more limited investment spectra.

8. Final reflections

From a theoretical viewpoint, the figure of the independent director has raised high expectations as regards improving corporate governance. Many of the recommendations included in the codes of good governance are based on agency theory and, therefore, focus on highlighting situations that can generate conflicts of interest. This approach is insufficient, as it raises the risk of making *«an interpretation* (of the director's independence) *that is closer to the letter than to the spirit of the name»*[23], complying the with the minimum requirements for eligibility for independent directorship while not guaranteeing effective independence.

Following the thesis proposed by Canals (2008), we have wished to highlight in this study that directors' independence is something that transcends compensation or the criteria that may be included in the regulations. Independence cannot be produced by an optimal combination of requirements. Rather, it is a feature of the individual that emanates from virtues and qualities that have been cultivated during his life. It therefore seems wise that the recommendations contained in the codes and in the law itself should include the possibility of ignoring some of the rules with the goal of seeking the best solution, without sticking too closely to the letter.

The compensation of independent directors continues to be an open issue. In spite of the ideas given in the EU recommendation of 30 April 2009, it seems that the only financial criterion that safeguards the director's independence is that the

[22] Recommendation 37, Unified Code of Good Governance.

[23] Olivencia Report.

compensation obtained from the directorship should not represent a high percentage of his total income. Among the possible solutions for this problem, we would stress the need for greater transparency in each director's compensation, making public not only the sums received for the directorship but also the other sums that may be received from other positions.

The presence of independent directors in the governance of companies can be justified for several reasons but, as we have seen in the section devoted to the role of independent directors, a greater presence of independent directors on the Board of Directors cannot be justified by better performance. However, independent directors play an important role in the supervision and replacement of the CEO. The research performed to date indicates that poor-performing companies with a strong presence of independent directors are more likely to replace the chief executive. This can only happen if the independent directors have effective independence. But, at the same time, as independence is a personal feature, adequate supervision of the CEO can only be undertaken if the independent directors possess certain subjective qualities.

Recommendations by codes of corporate governance concerning Board of Director membership

	Code	Recommendations
SPAIN	Olivencia Report (1998)	The Board of Directors should include a reasonable number of independent directors who are people of good professional renown and dissociated from the executive team and significant shareholders. ***(Recommendation 2)*** Outside directors (nominee and independent directors) should have an ample majority over executive directors in the membership of the Board of Directors, and the proportion between nominee and independent directors should be established taking into account the relationship between significant equity holdings and the rest. ***(Recommendation 3)***
	Aldama Report (2003)	There should be an ample majority of outside directors on the Board and, among these, a very significant percentage of independent directors, taking into account the company's shareholding structure and the equity capital represented on the Board. ***(Point 3)***
	Unified Code of Good Governance (2006)	Nominee outside directors and independent directors should make up an ample majority of the Board and the number of executive directors should be the minimum necessary, taking into account the complexity of the corporate group and the percentage share of the executive directors in the company's capital. ***(Recommendation 10)*** Independent directors should represent at least one third of the total number of directors. ***(Recommendation 13)***
INTERNATIONAL	Cadbury Report (1992)	We recommend that the calibre and number of non-executive directors on a Board should be such that their views will carry significant weight in the Board's decisions. To meet our recommendations on the composition of sub-committees of the Board, all Boards will require a minimum of three non-executive directors, one of whom may be the chairman of the company provided he or she is not also its executive head. ***(4.11)***
	Higgs Report (2003)	At least half of the members of the Board, excluding the chairman, should be independent non-executive directors. ***(9.5)***
	NYSE 303A Corporate Governance Standards (2003)	Listed companies must have a majority of independent directors. ***(303A.01)***
	European Commission Recommendation (2005/162/EC)	A sufficient number of non-executive or supervisory directors should be appointed to companies' Board of Directors or Supervisory Board to guarantee adequate handling of serious conflicts of interest involving the company's officers. ***(Section II, point 4)***
	Combined Code on Corporate Governance (2008)	The Board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the Board's decision taking. ***(A.E Main Principle)*** At least half the Board, excluding the chairman, should comprise non-executive directors determined by the Board to be independent. A smaller company should have at least two independent non-executive directors. ***(A.3.2)***
	Code de Gouvernment d'entreprise des sociétés cotées (2008)	The independent directors should account for half the members of the Board in widely-held corporations and without controlling shareholders. In controlled companies, independent directors should account at least for a third. ***(8.2)***
	Deutscher Corporate Governance Kodex (2009)	To permit the Supervisory Board's independent advice and supervision of the Management Board, the Supervisory Board shall include what it considers an adequate number of independent members. ***(5.4.2)***
	Hong Kong Code on Corporate Governance (2004)	Every Board of Directors of a listed issuer must include at least three independent non-executive directors ***(Main Board Listing Rules 3.10)*** The Board should have a balance of skills and experience appropriate for the requirements of the business of the issuer. The Board should ensure that changes to its composition can be managed without undue disruption. The Board should include a balanced composition of executive and non-executive directors (including independent non-executive directors) so that there is a strong independent element on the Board, which can effectively exercise independent judgement. Non-executive directors should be of sufficient calibre and number for their views to carry weight. ***(A.3 Board Composition)***

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REFORM OF MINORITY SHAREHOLDER RIGHTS: AN INTERNATIONAL PERSPECTIVE

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Abstract

This research investigates recent international reforms of minority shareholder rights (MSRs), and the relationship between those reforms and national legal systems. No previous studies have investigated such changes and their underlying causes; nor have they viewed the phenomena concerned through a dynamic lens. The study uses secondary data from 142 countries over a five-year period (2006-2010). Using growth curve modelling and the panel data method, the study finds that legal systems and law enforcement affect reforms positively. On average, countries' MSRs are improving, but this is not consistent across nations. The findings contribute to the current debate on the relationship of law to minority shareholder protection and will assist policy-makers in the area of investor protection reforms. Future research directions are suggested at the end of the paper.

Keywords: Corporate Governance Reform, Minority Shareholder Rights, Legal System

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1.0 Introduction

Within the last decade many countries have paid attention to the rights of minority shareholders who are subjected to controlling shareholders' behaviour that is oppressive, prejudicial and discriminatory. Such behaviour may include the withholding of dividends, exclusion from management, and a range of other forms of self-interested dealings. Many countries have reformed their corporate sector to give better protection to minority shareholders through preventative mechanisms and various remedies. These developments raise a number of questions. For example, are these reforms achieving their intended purpose? Are countries initiating reforms at the same pace? If not, which countries are leading the reform process and what factors are precipitating those reforms? Answers to these and related questions are needed to inform country policy-makers, yet the issues concerned have not been subjected to rigorous investigation.

Reform that is well-informed, evidence-based and properly executed can lead to improvement in minority shareholder rights (MSRs). However, there is a paucity of research into MSR reforms. The few notable exceptions are those researchers (Johnson *et al.* 2000; La Porta *et al.* 2008; La Porta *et al.* 1998; La Porta *et al.* 1997, 2000b) who focus on the quality and enforcement of law as a means of enhancing minority shareholder protection. According to their research, countries with an English common law system and effective law enforcement have been found to have better quality minority shareholder protection than countries with civil law systems and poor enforcement of law. This group of researchers suggests that high judicial independence (La Porta *et al.* 2004) and a quality legal system (Johnson *et al.* 2000) are reasons for greater protection of minority shareholders in common law countries and recommend quality legal reform, reform sensitive to legal tradition and enforcement of those reforms as a means of minority rights improvement (La Porta *et al.* 2008; La Porta *et al.* 2000b).

Some scholars, however, find unpalatable the notion of a relationship between law and legal

enforcement, on the one hand, and minority shareholder protection on the other.[24] Pagano and Volpin (2005), for example, argue that the idea is not based on strong theoretical reasoning. In response to the claim that minority shareholder protection is superior in common law countries with effective law enforcement systems, Lamoreaux and Rosenthal (2004) and Rajan and Zingales (2003)[25] point out that in the nineteenth and twentieth centuries France and French civil law countries were much more investor-friendly than common law countries and that, in any event, differences between common law and civil law countries have changed over time. Roe (2006) argues that investor protection and capital market development are more to do with political attitude and ideology about the capital market than with the common or civil law system—civil law is as good as common law as far as investor protection is concerned; the correlation between legal origin and minority investors' protection found in past literature is mere coincidence.[26] According to Roe (2000), social democracies have weak minority shareholder protection.

Although the debate waxes on whether legal origin matters in protecting minority shareholders, there is no controversy about the importance of affording protection to this group. Lack of such protection can affect the economy of a country. Strict investor protection is associated with greater equity investment and financial market development (Djankov *et al.* 2008). A developed capital market enhances saving, turns savings into investment, and thus aids a country's economic development (Beck *et al.* 2000).

While some studies have investigated the relationship of MSRs to legal origin and other variables, no study to date has looked at the nature and the causes of reform and how these change over a period of time. The dynamic nature of the present study thus contributes uniquely to the current literature. Investigation of this issue can shed light on the assertion that there is a link between legal origin and minority shareholder protection. Thus this research has the potential to give direction to national policymakers on whether the reform of its legal and law enforcement systems represents an appropriate avenue through which to protect minority shareholders

2.0 Minority shareholder rights reform around the world

In recent years, many countries have reformed their corporate governance systems in order to improve minority shareholder protection. Table 1 presents these reforms chronologically from 2005-6 to 2009-10.

The three broad categories of reform that took place during the 5-year period represented in Table 1 were: reform on disclosure of information; reform on related party transactions; and the right to sue directors and make them increasingly liable for their activities.

Securing information about their investment is a right of shareholders; greater disclosure should mean better-informed stakeholders, although this does not always follow. Over the past five years many countries have increased the disclosure requirement in general and particularly the disclosure of related party transactions. Moreover, some countries allow access to company books by minority shareholders.

Countries have also reformed the related party transaction (RPT) approval procedure. Some countries now require shareholder approval of RPTs while others have the requirement of pre-review of RPTs by an external independent party. In Australia, for example, a Regulatory Guide is due for release in 2011 following the issuance of Consultation Paper 142 by the Australian Securities and Investment Commission (ASIC 2010).

It has also been made easier for minority shareholders to sue directors for misconduct. An example of one such reform is the derivative action procedure. In many countries shareholders can sue directors or management on their own account. However, a derivative suit gives shareholders the right to sue directors and managers on behalf of the company concerned. In Australia the relevant legislation is Part 2F.1A of the Corporations Act 2001 (Cth). In England and Wales, the Civil Procedure Rules 1998 [SI 1998/3132] contain the relevant provision. Germany has lowered the shareholding requirement of derivative suits from 10% to 1%, Poland from 5% to 2%, and Greece from 33% to 10 per cent. In Tajikistan and Slovenia, aderivative suit can be brought by at least 10% of shareholders (World Bank 2007, 2008, 2009, 2010, 2011).

[24] Some researchers have studied MSR without directly taking part in the debate but have evaluated specific reforms in a country. For example, Mukherjee-Reed (2002) investigates the effect of corporate governance reform on minority shareholders in India, Linciano (2003) and Mengoli *et al*. (2009) investigate the effect of corporate governance reform on improving MSRs in Italy.

[25] La Porta et al. (2008) demonstrate that the historical data provided by Rajan & Zingales (2003) are over estimated and inconsistent with other researchers data—for example, that of Bozio (2002) and Sylla (2006).

[26] La Porta et al. (2008) counterargue that Roe's findings are statistically flawed.

Table 1. Minority Shareholder Rights Reform around the World (2005-2010)

Minority Shareholder Rights Reform
2005-06
Mexico, Peru, Poland, Romania, Sweden, United Kingdom - increase disclosure requirement for companies.
Germany, India, Mexico, Tanzania – make it easier to sue directors.
China, Hong Kong and Tunisia - amend law to require companies to open books for shareholders inspection.
Israel and New Zealand – require approval by shareholders for related party transactions.
2006-07
Belarus, Colombia, Georgia, Iceland, Indonesia, Vietnam - increase disclosure requirement.
Georgia, Mozambique and Portugal - define duties for directors and controlling shareholders.
Norway and Slovenia - require approval of shareholders for related party transactions.
2007-08
Albania, Azerbaijan, Egypt, Saudi Arabia and Tajikistan – increase disclosure requirements.
Albania, Botswana, Greece, Slovenia, Kyrgyz Republic and Thailand - make it easier to sue directors by the shareholders.
Albania, Azerbaijan and Tajikistan - require approval of related party transactions by shareholders. Egypt introduces prior review of related party transaction by external party.
2008-2009
Dominican Republic, Indonesia, Macedonia, Rwanda, Sierra Leone, Tajikistan, Tunisia and Ukraine - increase disclosure requirement.
Dominican Republic, Macedonia, Rwanda, Sierra Leone, Tunisia and Ukraine - require shareholders' approval for related party transactions. Tajikistan and Tunisia - introduced prior review of related party transactions by external party.
Colombia, Dominican Republic, Macedonia, Rwanda and Tajikistan - make it easier to sue directors. Dominican Republic and Rwanda - allow access of company book by shareholders.
2009-10
Kazakhstan, Morocco, Swaziland and Tajikistan – reform for higher disclosure by companies.
Chile, Swaziland and Sweden - require approval of related party transaction by shareholders. Sweden - also requires prior review of related party transaction by external parties.
Georgia, Swaziland and Tajikistan – make it easier to access corporate information.

Source: World Bank (2007, 2008, 2009, 2010, 2011)

4.0 Ways of Appropriating Minority Shareholder Rights

Controlling shareholders of a company can appropriate minority shareholder rights in different ways.[27] This section describes the major means of deprivation of minority shareholders by the controlling owner group of a company.

4.1 Related party transactions

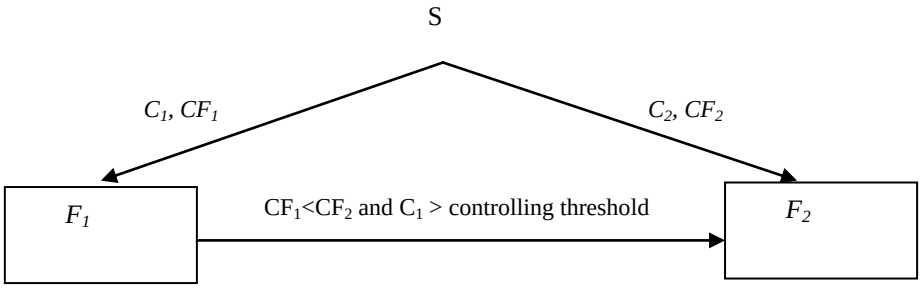
Many empirical studies have shown that RPTs are used mainly by controlling shareholders to tunnel out resources from companies (e.g. Atanasov 2005; Bertrand *et al.* 2000; Cheung *et al.* 2006; Dow and McGuire 2009; Gao and Kling 2008; Peng *et al.* 2011). Controlling shareholders can erode MSRs by selling assets at a reduced price, acquiring assets at inflated prices (Cheung *et al.* 2009a, 2009b), paying cash to related parties (Cheung *et al.* 2009a), borrowing at a higher interest rate (Weinstein and Yafeh 1998), using company assets as security for a loan from related parties and so on.[28] This is a legal way (in the extrinsic sense) of asset appropriation of a company. Controlling shareholders appropriate assets of minority shareholders by transactions with related firms or parties where the controlling shareholders have higher cash-flow rights.

Consider that a controlling shareholder, *S* has CF_1% cash flow right and C_1% control in firm F_1 and CF_2 cash flow right and C_2 control in firm F_2. *S* will be benefited from any favourable transaction between F_1 and F_2 if $CF_1 > CF_2$. Therefore, *S* will be motivated to be involved in a transaction that favours firm F_2. Another, important factor that is required for giving F_2 a favourable deal is the control of *S* on F_1. *S* can control F_1 if it exceeds a certain threshold. Theoretically the threshold is more than 50%, but practically much less than that (see the next section). However, in general *S* is more likely to make a transaction more favourable to F_2 as C_1 increases. Therefore, C_1 has a direct and CF_1 has an inverse relationship with minority asset appropriation. This process is shown in Figure 1.

[27] Theoretically, a 50.01% share of a company is required to control it. However, in reality, often a 20% (or even 10%) owner of a company controls it. The literature shows that a powerful shareholders' group retains control three ways: issuing dual class shares, via a pyramid structure, and cross shareholdings (Bebchuk *et al.* 2000)

[28] However, many RPTs arise for strategic or other fully legitimate reasons—such as buying from own subsidiary for strategic purposes, freducing tax and so on.

Figure 1. Conditions for asset appropriation by related party transactions



4.2 Dividend

The seminal Finance theory of Miller and Modigliani (1961) states that in a well functioning market and tax and transaction costless world, the dividend payout ratio has no effect on corporate value. In practice the dividend decision is made taking into consideration many factors, for example, the effect of the dividend rate on share price, the tax effects of paying dividends and so on. Of late, researchers have seen the dividend payout decision as a means of expropriating from minority shareholders (Faccio *et al.* 2001; LaPorta *et al.* 2000a). Majority shareholders (who are many cases the directors of a company or control the directors) keep the dividend payout ratio low to retain profit within the company. This retained profit can be used by controlling shareholders to invest in projects that yield private benefits, or to tunnel monies out to firms where they have higher ownership. This idea is supported by the empirical finding which shows that dividend rates are lower in countries where there are more controlling shareholders and more family firms—for example, in Asian countries (Faccio *et al.* 2001); on the other hand countries with higher legal protection for minority shareholders, such as common law countries, have higher dividend payout ratios than civil law countries (La Porta *et al.* 2000a).

4.3 IPO and Private Placement

The ownership of existing shareholders is diluted when a company issues new equity either by initial public offerings (IPOs) or by private placement.[29] In both cases minority shareholder rights may be violated. In the case of an IPO the shareholders' relative strengths may be changed without the consent of the minority shareholders. The controlling shareholders might sell shares at the highest possible price while concealing negative information about the company and diverting its cash flows and assets to themselves (La Porta *et al.* 2006). In the case of a private placement the controlling shareholders may sell shares to a related party at a lower price than the market (for listed companies) or the net asset value of the company (for private companies and non listed companies) which not only changes the ownership structure but also tunnels out resources at the expense of the minority shareholders. The controlling shareholders can use different mechanisms to retain their existing control (Högfeldt 2004).[30] The minority shareholders may not have any voice in this.

5.0 Legal origin view of minority right

The quality of the law and law enforcement are considered major protection mechanisms for minority shareholders. The legal systems of countries around the world can be classified into two families: English common law and civil law. The latter is subdivided into three categories: French civil law, German civil law and Scandinavian civil law. The spread of legal systems across the world was influenced by one or a combination of several factors: (1) the colonization of England and France spread English common law and French civil law to the colonies; (2) imitation and adaptation—for example, Japanese adaptation of the German legal system; and (3) regional influence—for example, Scandinavian countries have a similar legal system (La Porta *et al.* 2008).

A common law system is present in England, the United States of America, Australia, New Zealand and many former colonial countries of England. The French civil law system is present in France, Spain, Mexico, Argentina, Peru, Brazil and many formal colonial countries of France. Germany, Japan, Switzerland, South Korea and Taiwan have the German civil law system; and Scandinavian civil law is seen in Scandinavian countries.

Empirical research suggests that the English common law system affords a greater level of protection for minority shareholders than other systems (LaPorta *et al.* 1998; La Porta *et al.*

[29] IPO is an offer to all investors willing to invest in a company; on the other hand, private placement is a share issued to a particular investor(s) generally chosen by the controlling shareholders of a company.

[30] For example, Swedish companies issue B class shares, a lower type voting right share, for IPOs and private placement of new issue.

2000b). This is so because of the nature of the system, (Johnson *et al.* 2000) which allows more freedom than in civil law countries (La Porta *et al.* 2004). In common law countries, the judiciary has the power to make decisions based on broad principles of law. However, in civil law countries, the legal system is based on comprehensive legal codes and judges are not permitted to go beyond those codes in making judgements. Therefore, it is more difficult to use legal loopholes in common law countries than in civil law countries to disadvantage minority shareholders.

Although many countries allow minority shareholders to sue directors (who are in many cases controlling shareholders) for tunnelling out assets through RPTs, these cases are treated differently in civil and common law countries. The courts in civil law countries will consider such actions legal if the RPT concerned conforms with the legal code—the focus is not on fairness and MSRs. In contrast, the main emphasis of a common law court is fairness to minority shareholders going beyond the code (Johnson *et al.* 2000).

Another factor that influences minority shareholder protection is implementation of the law. Having good quality law and a sound legal system is not enough; legal enforcement is also important. Empirical studies suggest that countries with a higher level of law enforcement provide better minority shareholder protection (La Porta *et al.* 1998; La Porta *et al.* 2000b). Referring to legal literature (Berman 1983; Damaska 1986; Merryman 1985; Schlesinger *et al.* 1988), Djankov *et al.* (2003) argue that civil law countries require more formalism for judgement in a lawsuit. They empirically show that civil law countries have higher expected duration of judicial proceedings, more corruption, less consistency, less honesty, less fairness in judicial decisions, and inferior access to justice than that of common law countries.

The purpose of this paper is consider reforms and changes in MSRs over time, and to test the Legal Origin theory (La Porta *et al* 2008), that the differences in legal systems matter in terms of effective minority shareholder rights. It does this using more sophisticated models than have been used previously, and a larger data set, notably covering five years data of 142 countries which enable dynamic elements to be included in the models., including consideration of the pace of reform The specific research questions are:

- How can reforms lead to greater protection of minority shareholder rights?
- Are improvements in MSRs related to the basic legal system of a country?
- Are improvements in MSRs homogeneous across legal systems?

6.0 Methodology

Data. This study uses data from 142 countries from 2006 to 2010. Data on MSRs are obtained from the World Bank's annual publication titled Doing Business; data on the implementation of law are extracted from annual publications of Transparency International; data on legal systems are obtained from the Central Intelligence Agency's World FactBook (2010) and websites of national governments; data on the economic condition of a country are taken from the World Economic Outlook Database of The International Monetary Fund. These databases and publications do not have data for all the variables for all countries of the world. After excluding countries with missing values, the study draws on five years' data for all the variables of 142 countries.

Variables. MSRs is the independent variable in the study. The variable is measured by the investor protection index. Details of the methodology of the Index can be found in Djankov et al. (2008). The index covers minority investor rights related to approval of RPTs, disclosure of RPTs, shareholder rights in the case of prejudicial RPTs by controlling shareholders, minority shareholder rights to sue directors, minority shareholder access to corporate documents and so on. The index value ranges from 0 to 10, with higher values indicating greater investor protection.

Independent and control variables of the study are as follows:

English common law country. This dummy variable is coded 1 if the legal system of a country is the English common law system and 0 otherwise.

French civil law country. This dummy variable is coded 1 if the legal system of a country is the French civil law system and 0 otherwise.

German civil law country. This dummy variable is coded 1 if the legal system of a country is the German civil law system and 0 otherwise.

Scandinavian civil law country. This dummy variable is coded 1 if the legal system of a country is the Scandinavian civil law system and 0 otherwise.

Enforcement of law. The Corruption perception index of Transparency International is used as a proxy measurement for this variable. This proxy has been used in past studies (LaPorta et al. 1998; LaPorta et al. 2000b) for measuring enforcement of law. The index ranges from 0 to 10. Higher scores on the index indicate lower corruption, therefore higher enforcement of law, and vice versa.

Time. This variable is used to measure change. The first year of data (year 2006) is considered as the base year and hence coded as 0, the next year is coded as 1 and in this way the last year, 2010 is coded as 4.

GDP per capita. Following previous studies, this study controls for the economic condition of a country. The natural log of per capita gross

domestic product in current prices (in US dollars) is used as a proxy variable for this.

Statistical Method Used

This study uses Growth curve modelling (GCM) for analysis of the data. GCM is a technique for the analysis of change over time. It has been used in medicine (Pan *et al.* 2008), organizational behaviour (Bliese and Ployhart 2002), sociology and psychology (Kashy *et al.* 2008; Schaeffer *et al.* 2006), for studying growth of different phenomena. This study uses GCM as this can analyse a phenomenon over time and that is one of the primary foci of this research.

In GCM, time is included as an independent variable to trace change in the dependent variable over time; moreover interaction terms of time with other explanatory variables are used to trace change in the impacts of these other variables over time. The parameters of GCM are estimated using the maximum likelihood estimation method. In GCM both a fixed and a random part of the intercept and impacts of the independent variables are considered. Following is an example of GCM:

$$y_{it} = (\alpha_1 + \alpha_i) + (\beta_1 + \beta_{1i})time_i + (\beta_2 + \beta_{2i})X_{it2} + ... + (\beta_k + \beta_{ki})X_{itk} + u_{it} \quad (1)$$

In the above model α_1 is the fixed intercept and α_i is the random part of the intercept; β s with suffix roman numbers only are fixed parameters to be estimated and all $\beta_{.i}$ s are the random part of each parameter.

GCM provides more information than traditional regression analysis where only the fixed part of the parameter is estimated. For example, α_1 indicates the mean of the model i.e initial situation at the beginning of time period and α_i indicates variation among each individual (in this analysis, country).

Along with GCM, panel data have been used in this study. Non-experimental data are often used in social science and business analysis. However, non experimental data have the drawback that they cannot control all the factors that affect the dependent variable. Therefore, causal conclusions are difficult using non experimental data as many factors remain uncontrolled. Panel data lessen this problem. Using panel data has the advantage over cross sectional and time series data that it can control unobserved heterogeneity in the observation (Wooldridge 2003). Two panel data methods are considered for this study: fixed effect estimation (FE) and the random effect estimation method (RE).[31] The FE method is used when unobserved effects are correlated with explanatory variables of the model, while the RE method is suitable when these are not correlated. Thus, the nature of the data dictates which method can be applied. Arbitrary assumptions about the correlation among unobserved heterogeneous effects and explanatory variables may lead to inconsistent estimation of parameters (Greene 2000).

Model Specification

Two models have been developed in this paper. The first one is a GCM model that has been developed for studying change in minority shareholder rights over time, for finding out the initial condition of minority rights in different countries of the world, the variability of the minority rights and effect of legal systems on minority shareholder protection. This model captures whether legal quality affects the MSRs in common law countries faster than in civil law countries. To test that, an interaction term between time and English common law country variables is included in the model. The model is as follows:

[31] The first difference estimation method (FD) is not considered as the number of countries in this study is much higher than the number of time periods. In this case, FD would be unbiased and consistent, but less efficient than the FE method (Wooldridge 2003).

$$\begin{aligned}\text{Min\_Right}_{it} &= (\alpha_1 + \alpha_i) + (\beta_1 + \beta_i)time_i + (\beta_2 + \beta_i)English_i + (\beta_3 + \beta_i)German_i \\ &+ (\beta_4 + \beta_i)Scan_i + (\beta_5 + \beta_i)Enforce_{it} + (\beta_6 + \beta_i)LnGdp_{it} \\ &+ (\beta_7 + \beta_i)Time_t\,XEnglish_i + \varepsilon_{it}\end{aligned} \quad (2)$$

where,
Min_Right_{it} = minority shareholder rights of country *i* in year *t*.
Time = indicates time where first year is the base year.
English_i = a dummy variable indicating English common law system of country *i*.
Germna_i = a dummy variable indicating German civil law system of country *i*.
Scan_i = a dummy variable indicating Scandinavian civil law system of country *i*.
Enforce_{it} = enforcement of law in country *i* in year *t*.
Ln_Gdp_{it} = the natural logarithm of gross domestic product per capita of country *i* in year *t*.
Time_i*English_i = interaction between time and English common law system.

The second model is a panel data regression model to investigate the effect of the legal system and law enforcement on minority shareholder protection in a country. This is similar to earlier studies, for example, La Porta *et al.* (1998). However, earlier studies used cross sectional regression models and much smaller data sets.[32]

$$\text{Min\_Right}_{it} = \alpha_0 + \beta_1 English_i + \beta_2 German_i + \beta_3 Scan_i + \beta_4 Enforce_{it} + \beta_5 LnGdp_{it} + \varepsilon_{it} \quad (3)$$

where,
Min_Right_{it} = minority shareholder rights of country *i* in year *t*.
English_i = a dummy variable indicating English common law system of country *i*.
German_i = a dummy variable indicating German civil law system of country *i*.
Scan_i = a dummy variable indicating Scandinavian civil law system of country *i*.
Enforce_{it} = enforcement of law of in country *i* in year *t*.
Ln_Gdp_{it} = the natural logarithm of gross domestic product per capita of country *i* in year *t*.

[32] This study uses 710 country year observations.

7. Results

Table 3 presents the descriptive statistics regarding the variables of this study. In the descriptive statistics, the large standard deviation (1.57) for MSRs of all countries compared to the mean (5.01), minimum value (1.7) and maximum value (9.7) of MSRs indicates disparity of minority shareholders' rights among the sample countries.

Table 3. Descriptive Statistics

Variables	Mean	Standard Deviation	Minimum	Maximum
All countries (142)				
MSRs	5.01	1.57	1.7	9.7
Enforcement of law	4.01	2.12	1.3	9.6
GDP per capita	11213.28	16218.82	120.34	93235.22
Common law countries (37)				
MSRs	6.01	1.90	2	9.7
Enforcement of law	4.48	2.38	1.5	9.6
GDP per capita	12683.2	17486.68	270.01	59901.95
French civil law countries (83)				
MSRs	4.48	1.27	1.7	8.3
Enforcement of law	3.28	1.47	1.3	9
GDP per capita	6661.38	10305.40	120.34	53354.89
German civil law countries (18)				
MSRs	5.19	1.00	3	7
Enforcement of law	5.35	1.84	2.7	9.1
GDP per capita	18843.24	16426.64	1223.77	67074.31
Scandinavian civil law countries (4)				
MSRs	6.03	.59	4.3	6.7
Enforcement of law	9.09	.40	7.9	9.6
GDP per capita	57733.54	15786.68	39414.66	93235.22

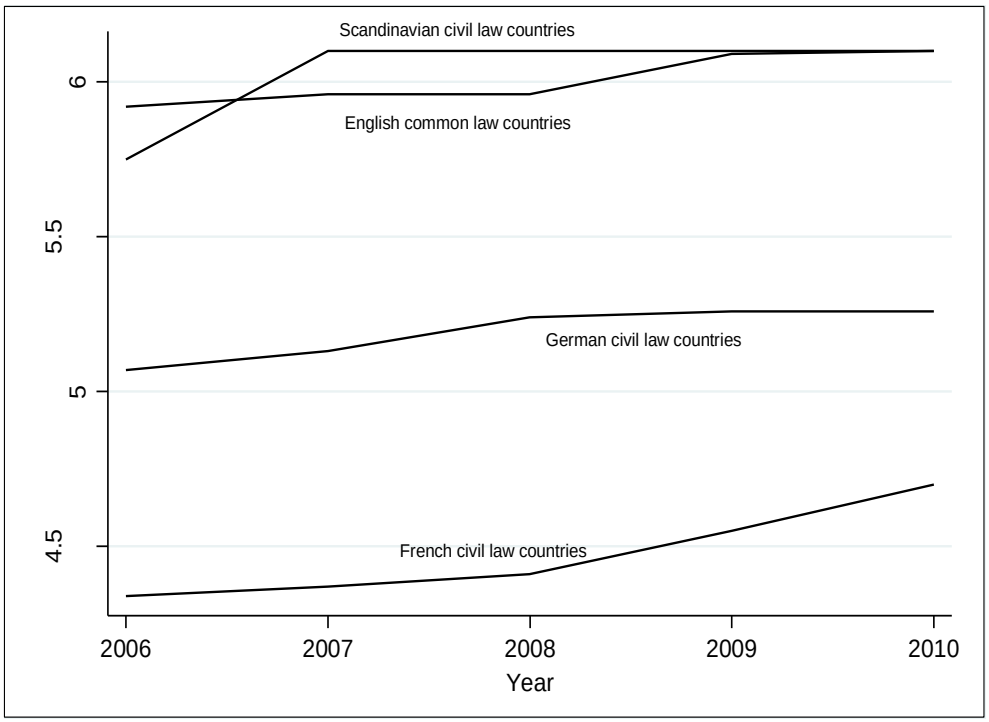
Note: GDP per capita is in US dollar and other variables are index values; director's liability and ease of suit are three variables that are the sub indices of minority shareholder rights.

Among the countries Scandinavian civil law countries (6.03) and English common law countries (6.01) have the highest level of MSRs followed by German civil law countries (5.19). French civil law countries have the lowest level of MSRs (4.48). Figure 2 presents changes in the indicators of minority shareholder rights by countries with different legal systems.

To check for any multicollinearity among the independent variables of the study, the Variance Inflation Factors (VIF) of the variables are calculated. The highest VIF is 3.52 for enforcement of law indicating that the independent variables of the study are free from any multicollinearity problem.[33]

[33] Though there is no precise VIF cut-off point for indication of multicollinearity, a VIF greater than 10 is often used as a rule of thumb for presence of multicollinearity among independent variables of a regression model.

Figure 2. Average Indices of Minority Shareholders' Rights (2006-2010)



The results of the GCM modelling show (see Table 4) that the average MSRs in 2006 was 2.65 in the 142 sample countries; on average, reform improves MSRs about 0.07 per year or .35 in five years. However, the initial condition of MSRs and the reform is not homogenous in all countries. MSRs in 2006 vary by about 0.99 points (σ (Constant)) among countries. The improvement of MSRs also varies about 0.17 point (σ (Time)) per year. The result also shows that English common law countries have better minority shareholder rights than French civil law countries by about 0.23 points on average, but the variation among English common law countries compared to French civil law countries is about 0.88 points (σ (English common law)). The analysis also shows that enforcement of law significantly influences improvements of minority shareholders' rights in a country. A one point improvement in the enforcement of law improves minority shareholder rights by about 0.22 points. However, there is variation in this improvement among countries by about .11 points (σ (Enforcement of law)). This study also investigated whether the English common law countries and countries with better law enforcement reform their MSRs faster (see, Table 4: model 2) by incorporating two interaction terms with time. However, the results show no indication of that.

For the panel data analysis, the Hausman test (1978) is performed to identify which panel data method is suitable for the data set used in this study.[34] The test finds that there is correlation between unobserved country specific heterogeneity and the independent variables ($\chi^2 = 4.38, p = .11$). Therefore, the FE method is more appropriate than the RE method. The FE method shows that the enforcement of law can increase MSRs of a country. The result shows that a one point increase of law enforcement increases point minority shareholder rights by 0.23 (t = 2.27) after controlling for per capita income of a country.[35] This result is very similar to the result found in the fixed effect part of GCM result above. The FE method has a drawback in that it cannot estimate any time invariant variable. As the legal system is time invariant, the time de-meaning

[34] The Hausman test is used for detecting correlation between unobserved effects with explanatory variables of a panel data model. The test is based on the idea that if there is no correlation between the error term and explanatory variables then the parameter estimation method of FE and RE are both consistent, but FE is inefficient; however, if there is correlation then the FE is consistent but the RE estimation is not (Green 2000). Therefore, the test is based on the difference of the estimates of the two methods that are as follows:

$W = \chi^2[k-1] = (\hat{\beta}^{FE} - \hat{\beta}^{RE})^2[\text{var}(\hat{\beta}^{FE}) - \text{var}(\hat{\beta}^{RE})]^{-1}$

where, W is the Housman test statistic distributed as chi-squared (χ^2) with (k-1) degree of freedom; k is number of parameters to be estimated.

[35] This result is based on heteroskedasticity robust standard errors

process of the fixed effect estimation method excludes these variables.

Table 4. Growth Curve Models Result

	Model 1	Model 2
Fixed effects		
Constant	2.65*** (5.51)	2.68*** (5.58)
Time	.07*** (4.11)	.10*** (2.90)
English common law	1.23*** (4.58)	1.23*** (4.60)
German civil law	.25 (.82)	.26 (.82)
Scandinavian civil law	-.06 (-.08)	-.07 (-.09)
Enforcement of law	.22*** (4.70)	.23*** (4.81)
Ln GDP per capita	.11* (1.77)	.11* (1.61)
Time * Enforcement of law	-	-.01 (-.80)
Time * common law	-	-.03 (-.90)
Random effects		
σ (Time)	.17*** (13.51)	.17*** (13.33)
σ (English common law)	.88** (2.78)	.88** (2.78)
σ (Enforcement of law)	.11** (2.73)	.11** (2.75)
σ (Constant)	.99*** (10.75)	.99*** (10.85)

Note: * <10%, ** <5%, *** <1%; values in the parenthesis are *t* statistics of the coefficient; σ indicates standard deviation.

8. Conclusion

This paper investigates changes in minority shareholder protection in recent years and whether these relate to the contested legal origin view of minority shareholder protection. The novelty of the study is that it has seen this phenomenon though a dynamic lens. It achieves this by analysing data of 142 developed and developing countries for five year. It shows that, on average, countries across the world have improved minority shareholder protection but that the improvement is not homogenous across countries. The study also finds that a legal system does not affect the pace of reform for minority shareholders. Therefore, the reforms are not connected with a country's legal system – other efforts are needed to bring that about. This echoes the view of La Porta *et al*. (2008):

> Some accuse us of claiming that legal origin is destiny, so any reform of investor protection or of other regulations short of wholesale replacement of the legal system is futile. This is not what Legal Origin Theory says. The theory indeed holds that some aspects of the legal tradition are so hard-wired that changing them would be extremely costly and that reforms must be sensitive to legal traditions. Nonetheless, many legal and regulatory rules, such as entry regulations, disclosure requirements, or some procedural rules in

litigation, can be reformed without disturbing the fundamentals of the legal tradition. (p. 325)

Like many past studies the study finds that English common law countries have a greater level of MSRs than civil law countries and such rights are greater in countries with more effective law enforcement. The findings are robust controlling for richness of a country. This finding supports the legal origin view of investor protection. Findings of this study give direction to policymakers that legal reform is important for minority shareholder protection.

The main focus of this research was minority rights reform and whether reform should follow the legal reform route or not. However, one of the limitations of this study is that it does not investigate the political view of minority investor protection, which is another way of looking at this area (Roe 2006; Pagano and Volpin 2005; Roe 2000). Future research may consider the effect of political ideology of a country's ruler on minority shareholder rights reform.

A current debate related to this paper is how minority investors protection law is to be enforced. The key point of the debate is the relative importance of public and private enforcement of investor protection law. Private protection is done though higher disclosure requirements on companies and greater liability of directors for any wrong doing and information dissemination. Public enforcement, on the other hand, is done though government agencies, for example, the Securities and Exchange Commission. One view is that private enforcement is more important than public enforcement in protecting minority shareholder rights (Djankov *et al.* 2008; La Porta *et al.* 2006), whilst others group disagree (Jackson and Roe 2009). Future research can investigate this issue further.

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CORPORATE GOVERNANCE AND INSTITUTIONAL OWNERSHIP: A CRITICAL EVALUATION AND LITERATURE SURVEY

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Abstract

This paper aims to analyse how effective the role of institutional shareholders is in corporate governance by examining the association between the different types of institutional shareholders and earnings management. Many prior studies have investigated the nature of several corporate governance practices and mechanisms and how they exist to strengthen institutions, however, there have been questions related to the role of governance failures in preventing unethical behavior by top management. The recent financial and accounting scandals that have engulfed major financial companies in the United States and other developed countries have renewed the interest in corporate governance issues and the role of shareholders. This study provides critical reviews of the theoretical and empirical literature on the inter-relationship between different types and composition of shareholders and influences on corporate governance outcomes. We evaluate what we can say with confidence about the interaction between ownership structures and corporate governance. Overall, there is a consensus among researchers that institutional investors and other outside blockholders vote more actively on corporate governance amendments than non-blockholders to enhance profitability and market valuation of firms.

Keywords: Corporate Governance, Institutional Shareholders, Performance, Firm Value

JEL Classification: G29, G30, M14

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1. Introduction

The study explores the effectiveness of institutional shareholders in corporate governance by examining the association between types of institutional ownership and earnings management. It is widely acknowledged that institutional investors have stronger incentives to monitor corporations and can better afford the monitoring costs (for review, see Brickley et al., 1988; Bushee, 1998; David et al., 2001; El-Gazzar, 1998; Shleifer and Vishny, 1986; Watts and Zimmerman, 1986). The literature well documents institutional shareholders' activism as one of the ways in which they exercise their rights as members and monitor managers. Shareholders' activism includes private negotiations with managers, contributing to decisions on board composition, proxy contests (Gillan and Starks, 2000; Boone et al., 2007; Pound, 1988), to mention but a few. However, the importance of institutional shareholders in monitoring firms' managers is not well known (Hartzell and Starks, 2003, p. 2351). Brickley et al. (1988) find that while some groups of institutional investors tend to side with managers due to existing or potential business relations, other groups of institutional investors are more likely to provide an oversight of managers to maximize shareholders' value. The former (such as banks and insurance companies) are classified as pressure-sensitive institutional investors, whereas the latter (such as pension funds and mutual funds) are labeled as pressure-resistant institutional investors. Several studies provide empirical evidence that is supportive of the difference between these two types of institutional investors (for example, see David et al., 2001; Kochhar and David, 1996; Pound, 1988; Van Nuys, 1993).

Moreover, corporate governance has been a subject of numerous studies during the last two decades (for example, see Chung et al., 2010; Gompers et al., 2003; Grossman and Hart, 1986; Huang, 2009; Shleifer and Vishny, 1997; Williamson, 1985), however none of these studies examines the effect of corporate governance on institutional ownership. Table 1 provides more details about the recent studies in corporate governance.

Table 1. Summary of recent corporate governance studies

Study	Research finding(s)
Bushee & Noe (2000)	Show that institutional investors prefer stocks of companies with better disclosure.
Gompers & Metrick (2001)	Show that institutional investors prefer stocks of larger companies.
McKinsey & Company (2002)	Survey more than 200 institutional investors in 31 countries and showed that institutional investors put corporate governance quality on a par with financial indicators when evaluating investment decisions' portfolios toward firms with better governance mechanisms, there is no significant relation between institutional ownership and corporate governance.
Dahlquist et al. (2003)	Find no relation between the ratio of control to cash flow rights and the holdings of foreign investors
Gompers et al. (2003)	Show that better corporate governance leads to greater firm values and higher stock returns.
Parrino et al. (2003)	Show that institutional investors prefer stocks of companies with better managerial performance.
Grinstein & Michaely (2005)	Show that institutional investors prefer stocks of companies that pay cash dividends or repurchase shares.
Giannetti & Simonov (2006)	Show that both foreign and domestic financial institutions are reluctant to holdshares of companies that have high control to cash flow rights ratios of principal shareholders.
Ferreira & Matos (2008)	Show that institutions hold fewer shares of companies that have more closely held ownership structure.
Li et al. (2008)	Show that institutions avoid investing in companies with dual-class shares.
Huang (2009)	Show that institutional investors prefer stocks that have higher market liquidity and lower return volatility.
Leuz et al. (2009)	Find that U.S. institutions invest less in foreign firms with large insider block ownership.
Al-Najjar (2010)	Investigates the relationship between ownership structure and corporate governance, namely the factors that determine institutional investors' investment decisions in emerging markets using Jordanian data. The results show that the Jordanian institutional investors consider firms' capital structure, profitability, business risk, asset structure, asset liquidity, growth rates, and firm size when they take their investment decisions. In addition, institutional investors in Jordan prefer to invest in services firms rather than manufacturing firms. Furthermore, the study cannot find any significant relationship between firms' dividend policy and institutional investors.

Bushee et al. (2010)	Analyse whether institutional investors tilt their portfolios toward firms with preferred governance mechanisms. The authors conclude that although institutional investors have incentives to tilt their survey results indicate that institutional investors prefer companies with good governance structure.
Chung et al. (2010)	Show that better governance results in higher stock market liquidity.
McCahery et al. (2010)	Conduct a survey to elicit institutional investors' views on country-level investor protection and firm-level corporate governance mechanisms. They find that among the institutions that responded to the survey, corporate governance is important to their investment decisions, and a number of them are willing to engage in shareholder activism (e.g., 80% of the institutions are willing to vote with their feet by selling their shares). They also show that the preferences for governance mechanisms vary across the institutional investor types.
Chung & Zhang (2011)	Examine the relation between corporate governance and institutional ownership. The empirical results show that the fraction of a company's shares that are held by institutional investors increases with the quality of its governance structure. In a similar vein, they show that the proportion of institutions that hold a firm's shares increases with its governance quality. Furthermore, the results are robust to different estimation methods and alternative model specifications. These results are consistent with the conjecture that institutional investors gravitate to stocks of companies with good governance structure to meet fiduciary responsibility as well as to minimise monitoring and exit costs.

This paper addresses the question of whether the different types of institutional investors affect managers' engagement in earnings management. The main objective of this paper is to enhance the understanding of how institutional blockholding can improve shareholder protections and corporate governance regulations by drawing on the latest research results of the streams of intellectual thought and experts in an array of academic fields, particularly in behavioral finance. The remainder of the paper is structured as follows. Section 2 presents the objectives and motivations of the study. Section 3 provides a review of corporate governance and institutional activism literature. Section 4 discusses the relationship between institutional shareholders and corporate behavior. Section 5 investigates the association between types of different institutional shareholders and corporate

governance. Section 6 is dedicated to the association between short-term and long-term oriented institutional shareholders and corporate governance. The final section provides conclusions and suggestions for future research.

2. Objectives and Motivations of the Study

The purpose of this study is twofold. Firstly, it addresses the question of how effective the role of institutional shareholders is in corporate governance by examining the association between different types of institutional shareholders and earnings management. Studies of this kind will contribute to the assessment of the merits of calls for institutional shareholders to play a more active role in corporate governance (Al-Najjar, 2010; Parliamentary Joint Committee on Corporations and Securities, 1994). Secondly, the study contributes to the understanding of the effect of institutional shareholdings on the practice of earnings management.

The separation of ownership and control and subsequent agency problems, calls for corporate governance to provide assurance of shareholders' value maximization (Watts and Zimmerman, 1986). Recent years have witnessed significant changes to the ownership structure of listed corporations, including the emergence of greater institutional ownership. In the United States, for example, institutional holdings of publicly traded shares grew from 26.8% in 1986 to 51.6% in 1996 (Gompers and Metrick, 2001, p. 236). In Australia, institutional investment in listed equities rose to around 49% in 1997 (Stapledon, 1998, pp. 242-260). Despite the growth of institutional ownership over the last few decades, their importance in monitoring firms' managers is not well known (Hartzell and Starks, 2003).

Table 2 presents some details, which illustrates the failure of a bank as an institutional investor to monitor managers of a firm. The facts given concern the failure of ABC Learning Centre Ltd. The reader may be tempted to believe that ABC's accounting information prior to the appointment of receivers must have been of a dubious nature. Yet the question remains: why did the Commonwealth Bank as an institutional investor of ABC not keep a closer eye on the childcare centre and ultimately failed to fulfill its fiduciary duties to its own shareholders? This question is closely related to the roles of institutional investors' activism in corporate governance. By examining the association between the types of institutional ownership and managers' engagement in earnings management, the study will shed some light on the roles of institutional investors in corporate governance. In some developed countries for example, it seems that there is considerable leeway under their corporate law for institutional investors to engage in shareholder activism; however, there have been legal obstacles to institutional investor activism (Chung and Zhang, 2011; Hill, 1994).

Table 2. The failure of a bank as an institutional investor to monitor managers of a firm

(1)	Angry shareholders have given the Commonwealth Bank a grilling over its $680 million exposure to failed childcare operator ABC Learning Centres.
(2)	Bank chief executive Ralph Norris confirmed CBA was writing off $440 million of listed notes issued by ABC and conceded that the bank needed to "learn from its mistakes".
(3)	ABC, with almost 1100 centre across Australia, plunged into receivership last week. Reports said a Sydney court was told ABC's total debt had so far reached $1.57 billion, including $110 million owed to external creditors.
(4)	It is also understood ABC's receivers have secured temporary funding. The ABC loss is the largest write-down for CBA since it lost more than $200 million on stricken exposures to Pasminco and Enron in 2002.
(5)	"The notes at this point are valueless-they have no ranking of any significance," Mr. Norris told shareholders.
(6)	Most of the banks were of the view until recently that ABC had a fundamentally sound business.

Source: Lekakis and Walsh, 2008.

The end of the 1990s and the beginning of the 21st century witnessed a series of worldwide accounting scandals. In the United States, Enron in 2001 marked the largest corporate bankruptcy, which was followed by a number of disclosures about errors in financial statements. Other companies included Worldcom, AOL, Qwest Communications and Xerox. Accounting failures, however, were not restricted to the United States. In Australia, for instance Adelaide Steamship, Bond Corporation, Harris Scarfe, One Tel and HIH Insurance. In Europe, companies involved in accounting scandals include Parmalat (Italy), Flowtex (Germany), Comroad (Germany), Royal Ahold (The Netherlands). In 2007, a loss of investor confidence in the value of securitised mortgages in the United States, led to the global crisis in real estate, banking and credit in the Unites

States and other countries. Again, the role of accounting has been subject to criticism (Mallin, 2007).

As Healy and Palepu (2001) stress, managers have access to information about the value of a firm and tend to overstate the firm's value through earnings management. This results in adverse selection of investment projects. On the other hand, following an investor's investment in a firm, managers are likely to expropriate investors' funds and maximise their self-interest through earnings management. According to Goncharov (2005), to resolve the problems related to allocation of capital, it is necessary to understand the determinants and implications of earnings management. Determinants of earnings management include factors motivating earnings management and factors constraining earnings management as well. As noted by Goncharov (2005) and Al-Najjar (2010), a good knowledge of determinants of earnings management is crucial for at least three reasons. Firstly, knowing the conditions under which earnings management are more likely to occur, investors can choose price protection or invest their funds elsewhere. Secondly, a good knowledge of determinants of earnings management will facilitate the decision making by regulators. Thirdly, efforts can be made to enforce inhibitors constraining earnings management to improve the quality of reported earnings.

There are very few studies that have examined how institutional shareholders influence specific actions of managers (Chung et al., 2002, p. 32; Chung and Zhang, 2011). Among these studies, there are even fewer which investigate how institutional shareholders affect earnings management. Rajgopal et al. (1999) show the absolute value of discretionary accruals declines with institutional ownership. The reason is that institutional owners are better informed than individual investors, which reduces managers' incentive to manage accruals. Chung et al. (2002) found the presence of large institutional shareholdings prevents managers from manipulating reported profits upwards or downwards. While the above studies provided evidence in support of a linear relationship between earnings management and institutional ownership, studies undertaken in Australia predict a non-linear relationship.

Koh (2003) classifies institutional shareholders into short-term oriented institutional shareholders (Bhide, 1993 and Porter, 1992) and long term oriented institutional shareholders (Bushee, 1998; Majumdar and Nagarajan, 1997). Koh (2003) uses levels of institutional ownership to approximate these two types of institutional shareholders, and yields results that support a non-linear relationship between institutional investors' ownership and earnings management: at a very low institutional ownership level, institutional ownership is not associated with income-increasing discretionary accruals; beyond the very low institutional ownership level, a positive association exists between institutional ownership and income-increasing discretionary accruals, supporting the view that transient institutional shareholders encourage managerial manipulating earnings upwards; beyond a certain higher institutional ownership level, a negative association exists between institutional ownership and income-increasing accruals management, supporting the view that long-term oriented institutional shareholders discourage managers from manipulating earnings upwards. Hsu and Koh (2005) examine the generalisability of Koh's (2003) findings beyond the income-increasing context by focusing on incentives created by threshold mentality and income-decreasing discretionary accruals. Their study indicates that the association between institutional ownership and earnings management is not systematic across all firms and is dependent on the context.

As Hsu and Koh (2005, p. 820) point out, future studies on the relationship between institutional ownership and earnings management could explicitly consider the effects of different types of institutional investors. Rather than using levels of institutional shareholdings to approximate types of institutional shareholders, the study classifies institutional shareholders into two types: pressure-sensitive and pressure-resistant institutional investors according to Brickley et al. (1988), who find that when voting on anti-takeover amendments, pressure-resistant or insensitive institutional shareholders (eg. mutual funds, foundations and pension funds) are more likely to oppose managers than pressure-sensitive institutional shareholders (eg. banks, insurance companies and trusts) due to the latter's existing or potential businesses relationships with the company.

By investigating the association between these two types of institutional ownership and earnings management, Hsu and Koh's (2005) study extends the studies of how institutional shareholders affect specific actions of managers by examining the association between types of institutional shareholders based on a new classification, and earnings management. This study differs from Brickley et al. (1988) in the sense that the former seeks systematic and inexpensive evidence about the effectiveness of the role of institutional shareholders in corporate governance whereas the latter provides piecemeal and costly evidence.

4. A review of Corporate Governance and Institutional Activism Literature

Shleifer and Vishy (1997, p. 737) adopt an agency perspective on corporate governance by defining corporate governance as "dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". Hart (1995, p. 680) regards corporate governance as "mechanism for making decisions that have not been specified in the initial contract". According to Hart (1995), good corporate governance is necessary if two conditions are present: firstly, there is a conflict of interests and secondly the agency problem cannot be fully dealt with by contracts primarily due to large contracting costs. Therefore, corporate governance serves as a mechanism for making decisions where they are not specified by contracts.

Thus, it is agency problems, namely conflicts of interests among stakeholders that make corporate governance necessary. Berle and Means (1932) explain these conflicts by examining the separation of ownership and control. The agency theory is further developed by Jensen and Meckling (1976), Fama and Jensen (1983), Jensen and Ruback (1983), Jensen (1986), and Watts and Zimmerman (1978, 1986 & 1990). Within the agency theory developed by them, the agency problem results from the separation of ownership and control. Managers (agents) raise funds from investors (principals): investors expect managers to generate returns on their funds and managers put investors' funds into productive use or to cash out their holdings. Principals, however, anticipate that managers are likely to take opportunistic actions that are detrimental to the interests of principals. In the absence of contracts, managers' likelihood of taking opportunistic actions results in higher costs of managers' raising capital. Thus, managers have an incentive to enter into contracts with principals. Yet it is technically impossible to sign a complete contract as future contingencies are hard to foresee and contracting is not costless. In other words, the agency problem can be mitigated but it always exists. This necessitates corporate governance as it constraints managers' opportunistic actions and assures financiers of returns on their funds (Gillan and Starks, 2000).

Gillan and Starks (2003) give a list of factors constraining executives' activities: the board of directors, financing agreements, laws and regulations, labor contracts, the market for corporate control and the competitive environment. They classify these factors as internal control mechanisms and external control mechanisms, and stress that the rise of institutional investors is an important external control mechanism affecting governance. The question then arises of how institutional investors can serve as an external control mechanism. The following section will discuss the role of institutional investors in corporate governance. As Mallin (2007, p. 76) points out, the pattern of ownership has been constantly changing with the decline of individual investors and the rise of institutional investors. The latter own large portions of equity in many corporations across the world and play a significant role in corporate governance. With the emergence of institutional investors, their role in corporate governance has been a subject of debate (Gompers and Metrick, 2001; Stapledon, 1998).

Many researchers argue that institutional shareholders reduce agency problems as they have the incentive and resources in monitoring and controlling managers' activities. Shleifer and Vishny (1997) describe two common approaches to corporate governance: legal protection of investors from managers' opportunism; and concentrated ownership, which is ownership by large investors. Large investors have "the incentive to collect information and monitor the management, thereby avoiding the traditional free rider problem" (Shleifer and Vishny, 1997, p. 754). The question then arises as to who are these large shareholders. Shleifer and Vishny (1986) examined a sample of 456 of the Fortunate 500 firms and found a significant number of large shareholders are families represented on boards of directors, pension and profit-sharing plans, financial firms such as banks, insurance companies and investment cases.

Admati et al. (1994) developed a model with an attempt to analyze the effects of large shareholder activities on securities market equilibrium: passive shareholders benefit from large shareholders' activism and yet don't incur the related monitoring costs; despite the free-rider problem, large shareholder activism is consistent with equilibrium. Their analysis, however, deals only with one large investor. Huddart (1993) predicts that share prices will increase with increasing concentration of share ownership and explains why the pattern of stock ownership affects a firm's market value. Shareholders with less than the threshold amount of stock delegate the task of monitoring managers to large shareholders. Large shareholders have the incentive to do so because monitoring results in their access to more information about the firm's value and they could earn a return by trading on this information. Large shareholders' incentives to monitor managers increase with the concentration of share ownership, and thus the ownership structure affects a firm's market value. Several studies provide empirical evidence on the effective monitoring of institutional investors by examining the association between institutional ownership and corporate behavior, although empirical results from these studies are somewhat mixed. Corporate behavior under investigation includes executives' compensation,

research and development investment, and earnings management (for review, see Bushee et al., 2010; Chung et al., 2010; Gompers et al., 2003; Grossman and Hart, 1986; Williamson, 1985).

4. Institutional Shareholders and Corporate Behavior

According to O'Reilly et al. (1988), chief executive officer (CEO) remuneration primarily has three components: cash compensation such as salary and bonus, long-term incentives including various forms of stock options and deferred compensation, and perquisites and supplementary benefits such as insurance and club membership. Several factors affect executives' remuneration with one of them being ownership and control (O'Reilly et al., 1988, p. 258). The reason is that without strong owners, CEOs are more likely to have power to extract higher pay than is justified by market considerations (David et al., 2001; Kochhar and David, 1996). Bertrand and Mullainathan (2001) find that pay for luck (CEO is rewarded for changes in firm performance that are beyond CEO's control) is strongest in poorly governed firms and yet adding a large shareholder on the board will reduce the pay for luck by 23% to 33%. Also, Hartzell and Starks (2003) find a positive relationship between institutional ownership concentration and pay-for-performance sensitivity of executive compensation, and a negative relationship between institutional ownership concentration and the level of compensation, even after controlling for firm size, industry, investment opportunities and performance. These findings support the hypothesis that institutional investors play a monitoring role in mitigating the agency problem between shareholders and managers. On the other hand, Cosh and Hughes (1997) find little evidence that the presence of significant institutional shareholdings or non-executive directors restrains the discretionary component of executive pay, and that it affects the sensitivity of pay to shareholder performance measures.

Previous studies explore the relation between a firm's institutional ownership and its investment in research and development (R&D) with an attempt to find evidence of institutional investors' impact on managers' activities (for example, see Bushee, 1998, 2001; Chung et al., 2010; Chung et al., 2002; Coffee, 1991; David et al., 2001). As a firm's earnings can be affected by managers' decisions to incur research and R&D, these studies also provide evidence of the association between earnings management and institutional holdings. Bushee (1998) finds a lower likelihood of managers to cut R&D to reverse an earnings decline when institutional ownership is high. This provides empirical evidence of institutional shareholders' monitoring and disciplining managers. Nevertheless, they find that a large portion of institutional ownership with a high portfolio turnover increases managers' likelihood to reduce R&D to reverse an earnings decline. The research is therefore seminal in the sense that it explores how myopic and non-myopic behavior of institutional investors affects managers' discretion to reduce R&D to manage earnings. Wahal and McConnell (2000), however, find a positive relation between firms' expenditures for PP&E and R&D and the level of institutional ownership and trading activity based on a sample of around 2500 firms between 1988 and 1994. The findings cast doubt on the view (Blinder, 1992; Thurow, 1993) that institutional owners can encourage managers to behave myopically. In other words, the findings support the view that institutional owners do play a role in monitoring managers and encourage them to have longer investment horizons. Based on a sample of 100 US corporations from 1977 to 1986, Bange and DeBondt (1998) find that R&D expenditure is used to reduce the perception gap between reported income and analysts' earnings forecasts. While much of the cross-sectional variation in gap closure can be explained by information asymmetry and managerial incentives, there is less gap closure where CEO and institutional investors own a large stake of a firm's ownership interest. Hence, the latter findings do provide empirical evidence of institutional investors' monitoring earnings management by R&D which serves as a proxy for their activities.

Although, R&D investment is typical of earnings management through events' occurrence, discretionary accruals can also be used to manage earnings. In fact, only a few studies have examined the association between the level of institutional ownership and discretionary accruals management. Rajgopal et al. (1998 & 1999) show that, the absolute value of discretionary accruals declines with institutional ownership. The reason is that institutional owners are better informed than individual investors, which reduces managers' incentive to manage accruals. Chung et al. (2002) find the presence of large institutional shareholdings deterring managers from manipulating reported profits upwards or downwards with the use of discretionary accruals. Moreover, Koh (2003) examines the association between institutional ownership and firms' income-increasing accruals management and claims to be the first known research in Australia. The research yields results that support a non-linear relationship between institutional investors' ownership and earnings management. The finding of Hsu and Koh's study (2005) reveal an association between income-increasing accruals management and transient institutions, and the constraint long-term oriented institutions impose on income-increasing accruals management. This indicates that the

association between institutional ownership and earnings management is not systematic across all firms and dependent on contexts.

5. Types of institutional shareholders and corporate governance

There are many types of individual shareholders such as employee shareholders (managers, directors and other employees) and independent individual shareholders including entrepreneurial individual shareholders who purchase a large number of shares in a listed company in order to bring about changes to the company (Useem and Gager, 1996; Klein and Zur, 2009). Not surprisingly, individual shareholders have been perceived to be heterogeneous (Beaver and Demski, 1979, p. 39). Many studies like most of the aforementioned studies assume that unlike individual shareholders, institutional investors are homogeneous, and ignore their heterogeneity. As Hampell Committee, Final Report (1998, p.40) notes:

> "Institutional investors are not a homogeneous group. They all have an overriding responsibility to their clients, but they have different investment objectives. Typically institutions used not to take much interest in corporate governance. They tried to achieve their target performance by buying and selling shares, relying on their judgment of the underlying strength of companies and their ability to exploit anomalies in share prices regularly, and to intervene directly with company management only in circumstances of crisis."

In recent study, Ozer et al. (2010) examine whether ownership structure influences a firm's propensity to be politically active. They incorporate insights from agency theory into corporate political strategy research to demonstrate that heterogeneity of institutional shareholders affect firms' decisions to invest in political action. They also examine their model in the context of the U.S. manufacturing industry in the period of 1998-2002. Their results suggest that heterogeneous motives and objectives of institutional shareholders influence their support for firms' decision to be politically active. Ozer et al. (2010) offer insights to managers who play pivotal role in strategic decision making process. It provides a new perspective for managers to consider the heterogeneity of institutional shareholders while investing in corporate political strategies.

Coffee (1991) maintains that optimal monitors possess the following three elements: an ability to hold large equity stakes, a tendency to hold in the long run, and the absence of any substantial conflict of interest. Thus, Coffee notes that pension funds and closed-end mutual funds are more likely to be potentially superior to banks and other creditor-shareholders, and investors with business relations with firms tend to show a bias for management with regards to control matters. Brickley et al. (1988) find significant differences between various types of institutional investors in voting: pressure-resistant institutional investors (including mutual funds, endowments, foundations, and public pension funds) are more likely to oppose managers than pressure-sensitive institutional investors (including banks, insurance companies and trusts). The reason is that pressure-sensitive institutions have current or potential business relations with firms and managers might threaten to sever business relations if they don't support managers' proposals.

Van Nuys (1993) examines a proxy solicitation and subsequent restructuring at Honeywell Inc. in 1989. The evidence presented by Nuys indicates that over half of the banks and insurance companies in the sample supported managers' proposals, and in contrast, the public pension funds in the sample generally voted against the proposals. Pound (1988) also provides evidence supporting the view that it is hard for dissidents to gain victory due to three systematic incentives problems in proxy contests. One of the problem is institutional investors are more likely to vote with management against their fiduciary interests due to conflict-of-interest pressures. Take an insurance company for instance. It may hold a significant portion of a corporation' stock and meanwhile act as its primary insurer. If the insurance company votes against management, this may significantly affect the firm's business relationships with managers. Conflict-of-interest pressures are also used by David et al. (2001) explain why institutional owners that rely on a firm for their own business are not able to influence the firm's executives' compensation whereas institutional owners that only have investment relations with the firm affect its executives' compensation.

While the above studies indicate that pressure-insensitive institutional shareholders are more effective in monitoring management than pressure-sensitive shareholders, the question then arises of whether the capital market considers the different types of institutional shareholders and how their perceptions affects a firm's market performance. Borokhovich et al. (2006) are among the few studies which address this question. They classify investors according to whether they are likely to have business relationships with the firm or not, and examine the market reaction to the announcement of antitakeover amendment proposals. They find that firms with unaffiliated blockholdings exceeding affiliated blockholdings exhibit more positive stock price reactions to antitakeover amendment proposals than firms with affiliated blockholdings exceeding unaffiliated blockholdings. Furthermore, the percentage of

blockholdings and the market reactions are positively related for pressure-insensitive blockholders, and the percentage of blockholdings are the market reactions are negatively related for pressure-sensitive blockholders. This serves as evidence that affiliated blockholders are regarded as inefficient monitors of management. Similar relations are observed when the research focuses on institutional stockholdings.

Others focus on the role of a particular group of institutional investors in corporate governance. Romano (1993) argues that restraints on the effectiveness of public fund activism can arise from political pressure to support firms and engagement in other firms of social investing. Therefore, such pressure results in conflicts of interest for public fund managers. Guercio and Hawkins (1999), however, yield results that are not consistent with such an argument. They explore the effects and incentives of pension fund activism by examining the shareholder proposals submitted by five of the largest and most activist funds. They find significant additional corporate governance activity and broad corporate change following the shareholder proposals by pension funds. Hence, they conclude that pension funds' activism is effective in initiating changes at target companies and pension fund activism is consistent with fund value maximization. Wahal (1996) study firms targeted by the nine most active funds from 1987 and 1993 and find that pension funds use various monitoring mechanisms and are reasonably successful in changing the governance structure of targeted firms. While this serves as evidence of the impact of pension funds on targeted firms' corporate governance, the research finds no evidence of significant long-term improvement in either stock price or accounting measures in the post-target period. Wahal and McConnell (2000) view this as evidence of ineffectiveness of pension fund activism. The interpretation of the lack of improvement in firms' performance, however, shall be more cautious: pensions' funds activism may be effective but their impact on firms' performance may be offset by other factors which impact on firms' performance. Despite the controversy in the interpretation of the results, the study is supportive of the view that pension funds play an active role in corporate governance.

Payne and Robb (1997) focus on banks as a group of institutional investors. Their study aims to explore how conflicting relationships affect banks' voting behavior as fiduciaries (of shareholders of banks). The empirical results indicate that where directors interlock and income-related relations are present, banks are more likely to vote for management antitakeover proposals, and where these relations are absent, banks are more likely to vote against those proposals. Boehmer (2000) studies the impact of German takeovers on the market value of bidding firms with the aim of establishing a link between ownership structure and performance. Part of the research results indicates that the most value-reducing takeovers are completed by bidders that are majority-controlled by financial institutions. This result is inconsistent with the contention that German banks are monitoring corporations very efficiently. Franks and Mayer (1998) investigate the effects of German banks in hostile takeovers in Germany. They find that banks' influences arise from their chairmanship of boards and the proxy votes they can cast on behalf of individual shareholders. Although proxy votes provided banks with the means to protect minority shareholders, they find that banks did not succeed in securing a bid premium in the bids for Continental and Hoesch. Franks and Mayer find it hard to determine whether banks were too frustrated to protect minority shareholders or whether they were driven by self-interest or interests of other stakeholders. Yafeh and Yosha (2003) find that large shareholders impose a reduction of firm expenditures for managerial private benefits by studying a sample of Japanese firms in the chemical industry, which serves as evidence of the association between concentrated ownership and corporate governance. Yet they do not find that banks are particularly important in this respect.

6. Short-term and Long-term Oriented Institutional Shareholders and Corporate Governance

As Maug (1998) points out, it has been conventionally acknowledged that there exists a negative relation between liquidity of capital markets and control of corporations: liquid markets make shareholders' monitoring less effective because a liquid market allows them to sell out easily; a less liquid market makes shareholders' monitoring more effectively because a less liquid market forces them to hold on to their investment and use their votes to interfere in corporations. Bhide (1993), for instance, argues that liquidity of stock markets exists at the price of effective governance. Coffee (1991) employs the binary opposition of the liquidity versus control when discussing the development of a system of institutional monitoring. To put it simply, institutional investors in a liquid market are more likely to be short-term oriented in their speculation whereas in a less liquid market they tend to be more long-term oriented and monitor corporations more effectively as they find it hard to dispose of their large stakes of ownership. Not surprisingly, there have been studies which examine institutional investors' myopia or their interest in firms' long-term performance.

There has been a recurrent claim that institutional investors' obsession on short-term performance induce firms' managers to make operational and accounting decisions that increase near-term earnings at the price of long-term earnings. Jacobs (1991), for instance, argues that shares are being treated as a commodity, and so shareholders only respond to changes in current performance and don't show interest in firms' long-term performance. Porter (1992) also argues that due to the fluidity of capital in the market, the relationships between American firms and capital markets result in corporations' underinvestment in long-term projects. While arguments by Jacobs (1991) and Porter (1992) almost exclusively focus on economic dimensions, Laverty (1996) suggests a cross-discipline, multilevel research agenda for this contention. Bushee (2001) tests the contention that, institutional investors are transient or short-term oriented and prefer a firm's value to be realized in near-term earnings to long-term earnings. Such a preference arises from competitive pressures, frequent performance evaluations and prudent person standards, and induces managers to be myopic too. They find a positive (negative) association between the level of transient institutional ownership and the amount of firm value in expected near-term (long-term) earnings, and a positive (positive) association between the level of ownership by institutions held to stringent fiduciary standards and the amount of firm value in expected near-term (long-term) earnings. Hence, the study by Bushee (2001) does yield evidence supporting the contention that institutional investors are inherently short-term oriented or shortsighted. Gaspar et al. (2005) also investigate the impact of the investment horizons of a firm's institutional shareholders on the market for corporate control. They find that target firms with transient institutional shareholders tend to receive an acquisition bid but with lower premiums and are more likely to experience worse abnormal returns around the merger announcements and a higher long-run underperformance. The results suggest that firms with transient institutional shareholders have a weaker bargaining position in acquisitions because weaker monitoring from transient institutional shareholders induces managers to proceed with value-reducing acquisitions or to bargain for personal benefits. Ke and Ramalingegowda (2005) make a contribution to the understanding of transient institutional investors with a focus on the post-earnings announcement drift. They find that transient institutions exploit the post-earnings announcement drift based on 58,214 quarterly earnings announcement between 1986 and 1999.

As a firm's ownership becomes concentrated in a number of institutional shareholders, the exit option becomes more expensive with large stakes of ownership being involved (Black and Coffee, 1994). Therefore, in a less liquid market, institutional shareholders are more likely to hold their ownership stake in the long run and show interest in a firm's long-term performance; therefore, they tend to be more active in the monitoring process. Solomon and Solomon (1999) provide empirical evidence of institutional shareholders' long-termism. They study the influence of reforms in UK corporate governance with a focus on unit trust managers as a particular group of institutional shareholders. This study yields strong evidence that unit trust managers are encouraging relationship investing and the development of linger and stronger communication links with their investee corporations. Bushee (1998) aims to find out whether institutional ownership affects R&D spending for firms in which a decline in earnings could be reversed by a decrease in R&D spending. The results indicate a lower likelihood of managers cutting R&D spending when institutional ownership is high. These findings support the view that institutional investors and their sophistication deter managers' myopic investment behavior by fulfilling their monitoring roles. Field (1995) also addresses the question of whether institutional investment in initial public offering related to long-term performance of these firms as typically poor long-term performance of initial public offering has been documented in the literature. The study finds that initial public offerings with higher institutional ownership are more likely to earn significantly higher long-run returns than those with lower institutional ownership. One of the possible explanations is that institutional investors show more interest in long-term performance of firms and so make an investment in firms with larger long-term returns. Cox et al. (2004) investigate the association between the pattern of institutional ownership of firms and their social performance. They find that long-term institutional investment is positively related to corporate social performance. This serves as evidence of long-term oriented institutional investors' interest in corporate social performance.[36]

7. Conclusion and Future Research

Corporate governance has attracted enormous research interest in the last decade from researchers in behavioral finance, strategy and organizational management and institutional leadership. An area that has also attracted research attention in recent years is the role-institutional shareholders and

[36] Figure 1 summarizes the relationship between institutional ownership and corporate governance and how such a relation can lead to a superior governance mechanisms and positive impact on corporate performance.

institutional factors that influence governance in modern corporate world play in effective corporate governance. Large corporate failures and the underlying agency problem have led to increased scrutiny of corporate performance and stimulated public interest in corporate governance. The fact that institutional shareholders and investors control large block of votes means that they can influence corporate behavior and decision of the board in capital investment and major strategic activities. They can also undertake monitoring roles and, by ensuring that management do not undertake projects that are not of best long-run interest of the company, enhance its long-term value. Most importantly, recent studies have actually reported that control by blockholder ownership play a positive role in reducing harmful information asymmetries, thereby reducing companies' overall cost of capital (Huyghebaert and Van Hulle, 2004).

As we have mentioned earlier, it is widely acknowledged in the existing literature that institutional investors have stronger incentives to monitor corporations and can afford the monitoring costs. However, it should also be mentioned here that institutional investors are not homogeneous. This research has attempted to provide a synthesis of prior research results concerning the types of institutional investors that affect managers' engagement in earnings management. The paper further highlights active and positive roles institutional shareholders play in corporate governance. For example, emergence of institutional ownership in the last two decades has resulted in institutional holdings in the United State increasing from about 26.8% in 1986 to 51.6% in 1996. In Australia, institutional investment in listed equity rose to around 49% in 1997. It could be argued that these increases in the level of holdings of institutional investors have enhanced companies' financial stabilities, fostered long-term profitability and growth and have had remarkable influences over corporate structure of modern financial system. Over time, these changes have also improved minority shareholder protections and led to effective risk management strategies.

Research results from recent assessment indicate that institutional investors and other outside blockholders vote more actively on corporate governance amendments than nonblockholders. In line with earlier studies such as Brickley et al. (1988), it is shown that there exist significant differences between various types of institutional investors in voting. Thus pressure-resistant institutional investors (including mutual funds, endowments, foundations, and public pension funds) are more likely to oppose managers than pressure-sensitive institutional investors (including banks, insurance companies and trusts).

To this date, most of the empirical research on the role of institutional ownership and operating performance has focused on institutional investor activism. As availability of micro-level data improves, there is a need to focus more on the linkages of ownership structure to firm performance and financial reporting outcomes and quality. Although issues remain complicated enough given the conflicting theoretical view points, the use of a dynamic model of different information together with appropriate theoretical constructs will surely provide further insights.

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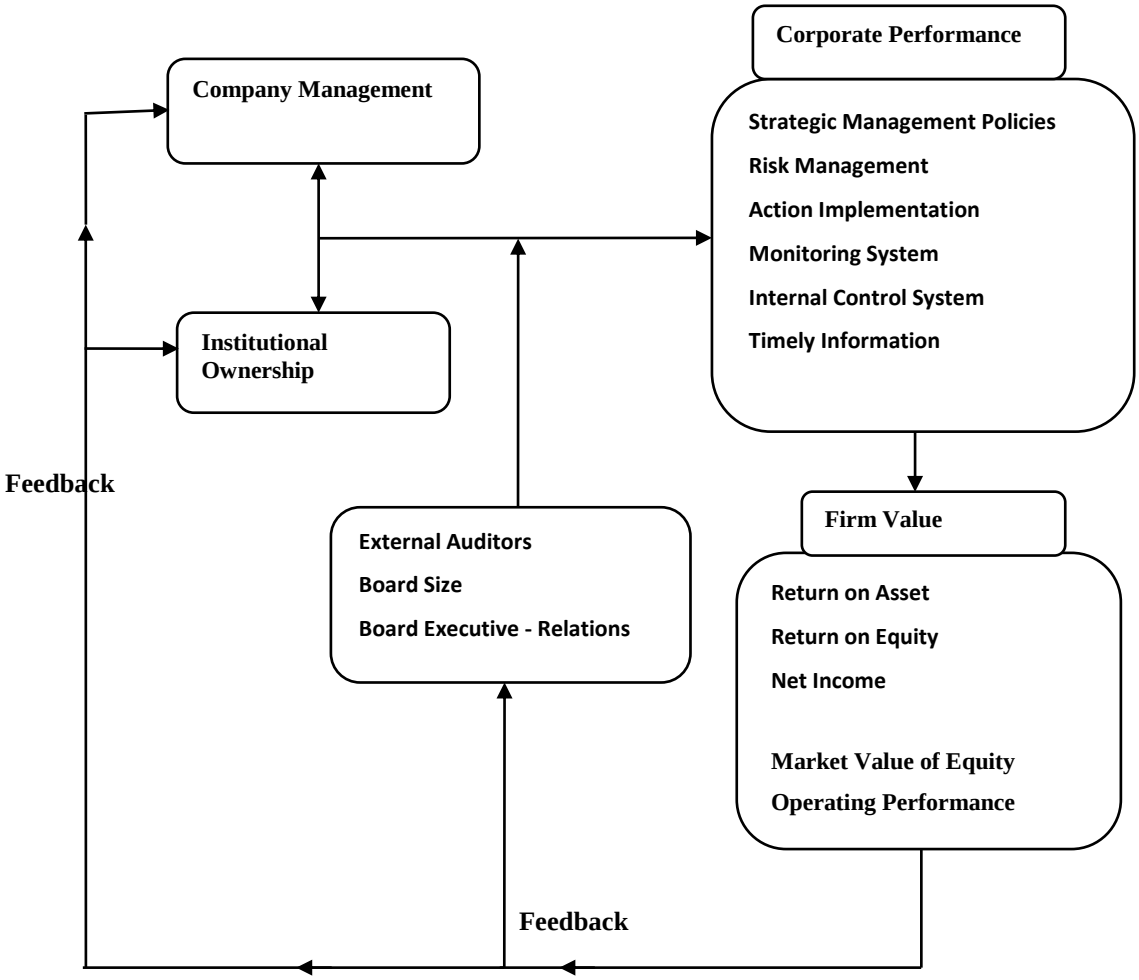
Figure 1. The Relationship between Institutional Ownership and Corporate Performance



EARNINGS MANAGEMENT AND CEO CHARACTERISTICS IN PORTUGUESE FIRMS

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Abstract

The separation between control and ownership in the modern firm creates information asymmetry between managers and shareholders. The superior knowledge about the firm's operations stimulates managers to manage financial information. We investigate which managers characteristics are more likely to positively influence earnings management practices. Specifically, we study whether the CEO's age, education, expected tenure and duality of roles affects earnings management for a sample of listed Portuguese firms for the fiscal years 2005 to 2009.
Results indicate that older CEOs, CEOs with management or finance background, and CEOs that also hold the position of Chairman of the board of directors are more prone to manage earnings.

Keywords: Corporate Governance, CEO, Earnings Management

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1. Introduction

Accounting literature has widely studied the concept and the implications of earnings management. Earnings management behavior takes place when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the firm or to influence contractual outcomes that depend on reported accounting numbers (Healy and Wahlen, 1999). Because capital markets are imperfect and incomplete, accounting information is necessary to solve information asymmetry problems (Jensen and Meckling, 1976; Dechow and Skinner, 2000). Managers are required to provide financial reports to external users of information particularly to capital providers. Discretionary reporting and earnings manipulation occur because managers have more knowledge about the firm than external users and have incentives to manipulate. Managers manipulate earnings to increase compensation, ensure job security, and meet analysts' earnings forecasts (Schipper, 1989; Burgstahler and Eames, 2006). In addition, managers manage accounting numbers to avoid violation of debt covenants and maintain favorable conditions in debt contracting (Chava *et al.*, 2010; Defond and Jiambalvo, 1994).

As the CEO is the critical agent determining financial reporting quality, his particular conditions on the job are likely to influence the level of earnings management. We investigate the association between characteristics of the firm's CEO and earnings management, namely the CEO's age, education, expected tenure in the firm, and duality of chair roles. Prior studies have established a link between these characteristics and financial reporting policies. For example, Gibbons and Murphy (1992a) show that the agency problem increases as the CEO approaches retirement. In his last year in the job the CEO takes advantage of his private information to improve firm performance in order to achieve higher compensation in the final year or after leaving the job. And Bhagat *et al.*, (2010) find that CEOs with MBA degrees tend to manage accounting numbers in order to improve short-term firm performance. We study the association between CEO characteristics and earnings management in Portuguese listed firms for the period 2005 to 2009. Portugal is a small economy where many firms are family-owned, CEOs often have close relationships with board members and shareholders, and controls over-sighting the CEO actions are usually weak (La Porta *et al.*, 1998; La Porta *et al.*, 1999; Djankov *et al.*, 2008). Moreover, Portuguese regulation of corporate governance is mostly about disclosure and it is often not enforced. In fact, both the stock market regulator and the OECD recognize that the application of the rules has been weak (CMVM, 2006 and OECD, 2011). It is interesting to observe such context because on one hand CEOs have more freedom to manage earnings when governance

controls are inefficient and enforcement is weak, but on the other hand CEOs has fewer incentives to manage accounting numbers because there is less information asymmetry between shareholders and managers.

The empirical results show that CEO's characteristics affect earnings management behavior in listed Portuguese firms. Namely, we find that older CEOs, CEOs with management or finance education, and CEOs that also hold the position of Chairman of the board of directors are more prone to manage earnings. The results indicate that the choice of the individual to manage the business and his contract conditions have important economic consequences for shareholders and users of financial information. These findings can help shareholders in the selection of the appropriate CEO and can also assist financial statement users to infer about the quality of accounting numbers reported by the manager.

The remainder of the study is organized as follows. Section 2 reviews prior literature and develops the hypotheses. Section 3 presents the research design. Section 4 describes the sample and descriptive statistics. Section 5 discusses the empirical results. Section 6 concludes.

2. Prior literature and hypotheses

Agency theory suggests that CEO reporting practices vary throughout his career. When a CEO is older and is nearing retirement age the horizon problem may occur. The horizon problem is related to a myopic behavior of the CEO who focuses on short-term performance instead of investing on future profitability and firm value creation (Dechow and Sloan, 1991). As the CEO comes close to retirement, reputation and career concerns typically diminish. In addition, in the last years with the firm the CEO is less prone to take on positive net value projects that have long payback periods that will only reward their successors. This behavior increases the agency problem as the CEO take advantage of his private information to improve short-term firm performance in order to achieve better compensation in the last years, greater retirement pay, and greater option value (Gibbons and Murphy, 1992a). For these reasons we expect to observe more earnings management as the CEO´s age increase. This phenomenon has been observed in relation to R&D expenses (Barker and Mueller, 2002), capital expenditures (Conyon, 2006) and firm profitability (Davidson III *et al.*, 2007). Taking these points into consideration we test the following hypothesis:

H1: The CEO's age is positively related to earnings management

CEO education is one of the characteristics considered by the board when selecting a executive to manage the firm. The board typically chooses a manager with appropriate knowledge, expertise and competence to maximize shareholder value. CEOs with higher education in management and finance sciences are usually seen as the best equipped to run a business and make it grow. However, their expertise can also be used for their own benefit. Given the right incentives CEOs with a management and finance background are more skilled to use discretion in the choice of accounting policies and to manipulate earnings. Bhagat *et al.*, (2010) show that hiring CEOs with MBA degrees leads to improvements in short-term firm performance but not in long-term performance. Bertrand and Schoar (2003) find that CEOs with MBAs are in general more aggressive managers. Thus, we study the following hypothesis:

H2: Management and financial education of the CEO increases the practice of earnings management

When the CEO plans to leave the firm in a short horizon he may be motivated by self interests rather than maximizing shareholders' wealth. Similarly to older CEOs, the executive with short-term horizon takes on projects with lower or negative net present values, with higher current earnings and fast payback periods instead of projects with higher net present value but with longer payback periods (Antia *et al.*, 2010). In order to get greater compensation and signal superior abilities to the labor markets, the CEO may choose to manage earnings in his last years in the firm hoping to exit the firm before his poor performance becomes visible (Campbell and Marino, 1994). For example, Dechow and Sloan (1991) shows that CEOs decrease R&D and advertising expenditures in their final years in office to increase short-term earnings and bonuses. But contrary to this evidence Cheng (2004) does not find a relation between CEO turnover and R&D expenditures, and Gibbons and Murphy (1992a) and Murphy and Zimmerman (1993) show that investment decisions are not explained by CEO turnover. Another motivation of CEOs to manage earnings in the final years in office is to ensure board seats. The number of board seats after retirement depends largely on the reported performance of the CEO in his final years in the firm. Therefore, CEOs about to retire have incentives to use their discretion to manage earnings as a way to ensure future board roles (Brickley *et al.*, 1999). But this desire to get more board seats can also work as an incentive to non-manipulation behavior because the CEO may want to keep a board seat in his firm after retirement and be worried about maintaining his reputation. We investigate whether the proximity of the CEO's final year in the job increases or decreases earnings management behavior. We state the following hypothesis:

H3: When the CEO is in his final years in office there is higher earnings management

Another agency problem that may lead to earnings management is the concentration of CEO functions, particularly the functions of Chairman of the board and CEO. National and international regulations recommend separation between the Chairman and the CEO as a way to allocate monitoring and management responsibilities to different individuals (OECD, 2004; CMVM, 2010). The separation between management and monitoring improves independence and the quality of internal controls. In addition, non-dual leadership promotes the protection of minority shareholders that face higher information asymmetries as they are less informed and less in contact with top executives than the controlling shareholders (Fama and Jensen, 1983; Jensen, 1993). Prior empirical literature found evidence that earnings management increases when the CEO is simultaneously the chairman of the board (Dechow *et al*., 1996; Davidson *et al*., 2004). And Chen *et al*., (2006) show that firms that commit fraud usually have a CEO who also serves as the Chairman. However, Brickley *et al*. (1997) suggests that dual structures have costs associated with non-optimal decisions such as information costs, costs with two large salaries, reputational costs and other costs related to shared authority, suggesting that role separation costs may be higher than the agency costs of dual leadership. Thus, it is unclear whether duality affects earnings management behavior. We investigate whether there is a link between the firm's leadership structure and the susceptibility to earnings management activities and state the following hypothesis:

H4: When a CEO assumes both the role of chief executive and chairman of the board of directors there is higher earnings management

3. Research design

3.1. Earnings management

Earnings management is difficult to observe and thus complex to measure. A widely used method to detect earnings management is the discretionary accruals models. Although extensively used these models have also been criticized for measuring earnings management with substantial error (Guay *et al*., 1996; Dechow and Dichev, 2002; Dechow *et al*., 2010).

Income *Smoothing* is another method of detecting earnings management. The idea behind the method is that the CEO smooths earnings by maintaining it at the same level for several years and thus giving the idea of a constant earnings growth. The CEO may delay income recognition (understate) when the firm is over performing and shift income forward when the firm is underperforming (Gaver *et al.*, 1995). This way, the manager leads shareholders to believe that the value of their shares will constantly increase in the future. By smoothing earnings, the CEO feels that his tenure is secure and his bonus compensation will keep in line with the earnings level that he establishes (Fudenberg and Tirole, 1995; Gaver *et al.*, 1995). Examples of recent studies that measured earnings management through income smoothing are Burgstahler *et al.* (2006), Tucker and Zarowin (2006) and Leuz *et al.* (2003). We use income smoothing as a proxy for earnings management and estimate the following model:

$$P\,[Earnings\ management_{i,t} = \Psi\,[\propto_0 + \propto_1 CEO\ characteristics_{i,t} + \propto_2 Control\ variables_{i,t} + \varepsilon_i]$$

Ψ represents the logit response function $e^{\alpha' x} / (1+e^{\alpha' x})$. Next we define variables. All variables are for firm *i* and time *t* but for ease of notation subscripts are removed throughout the text.

Earnings management is defined as a dichotomous variable taking the value of one if the firm´s smoothness ratio is above the sample median and zero otherwise. Smoothness is calculated as the ratio of the five-year standard deviation of operating income divided by the five-year standard deviation of cash flows from operations, multiplied by minus one so that higher values of the measure indicate higher values of earnings management (Leuz *et al*., 2003). Using a discrete variable to measure earnings management has the advantage of reducing the influence of extreme observations which is particularly important in small samples.

3.2. CEO characteristics

We study the following CEO characteristics. The age of the CEO (*AGE*) defined as the CEO's age in years. In case of CEO turnover before the end of his mandate the average of both executives age is used. The CEO´s education (*EDUCATION*) defined as an indicator variable coded one when the manager's education is in the management or finance fields and zero otherwise (other fields of education). The CEO's *TENURE* defined as an indicator variable coded one if the CEO has one year or less to end his mandate and zero otherwise (more than one year left on the job). Duality of the CEO (*DUALILTY*) defined as an indicator variable that takes the value of one if the same individual held the positions of CEO and Chairman of the board in the firm and zero otherwise (CEO and Chairman are different

individuals). Following the hypotheses developed in the previous section we expect a positive relation between earnings management and these CEO characteristics.

3.3. Control variables

We have also considered firm specific conditions identified in previous studies as being associated with earnings management behavior. The firm characteristics are as follows. *SIZE* is measured as the log market capitalization at the fiscal year end. Large firms have more possibilities to manage earnings but they are also under more scrutiny from the public and regulatory entities which reduces incentives to manipulate earnings (Leuz *et al.*, 2003; Moses, 1987). *LEVERAGE* measured as the ratio of debt to equity is expected to be positively related to earnings management. Firms with higher leverage are more likely to violate debt covenants and thus have incentives to manage earnings (Watts and Zimmerman, 1986). *GROWTH* measured as the standard deviation of the firm's rolling five-year sales revenues, scaled by total assets. Growth in sales is usually associated with more earnings volatility and more negative values of our earnings management measure (Burgstahler *et al.*, 2006). *PERFORMANCE*, measured as *ROA* (return on assets equal to net income scaled by total assets), is a proxy for firm performance and is negatively associated with earnings management. Firms with better performance are more likely to meet analysts' forecasts and debt contracts thus do not need to resort to manipulation (Kalyta, 2009; Bauman and Shaw, 2006).

4. Data and descriptive statistics

Financial data for the sample firms was obtained via Thomson/Datastream and checked against firms' financial reports. CEO information was hand-collected from financial reports and press releases. The sample comprises all firms included in the PSI-20 stock market index. After dropping firm-years for which financial information was not available the final sample consists of 90 firm-year observations for 19 firms and for fiscal years 2005 to 2009. We selected these firms because they are the largest and economically more significant firms in the Portuguese economy. Also, they are subject to more stringent public and regulatory scrutiny and to additional auditing which is expected to result in higher reporting quality. These circumstances are likely to work against us finding the expected results.

Table 1 reports descriptive statistics. The average sample firm has 3,782 million Euros of market capitalization, 16,114 million Euros of assets and operating income of 330 million Euros. The level of debt exceeds equity more than three times and financial performance, based on ROA, is relatively low (3%). About 47% of the sample firms show signs of earnings management as the level of smoothness is above the sample median. The average executive age is 53 years. The CEO has a management or finance background in 84% of the cases, is about to leave his job in 31% of the cases, and accumulates the role of CEO and Chairman of the board in 37% of the cases.

Table 2 presents Pearson correlation coefficients for the variables used in the regression tests. The correlation between earnings management and the CEO characteristics is positive in all cases except for *TENURE* when it is close to zero. Overall, the Pearson correlations between variables are low indicating that multicollinearity is not a problem and is unlikely to affect the regression results. Variance inflation factors (VIFs) were also computed to check for multicollinearity problems. The VIF results (not tabulated) confirm that multicollinearity is not a serious problem as the factors are all smaller than the usual threshold of ten.

5. Empirical results

The empirical results of the association between earnings management behavior and four CEO characteristics are presented in Tables 3 to 6. For each CEO characteristic we estimate three logit models with a different set of control variables.

Table 3 presents the results of the association between earnings management and the CEO age. We find that age is positively and significantly associated with earnings management practices, for the three models. This result supports *H1* and indicates that older CEOs are more inclined to manipulate earnings to achieve higher short-term performance. In line with previous literature (Gibbons and Murphy, 1992a) we interpret this behavior as an attempt to improve compensation as retirement age approaches. The results for the firm-specific variables suggest that earnings management increases with leverage and decreases with growth and financial performance. But the results for the control variables are not statistically significant at the conventional levels.

The results of the association between earnings management and CEO education support *H2* (Table 4). Managers with management or finance studies are more prone to smooth earnings in all model specifications. This result is in line with the argument that a CEO with finance knowledge has more ability to manipulate accounting information. A CEO with management or finance education is more likely to manage earnings in order to report better firm performance in the short-term (Bhagat *et al.*, 2010).

Table 5 reports the estimated results on the relation between the CEO's tenure and earnings

manipulation. Contrary to the stated *H3* we find no significant association between the two variables. The fact that the manager is about to leave the job does not seem to increase earnings management. A possible reason for this result is that in a small business environment such as the Portuguese economy the CEO is often re-appointed as CEO or appointed to other relevant job in the firm. And even when he leaves the firm it is common that he keeps personal and professional links. Another explanation is the existence of governance mechanisms that mitigate managers' opportunistic behavior before turnover like stock-based incentives linked to future firm performance. But we have no information to explore these explanations.

Finally, in Table 7 we provide empirical estimations on the association between CEO duality and earnings management. Consistent with *H4* we find that earnings management increase when the CEO also holds the position of Chairman of the board of directors. When the same individual assumes the functions of CEO and Chairman that individual has more power to influence board members reducing efficient board monitoring (Jensen, 1993).

Overall, the empirical results indicate that some CEO characteristics are relevant determinants of earnings management.

Conclusion

This study analyzes the relation between characteristics of the firm's CEO and earnings management. We find that earnings management behavior increases when the CEO is older, has a management or finance background and accumulates the role of CEO and Chairman of the board of directors. We study the association between CEO characteristics and earnings management in Portuguese listed firms for the period 2005 to 2009. Portugal is a small economy where many firms are family-owned, CEOs have close relationships with board members and shareholders, and controls over the CEO actions can be weak (Djankov *et al.* 2008). Moreover, Portuguese regulation of corporate governance is often not enforced (CMVM, 2006; OECD 2011). It is interesting to observe such context because on one hand CEOs have more freedom to manage earnings, but on the other hand CEOs face less incentives to manage accounting numbers because there is less information asymmetry between shareholders and managers. The empirical results show that CEO's characteristics affect earnings management behavior. Namely, we find that older CEOs, CEOs with management or finance education, and CEOs that also hold the position of Chairman of the board of directors are more prone to manage earnings. The results indicate that the choice of the individual to manage the business and his contract conditions have important economic consequences for shareholders and users of financial information. These findings can help shareholders in the selection of the appropriate CEO and can also assist financial statement users to infer about the quality of accounting numbers reported by the manager.

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Table 1. Descriptive statistics

Variable	Mean	Median	SD	%
Market capitalization (million Euros)	3,781.86	2,818.54	3,719.33	
Total assets (million Euros)	16,113.72	4,124.38	25,096.80	
Operating income (million Euros)	330.45	167.39	431.79	
Operating cash flow (million Euros)	494.49	315.90	588.86	
Smoothness	-0.85	-0.58	0.73	
Earnings management				47.1
Age	53.00	52.00	6.60	
Education				83.5
Tenure				31.8
Duality				36.5
Size	3.32	3.45	0.56	
Leverage	3.88	2.16	4.35	
Growth	7.66	7.48	1.05	
Performance	0.03	0.03	0.03	

No.observations = 90

This table presents mean, median, and standard deviation (for continuous variables), frequencies (for discrete variables) and the number of firm-year observations. The sample consists of 19 Portuguese firms included in PSI-20 index for fiscal years 2005 to 2009. *Earnings management* is an indicator variable taking the value of one if the smoothness ratio is above the sample median and zero otherwise. Smoothness is defined as the ratio of the five-year standard deviation of operating income divided by the five-year standard deviation of cash-flow from operations, multiplied by minus one. *Age* is the CEO´s age in number of years. *Education* is an indicator variable that takes the value of one if the CEO's education is in the management or finance fields and zero otherwise. *Tenure* is an indicator variable that takes the value of one if the CEO has one year or less to end his mandate and zero otherwise. *Duality* is an indicator variable that takes the value of one if the same individual hold the positions of CEO and Chairman of the board of directors and zero otherwise. *Size* is the log of market capitalization at fiscal year-end. *Leverage* is the ratio of debt to equity at fiscal year-end. *Growth* is the standard deviation of rolling five-year sales revenues scaled by total assets. *Performance* is the ratio of net income to total assets at fiscal year-end.

Table 2. Correlations

	Earnings management	Age	Education	Tenure	Duality	Size	Leverage	Growth	Performance
Earnings management	1								
Age	0.2083	1							
Education	0.1645	-0.0483	1						
Tenure	-0.0357	0.1155	0.0305	1					
Duality	0.1671	0.2681*	-0.0589	-0.0445	1				
Size	0.0092	0.1862	-0.3055*	-0.0776	0.0972	1			
Leverage	0.1452	0.1417	-0.1577	0.0689	0.081	-0.0003	1		
Growth	0.1547	0.3198*	-0.2343*	0.0264	-0.139	0.6173*	0.0815	1	
Performance	-0.1668	0.0141	-0.2817*	-0.045	0.0164	0.4738*	-0.3719*	0.1513	1

This table shows Pearson correlation coefficients between variables. The sample consists of 19 Portuguese firms included in PSI-20 index for fiscal years 2005 to 2009. *Earnings management* is an indicator variable taking the value of one if the

smoothness ratio is above the sample median and zero otherwise. Smoothness is defined as the ratio of the five-year standard deviation of operating income divided by the five-year standard deviation of cash-flow from operations, multiplied by minus one. *Age* is the CEO´s age in number of years. *Education* is an indicator variable that takes the value of one if the CEO's education is in the management or finance fields and zero otherwise. *Tenure* is an indicator variable that takes the value of one if the CEO has one year or less to end his mandate and zero otherwise. *Duality* is an indicator variable that takes the value of one if the same individual hold the positions of CEO and Chairman of the board of directors and zero otherwise. *Size* is the log of market capitalization at fiscal year-end. *Leverage* is the ratio of debt to equity at fiscal year-end. *Growth* is the standard deviation of rolling five-year sales revenues scaled by total assets. *Performance* is the ratio of net income to total assets at fiscal year-end. The symbol ***, **, * denote statistical significance at 1%, 5% and 10% levels, respectively.

Table 3. Earnings management and CEO age

	Model (1)	Model (2)	Model (3)
AGE	0.112**	0.138**	0.140**
	(2.08)	(2.08)	(2.12)
Size	-0.683	0.795	0.868
	(-1.04)	(0.79)	(0.82)
Leverage	0.022	0.015	0.015
	(0.40)	(0.30)	(0.28)
Growth		-0.705	-0.703*
		(-1.62)	(-1.65)
Performance			-3.581
			(-0.31)
Intercept	-3.933	-5.388	-5.619
	(-1.09)	(-1.34)	(-1.40)
No. observations	90	90	90
Pseudo R2	0.34	0.36	0.36
Time fixed effects	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes

This table reports estimates of a logit model of earnings management on CEO age and firm-specific variables. The sample consists of 19 Portuguese firms included in PSI-20 index for fiscal years 2005 to 2009. *Earnings management* is an indicator variable taking the value of one if the smoothness ratio is above the sample median and zero otherwise. Smoothness is defined as the ratio of the five-year standard deviation of operating income divided by the five-year standard deviation of cash-flow from operations, multiplied by minus one. *Age* is the CEO´s age in number of years. *Size* is the log of market capitalization at fiscal year-end. *Leverage* is the ratio of debt to equity at fiscal year-end. *Growth* is the standard deviation of rolling five-year sales revenues scaled by total assets. *Performance* is the ratio of net income to total assets at fiscal year-end. The symbol ***, **, * denote statistical significance at 1%, 5% and 10% levels, respectively.

Table 4. Earnings management and CEO management/financial education

	Model (1)	Model (2)	Model (3)
EDUCATION	1.584**	1.541**	1.910*
	(1.97)	(1.99)	(1.86)
Size	0.023	0.715	0.306
	(0.04)	(0.71)	(0.27)
Leverage	0.039	0.035	0.050
	(0.71)	(0.66)	(0.86)
Growth		-0.333	-0.303
		(-0.78)	(-0.70)
Performance			13.678
			(0.95)
Intercept	-1.306	-1.401	-1.039
	(-0.52)	(-0.56)	(-0.40)
No. observations	90	90	90
Pseudo R2	0.34	0.34	0.35
Time fixed effects	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes

This table reports estimates of a logit model of earnings management on CEO education and firm-specific variables. The sample consists of 19 Portuguese firms included in PSI-20 index for fiscal years 2005 to 2009. *Earnings management* is an indicator variable taking the value of one if the smoothness ratio is above the sample median and zero otherwise. Smoothness is defined as the ratio of the five-year standard deviation of operating income divided by the five-year standard deviation of cash-flow from operations, multiplied by minus one. *Education* is an indicator variable that takes the value of one if the CEO's education is in the management or finance fields and zero otherwise. *Size* is the log of market capitalization at fiscal year-end. *Leverage* is the ratio of debt to equity at fiscal year-end. *Growth* is the standard deviation of rolling five-year sales revenues scaled by total assets. *Performance* is the ratio of net income to total assets at fiscal year-end. The symbol ***, **, * denote statistical significance at 1%, 5% and 10% levels, respectively.

Table 5. Earnings management and CEO tenure

	Model (1)	Model (2)	Model (3)
TENURE	-0.164	-0.126	-0.125
	(-0.23)	(-0.17)	(-0.16)
Size	-0.193	0.586	0.584
	(-0.32)	(0.62)	(0.56)
Leverage	0.018	0.015	0.015
	(0.32)	(0.27)	(0.28)
Growth		-0.359	-0.359
		(-0.94)	(-0.94)
Performance			0.053
			(0.00)
Intercept	0.511	0.370	0.373
	(0.21)	(0.15)	(0.15)
No. observations	85	85	85
Pseudo R2	0.30	0.30	0.30
Time fixed effects	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes

This table reports estimates of a logit model of earnings management on CEO tenure and firm-specific variables. The sample consists of 19 Portuguese firms included in PSI-20 index for fiscal years 2005 to 2009. *Earnings management* is an indicator variable taking the value of one if the smoothness ratio is above the sample median and zero otherwise. Smoothness is

defined as the ratio of the five-year standard deviation of operating income divided by the five-year standard deviation of cash-flow from operations, multiplied by minus one. *Tenure* is an indicator variable that takes the value of one if the CEO has one year or less to end his mandate and zero otherwise. *Size* is the log of market capitalization at fiscal year-end. *Leverage* is the ratio of debt to equity at fiscal year-end. *Growth* is the standard deviation of rolling five-year sales revenues scaled by total assets. *Performance* is the ratio of net income to total assets at fiscal year-end. The symbol ***, **, * denote statistical significance at 1%, 5% and 10% levels, respectively.

Table 6. Earnings management and duality of CEO roles

	Model (1)	Model (2)	Model (3)
DUALITY	0.776*	1.137**	1.129**
	(1.69)	(2.31)	(2.29)
Size	-0.241	-1.200**	-0.935
	(-0.58)	(-2.11)	(-1.48)
Leverage	0.080	0.067	0.047
	(1.42)	(0.93)	(0.69)
Growth		-0.762**	-0.729**
		(-2.32)	(-2.21)
Performance			-8.168
			(-0.99)
Intercept	0.562	-2.211	-2.564
	(0.39)	(-1.13)	(-1.25)
No. observations	90	90	90
Pseudo R2	0.06	0.11	0.12
Time fixed effects	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes

This table reports estimates of a logit model of earnings management on CEO duality and firm-specific variables. The sample consists of 19 Portuguese firms included in PSI-20 index for fiscal years 2005 to 2009. *Earnings management* is an indicator variable taking the value of one if the smoothness ratio is above the sample median and zero otherwise. Smoothness is defined as the ratio of the five-year standard deviation of operating income divided by the five-year standard deviation of cash-flow from operations, multiplied by minus one. *Duality* is an indicator variable that takes the value of one if the same individual hold the positions of CEO and Chairman of the board of directors and zero otherwise. *Size* is the log of market capitalization at fiscal year-end. *Leverage* is the ratio of debt to equity at fiscal year-end. *Growth* is the standard deviation of rolling five-year sales revenues scaled by total assets. *Performance* is the ratio of net income to total assets at fiscal year-end. The symbol ***, **, * denote statistical significance at 1%, 5% and 10% levels, respectively.

РАЗДЕЛ 2

КОРПОРАТИВНАЯ СОЦИАЛЬНАЯ ОТВЕТСТВЕННОСТЬ

SECTION 2 CORPORATE SOCIAL RESPONSIBILITY

CORPORATE SOCIAL RESPONSIBILITY (CSR) REPORTING BY MULTINATIONAL CORPORATIONS (MNCS) SUBSIDIARIES IN AN EMERGING COUNTRY

Mahmood Ahmed Momin*, Mohammed Hossain**

Abstract

The paper examines the extent of corporate social responsibility (CSR) Reporting by subsidiaries of multinational corporations in Bangladesh in two different steps. At the first step, the study explores the general trend of CSR Reporting in Bangladesh, and then examines in more detail: (a) CSR of subsidiaries of MNCs and (b) CSR of UK MNCs and their subsidiaries in Bangladesh. Content analysis has been used to capture the nature and quantity of CSR issues provided in the annual reports by the companies that were listed on the Dhaka Stock Exchange during the study. The paper suggests that CSR Reporting by MNCs subsidiaries in Bangladesh mainly means employee disclosure. CSR Reporting mostly consists of voluntary information with minimum level of mandatory disclosure. More importantly, subsidiaries disclose social and environmental issues more in line with Bangladeshi national companies than they do with their MNC parents. This highlights the fact that MNCs do follow different CSR Reporting strategy based on country of reporting.

Keywords: Corporate Social Responsibility, Multinational Corporations, Emerging Country

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1 Introduction

Despite much literature on social reporting in developed countries, and some studies of CSR in developing countries, research into social reporting of MNCs appears to be relatively sparse (but see, UN, 1991; UN, 1995, Newson and Deegan, 2002). Moreover, studies of the CSR practices of MNCs tend to ignore CSR practices of their subsidiaries. Even the international initiatives mentioned above, such as the Global Reporting Initiative, are limited to developed countries and ignore the CSR practices of subsidiaries of large MNCs who also operate in developing countries. This paper investigates Corporate Social Responsibilty (CSR) Reporting by Multinational Corporations (MNCs) subsidiaries in an emerging country. In particular it aims to explore CSR Reporting of MNCs from United Kingdom and their subsidiaries operating in Bangladesh: an emerging economy country. To

achieve the aim of the paper the paper focuses on three particular issues. First, it investigates CSR Reporting of top 50 corporations listed at Dhaka Stock Exchange in Bangladesh in the year 1999 and 2000. Second it examines CSR Reporting of all subsidiaries of MNCs that are included in the sample of the top 50 corporations. Third, it examines CSR Reporting practices of particular UK subsidiaries and their parent corporations in Bangladesh and the UK found in sample corporation. Subsequently, the CSR Reporting of seven subsidiaries of MNCs from the top 50 corporations are examined. They represent four industrial groups out of the nine industrial groups taken from the total sample. Their CSR practices are illustrated and compared to the general CSR Reporting trend in Bangladesh. Moreover, their CSR practices are compared to domestic companies within similar industrial groups. Finally CSR of UK subsidiaries are compared with their parent corporations to see whether MNCs subsidiaries CSR Reporting practices are more in line with their head office CSR Reporting practices.

Multinational corporations need to be accountable for the impact of their actions to both the host and the home society, as well as for providing information about their actions (see also UN, 1999, 2004). In addition, the common control of these globally dispersed operations means that MNCs have an opportunity to coordinate pricing, sourcing, and location decisions in a manner that, while increasing net returns for the group, may be harmful to the emerging economy countries' natural environment and society at a large. This is the basis for a conflict of perspectives between that of the national view of various groups within the nation-state and the view of MNCs (Redebaugh and Gray, 1997). While increasing net returns by operating in different countries is for many MNCs just a part of their global business operation, this is the part that is of primary concern for most of those affected in the host country. This particular context appears to have given rise to pressure for exploring CSR activities of MNCs and their subsidiaries.

The remaining of the paper is structured as follows. First section describes literature review. The second section depicts research methodology. The third section illustrates findings and analysis and the final section conclude the study.

2 Literature Review

Teoh and Thong (1984) and Andrew et al (1989) provide some understanding of CSR Reporting practices of multinationals by including subsidiaries of MNCs in their sample. Teoh and Thong (1984) examined social disclosure and considered four levels: social awareness, social involvement, social reporting and social audit. They found that the level of social awareness is dependent on the affiliation of the parent company. According to them, the environmental and social awareness of the parent company appeared to have a direct or indirect influence on the social disclosure of their subsidiaries operating in developing countries. If their argument holds true, it would mean that subsidiaries of a foreign company would show greater concern for social reporting in a developing country than domestic corporations in the same industry. They found that foreign companies have a greater level of social awareness and involvement than domestic companies in Malaysia (but see also Andrew et al 1989). However, the result was too simplistic and not conclusive since social awareness may not translate into social disclosure practices because of cultural attributes prevalent in Malaysia (Andrew et al., 1989). Andrew et al. (1989) suggest that managers of domestic companies in Malaysia are often reluctant to disclose all their good deeds or social activities in the annual report due to their religious beliefs[37]. Regarding issues of disclosure, Teoh and Thong (1984) observe that both domestic and foreign affiliated companies made more disclosures relating to human resources and consumer issues than to issues of the natural environment or the community. This is supported by a later study by Andrew *et al.* (1989). Similarly, Disu and Gray (1998), in a study of 22 large multinationals in Nigeria, noted that all the companies included disclosure relating to employment and corporate governance data, while very few made voluntary social disclosure relating to the community and the environment.

Newson and Deegan (2002) and Maignan and Ralston (2002) have studied CSR Reporting practices of multinationals using samples from different countries. They studied social disclosure policies of multinationals based in Australia, Singapore and South Korea with the assumption that large multinationals need to respond to *'global expectations'* rather than to expectations of the people in their home country alone. To define 'global expectations' they used two survey results established by Enderle and Peters and Environics International in 1998 and 1999 respectively[38]. However, they found that social disclosure practices of large MNCs do not meet 'global expectations' and instead respond to the expectations of their national 'relevant public'. Moreover, Newson and Deegan (2002) also suggest

[37] Malaysian culture is dominated by the Islamic religion, in which there is a belief that to disclose all one's own good deeds appears conceited.

[38] The survey basically provided expectations of interest groups like non-governmental organisations of the multinationals. For example, Enderle and Peters cited in Newson and Deegan (2002) surveyed 133 interest groups, mostly non-governmental organisations, across 36 countries to determine reasonable expectations of the multinational corporations.

that large multinationals might use different disclosure strategies in different contexts. Maignan and Ralston (2002) studied the web-based social disclosure of MNCs from France, Netherlands, the UK and the US. They too conclude that corporations use different disclosure strategies in web disclosure when operating in different countries. Such different CSR strategies include different CSR principles, process and stakeholder issues. They noted that 58.5 per cent of US companies made social disclosure as a part of their firm's core values, while performance driven CSR principles mostly motivated UK companies (56 per cent of sample companies) and other European companies. However, these two studies cover only social disclosure made in the annual reports of MNCs in their home countries, not disclosure by their subsidiaries. The next section examines social disclosure practices of multinationals both at parent company and subsidiary level.

With few exceptions (as far as can be ascertained), the UN has led the study of social disclosure practices by MNCs by looking at both the parent company and the subsidiaries' annual report (UN 1991a, 1995). The UN report (1991) studied German and Swiss multinationals' environmental reporting practices in both the home and host countries. This study showed that German and Swiss firms do not disclose environmental issues in host countries, although such issues are reported in their home countries (UN 1991a). In 1995, the UN undertook another study with a wider coverage. This study again focused on multinationals' environmental practices but in three host countries: India, Malaysia and the Philippines. This study concludes that environmental information produced by multinationals in their annual reports in these developing countries is relatively low and weak compared to the environmental reporting by the same multinationals in their home countries. Both of the studies highlight the fact that the disclosure policy of multinationals varies not only according to their country of origin but also according to the country in which they report. This also highlights not only cross-country variations in environmental disclosure but also a variation in disclosure strategy within the same companies at different levels (subsidiary and parent company). Both studies suggest differences in environmental regulation among the countries as a possible explanation for such variations.

Ruud (2002) studied environmental management of subsidiaries in India. He noted that environmental management of these subsidiaries was strongly influenced by their headquarters' environmental policies and standards rather than being driven by local pressures (i.e. pressure from local environmental authorities and NGOs, industrial policy, pressure and incentives of the market). Fifty per cent of the sample subsidiaries mentioned the policies of their head office as a motivating factor, while 23 per cent mentioned fear of present or future environmental regulation as a motivating factor. Only 13 per cent of environmental management procedures are stated as being driven by the initiatives of the subsidiary's management. Environmental NGO's influence is mentioned by only 3 per cent of the companies as a motivating factor. A similarly low per cent of companies mention consumer pressure as a motivating factor. Ruud's study included detailed case studies of environmental management in Danish and German multinationals which operate in China, Malaysia and India (although he discussed findings from India only). Ruud (2002) noted that while environmental measures were implemented in accordance with the requirements of regulation and public expectation in the home countries of multinationals, there was a tendency by managers of subsidiaries to replicate policy statements (originally developed at headquarters) in an informal manner. Ruud argued that in the case of India, no evidence was found of attempts to make those commitments more specific. He mentioned that three-quarters of his sample also formalised environmental auditing where headquarters used to perform environmental auditing on a regular basis, and also formalised environmental reporting between headquarters and affiliates[39]. He contends that such initiatives placed subsidiary managers with more reporting responsibilities (although only to headquarters) while control actually remained with head office.

However, environmental information is only a part of social reporting and thus the findings may not be sufficient to explore the motivations behind a multinational using different social disclosure strategies for their parent company and for their subsidiaries.

Overall, previous literatures suggests that CSR Reporting practices particularly by MNCs and their subsidiaries, are arguably very few and are not conclusive. For example, it is suggested that subsidiaries of MNCs disclose more than domestic corporations due to their affiliation with their parent corporations (Teoh and Thong, 1984). On the other hand, Andrew et al (1989) suggest the possibility that cultural influence may lower the tendency of

[39] Rund (2002) found that environmental auditing rarely meets the objectives of environmental control. For example, in one of his case companies (a US based company), the environmental officer at subsidiary level never obtained a copy of the operational audit made by headquarter officials and did not get any feedback nor recommendations, even though a serious environmental problem was documented at that plant. Moreover, interviewing corporate managers he felt the existence of a global corporate strategy of 'informed' rather than 'involved' personnel in those activities.

domestic corporations' managers to report, compared with subsidiaries' managers, who may follow a more open disclosure policy. In addition, the UN study (1991a, 1995) shows that subsidiaries operating in LDCs are making less disclosure compared to their parent corporations. This study therefore intends to tease out some of these conflicting claims by focusing on UK subsidiaries operating in Bangladesh.

3. Method and data collection

This paper uses content analysis in collecting and analysing the data. Content analysis involves the identification of particular issues within a text (in this case, an annual report), which can be categorised under headings (such as environmental or social), and then analysed (Guthrie and Parker, 1990). Conducting a content analysis in this study involves at least four important steps: choosing the documents to analyse, selecting the categories or themes of CSR, and measuring the themes. Arguably, the first step in content analysis is to choose the document/documents to be analysed. Most previous studies have applied content analysis only to annual reports (see, Unerman, 2000). Reasons for focusing exclusively on the annual report are numerous (Gray et al, 1995a). One of the main reasons is the impossibility or impracticality of capturing all communications by a number of companies in a given period (Gray et al, 1995a). Indeed, it is virtually impossible to claim that one has captured all the media of communications and thus it is inevitable that the completeness of CSR analyses will be questionable (Gray et al, 1995a). Nevertheless, the annual report is regarded as a very important document in CSR research due to its high degree of credibility (Tilt, 1994), the frequent use of annual reports by a large number of stakeholders seeking a wide variety of information items (e.g., solvency, financial performance, investment or environmental information), and the regularity of its publication (Deegan and Rankin, 1997; Neimark, 1992, cited in Unerman, 2000). Recognising the strength of these justifications for using annual reports, the present study also considers the annual reports of companies in both the UK and Bangladesh. Another justification for using annual reports in this study is that in Bangladesh companies generally use annual reports rather than any other medium to disclose CSR information (see, Belal, 2001; 2000). The annual report is therefore the common single document used by both UK and Bangladeshi companies exclusively to report CSR information. So the annual report is chosen in this study as the document for content analysis.

3.1. Classification of themes: the pilot study

Several problems arise in categorising such themes over time and also when cross-country analysis is considered. First, new CSR themes are raised over time which may not fall within previous categories. This is due to the fact that changes of time can change the relative importance of issues included in CSR (see, Gray et al, 1995a, b). Second, categories and sub-categories of CSR vary between countries when cross-country CSR is considered. Therefore a pilot study was initially carried out to get an experience over the process of content analysis and also to get an idea about present categories and sub-categories of reporting issues in the UK and in Bangladesh.

The study follows the categorisation of CSR Reporting issues developed by Corporate Social and Environment Accounting Research Center (CSEAR) and specific decision rules in recording and classifying social and environmental themes in the UK for the year 2000. The four major themes of CSR Reporting (e.g employee, community, environment and customer information) suggested by Gray et al (1995b) in constructing the CSEAR database are taken as the starting point[40]. These categories are also consistently found in other CSR studies and are considered common over time periods and over cross-country practices, although the relative importance of these themes might vary (Gray et al, 1995b). These categories are: natural environment; employees; community; and customer information. As well as these categories, the present study considers two further categories: director and corporate governance. These are considered as separate themes due to the development of these issues in the UK and Bangladesh. For example, corporate governance issues became important in the UK with the emergence of the 'Combined Code' in June 1998[41]. In addition, a 'general and other category' also helps to capture other CSR themes which occur over time or are particular to Bangladesh due to the different country context. These main categories are then divided into different sub-categories to capture the whole amount of social information provided within the main categories. Following CSEAR decision rules a 'decision rule' defining these categories and sub-categories has been prepared so that another researcher can apply the same decision rules and replicate the study results[42]. Figure 1 shows the

[40] Please see, Gray et al, (1995b)

[41] Indeed, corporate governance became an issue since 1992. Please see, Cadbury code 1992, Greenbury 1995 and Hampel 1998.

[42] A detailed description of the decision rules is provided in Appendix 1.

categorisation used to study the CSR of UK corporations[43].

However, before finalising these categories and sub-categories for Bangladesh it was believed necessary to conduct a further pilot content analysis of Bangladeshi companies. The pilot study analyses 10 annual reports from 50 companies. The results confirm that CSR disclosure is mostly made within the main themes although not all companies follow all the sub-categories listed by Gray et al (1995b).

3.2 Measuring Themes

Another important aspect of content analysis is the measurement of these themes. Previous studies suggest that various types of measurement (ie number of words, sentences, pages or page proportion) have both advantages and disadvantages (see, Unerman, 2000). For example, those who use 'word' as a measurement unit argue that it has the advantage of counting a greater amount of detailed description of CSR with more accuracy (Zeghal and Ahmed, 1990). On the other hand, 'sentence' has been preferred by many researchers to infer meaning from the themes disclosed rather than counting isolated words (Hackston and Milne, 1996). However, both 'word' and 'sentence' have the disadvantage of ignoring non-narrative CSR disclosure (i.e. photographs and figures) and thus lower the total amount of disclosure (Unerman, 2000). Compared to counting words or sentences, measuring page proportions has the advantage of including both narrative and non-narrative CSR disclosure. Recognising the advantage of the 'page proportion' method suggested by Gray et al (1995a, b), the present study uses the method to measure the volume of CSR. To analyse the quality of CSR and to capture the meaning attached to it, three additional categories are suggested by Gray et al (1995a). These categories are 'evidence', 'news', and 'audit'. 'Evidence' describes whether the information is 'monetary quantitative', 'quantitative only' or 'declarative' in nature. 'Monetary quantitative' information consists of both the amount and type of information, and refers primarily to financial numbers. 'Quantitative only' refers to information solely relating to quantity. 'Declarative' information refers to qualitative information. 'News' describes whether the information provides a good, bad or neutral meaning to the receiver. 'Audit' describes whether the information provided has any chance of being audited, subject to being given access to the organisation.

After recording data for all companies in individual sheets, the data is transferred to a database created through Microsoft Excel for further statistical analysis. From the database, total CSR recorded for each corporation has been calculated according to the main categories or issues of reporting: environment; employee; community; customer; director; and corporate governance following Gray et al (1995b). Simple averages and percentages are then calculated to make data more meaningful. Figure 2 shows briefly the formula used to calculate the total volume of CSR according to issues and according to the nature of the information for UK companies.

[43] This categorisation mostly followed Gray et al.'s (1995b) categorisation. In Gray et al.'s (1995b) categorisation, Health and Safety appears twice - once in the employee category and again in the environmental category. Therefore, here as well, it is kept under both employee and environmental disclosure. However, that does not mean that Health and Safety is double counted in calculating the total level of CSR, as this is counted once (i.e. in employee disclosure) while measuring total CSR (please see formula used in calculating the total level of CSR. Moreover, relevance of disclosures relating to South Africa is questionable. However, it was decided to leave the category in the instrument in order to leave the original research instrument as it is.

Figure 1. Social reporting categories used to capture UK CSR (according to issues)

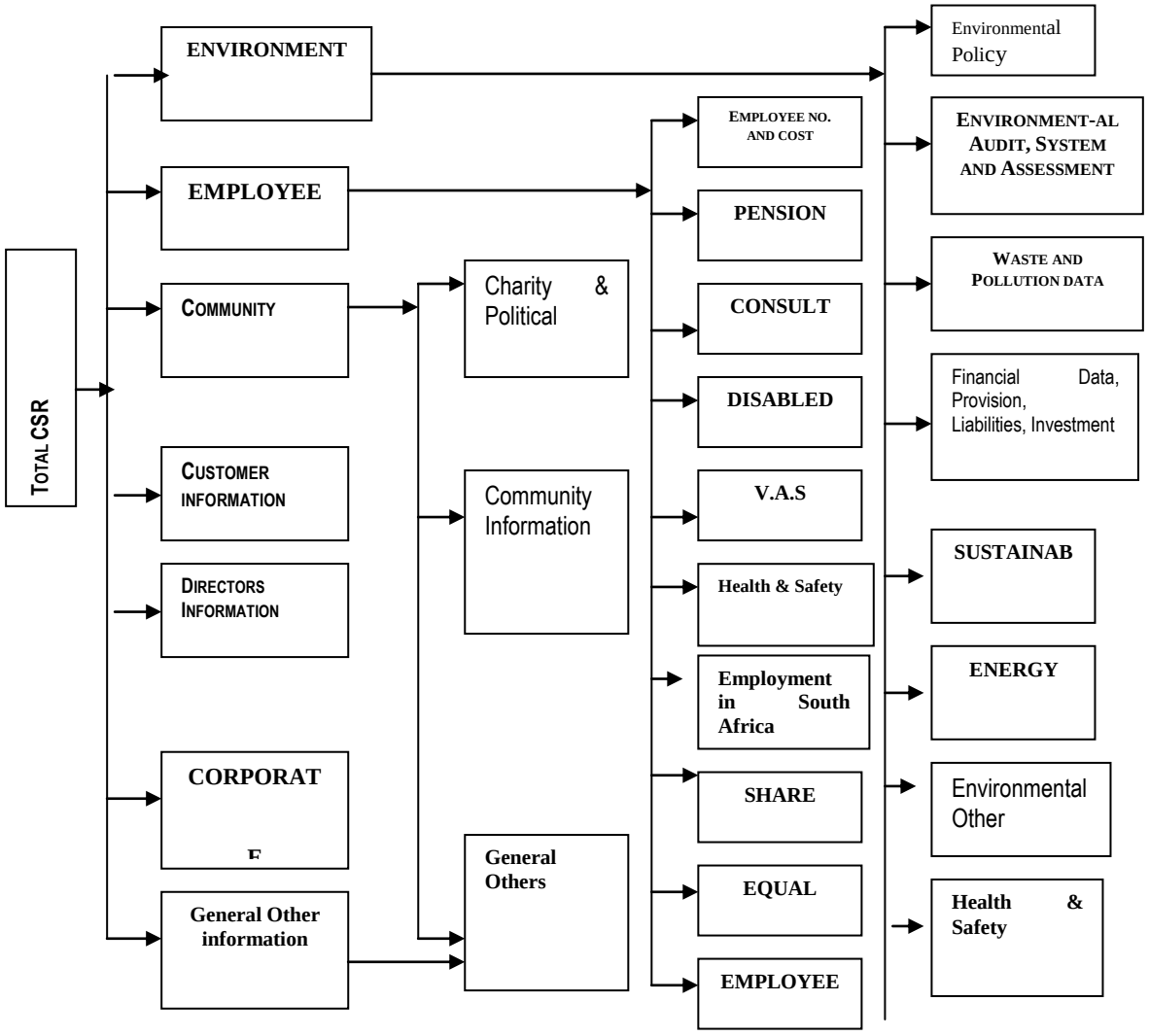


Figure 2. Formula used to calculate level of social and environmental information from annual reports of UK companies

i) Measuring Total CSR from categories and sub-categories:

$$\Sigma CSR = \Sigma ENV. + \Sigma EMPL. + \Sigma COMMU. + \Sigma CUST. + \Sigma DIR. + \Sigma CORPGOV.$$

ΣENV. = Environmental policy + Environmental audit + Waste + Financial data + Sustainability + Energy + Environmental other.
ΣEMPL. = Employee data + Pension + Consult employee + Disabled+ V.A.S + Health and Safety + Share employee + Equal opportunity + Employee other.
ΣCOMMU. = Community + Charity + General other
ΣCUST. = Consumer and product information.
ΣDIR. = All director information
ΣCORPGOV. = All corporate governance information

Where,

ΣCSR = TOTAL VOLUME OF CORPORATE SOCIAL AND ENVIRONMENTAL ISSUES

ΣENV. = Total volume of environmental data
ΣEMPL. = Total volume of employee data
ΣCOMMU. = Total volume of community data
ΣCUST. = Consumer and Product information.
ΣDIR. = All director information
ΣCORPGOV. = All corporate governance information

ii) Measuring Total CSR from the nature of the information.

$$\Sigma CSR = \Sigma V.\ CSR + \Sigma M^{1}.\ CSR$$

ΣV. CSR = ΣENV. + ΣV. COMMU. + ΣV. EMPL. + ΣCUST.
ΣV. COMMU. = Community + General Other
ΣV. EMPL. = V.A.S + H & S + Equal oops. + Employee other.
ΣCUST. = All customer information
ΣM^{1}. CSR = ΣM. CSR + Employee number & cost + Pension + Directors
ΣM. CSR = Charity + Consultation + Share Ownership + Disabled + C. Governance

Where,

ΣV.CSR means total voluntary corporate social Reporting issues, V. COMMU means, voluntary community information, and V.EMPL. means voluntary employee information, ΣM^{1}. CSR means mandatory plus total where as, ΣM.CSR means total mandatory information.

3.3 Selecting the sample annual report

Annual reports for the 50 largest Bangladeshi companies were selected out of 185 corporations (excluding purely financial and insurance companies) from the Dhaka Stock Exchange list on 31st December 2000, representing 27% of the population. They represent 79% and 80% of the total market capitalisation in the years 2000 respectively. These corporations are categorised in six industrial groups according to the Dhaka Stock Exchange schedule. Figure 3 shows the industrial classification of these corporations.

Figure 3. Industrial classification of sample corporations in Bangladesh

Number	Nature of industries
1.	Engineering
2.	Food Allied and Tobacco
3.	Fuel and Power
4.	Jute and Textile
5.	Pharmaceuticals
6.	Paper and Printing
7.	Service and Real Estate
8.	Cement
9.	Leather and Tanneries

4 Findings and analysis

4.1 General trend of CSR in Bangladesh

Table 4.1 shows the percentage of companies which report social and environmental issues in their annual report.

Table 4.1. Disclosure of social and environmental issues in Bangladeshi company annual reports for the years 1999 and 2000 (Percentage of companies)

Particular/Years	1999	2000	AVG
Environment	78%	84%	81%
Consumer	14%	16%	15%
Community	90%	86%	88%
Employee	100%	100%	100%
Directors	90%	94%	92%
Corporate Governance	0	8%	4%
General Other	72%	78%	75%
Voluntary	98%	100%	100%
Mandatory	100%	100%	100%
Total Companies	50	50	50

Note: Average means average over two years.

Table 4.1 shows that almost 100% of companies in Bangladesh disclose employee information in both years. Apart from employee disclosure, information regarding directors, community disclosure and environmental disclosure are the most popular area of disclosure, being disclosed on average by 92%, 88% and 81% respectively of the sample companies over the two years. The least popular area of disclosure is corporate governance followed by consumer information, the latter being reported by 14% and 16% of companies respectively. Table 4.2 shows the percentage of companies disclosing mandatory information in Bangladesh in detail. In short, in Bangladesh, 'energy information', 'employee numbers and cost', 'the contribution to workers' profit participation fund', and information regarding 'contribution to the Government Exchequer', are all mandatory information.

Table 4.2. Mandatory disclosure of social and environmental issues in Bangladeshi company annual reports for the years 1999 and 2000 (Percentage of companies)

Particular/Years	1999	2000	AVG (%)
Energy Consumption	74%	82%	78%
Employee No & Cost	100%	100%	100%
Contribution to W P P & P F	90%	92%	91%
Directors	90%	94%	92%
Contribution to National Exchequer	28%	30%	29%
Total Companies	50	50	100%

Notes: W P P F means Workers' Profit Participation Fund; P F means Provident fund.

Table 4.2 shows that the majority of companies comply with the minimum requirement of regulatory or mandatory disclosure, with all companies on average disclosing employee numbers and cost information in Bangladesh. In the case of Bangladesh all other areas of mandatory disclosure show some non-compliance, with the lowest disclosure being on 'contribution to the

national exchequer' (29% of companies on average). Table 4.3 gives details of voluntary disclosure in Bangladesh. It shows that there are differences in voluntary social and environmental issues in terms of number of companies reporting these issues. For example, employee information is disclosed by highest number of companies (94%), followed by charity (46%) and value added information (40%). Compare to these three issues, disclosure in environmental issues, health and safety issues are not disclosed by significant number of companies.

Table 4.3. Voluntary disclosure of information in Bangladeshi company annual reports for the years 1999 and 2000 (Number of companies)

Particular/Years	**1999**	**2000**	**AVG (%)**
Environmental policy	4%	4%	4%
Environmental Audit	2%	0	1%
Waste	10%	18%	14%
Financial data	0	2%	-
Sustainability	4%	2%	3%
Environmental other	8%	10%	9%
Consumer	14%	16%	15%
Community	10%	10%	10%
Charity	46%	46%	46%
V A S	40%	40%	40%
Health and Safety	8%	8%	8%
Equal opportunity	-	-	-
Employee other	94%	94%	94%
General other	60%	70%	65%
Total company	**50**	**50**	**100%**

Notes:
1. '***' means that the issue is mandatory for the particular country so not recorded.
2. ' - ' means insignificant amount

Table 4.4 shows the issues of disclosure and the page proportions devoted to such issues by companies in different areas of social and environmental disclosure in Bangladesh. As expected, the total volume of social and environmental issues reported in Bangladesh is very low. Table 4.4 shows that on average 1.96 pages are devoted to social and environmental issues in Bangladeshi annual reports.

Table 4.4. Amount of page proportion devoted to each issue in Bangladeshi company annual reports for the years 1999 and 2000 (By proportion of pages)

PARTICULAR/YEARS	**1999**	**2000**	**AVG**
	BD	**BD**	**BD**
Environment	0.08	0.1	0.1
Consumer	0.04	0.01	0.03
Community	0.31	0.3	0.31
Employee	1.1	1.2	1.15
Directors	0.32	0.30	0.31
Corporate Governance	-	0.17	0.1
Voluntary	0.97	1.14	1.05
Mandatory	.89	0.94	0.91
Total CSR	**1.85**	**2.08**	**1.96**

Note: Average means average of two years.

Table 4.4 shows the dominance of employee information in Bangladesh in terms of page proportion devoted to this issue. It shows that an average of 1.15 pages are devoted to this issue. The lowest disclosure is made of consumer issues; only 0.03 of a page in Bangladesh. In the case of Bangladesh, information on community issues and director issues are the second and third most popular area of disclosure in terms of page proportions (in both cases 0.31 of a page are devoted to the issue).

It is generally accepted that the size and industrial nature of a company has an effect on the volume and nature of disclosure. Usually, bigger corporations disclose more than smaller corporations. Moreover, Subsidiaries of MNCs, although listed within the top 50 corporations in Bangladesh, fall into different industrial groups in

Bangladesh. Therefore, it is important to look at the overall CSR trend according to industrial classification in Bangladesh. Table 4.5 shows the industry average of CSR in Bangladesh for the years 1999 and 2000.

Table 4.5. Industry average of CSR for the year 1999 and 2000 in Bangladesh (By proportion of pages in company annual)

Industrial groups / Years	1999	2000	Average
Engineering	1.84	1.36	1.6
Food Allied and Tobacco	.72	1.42	1.07
Jute and Textile	1.95	2.41	2.18
Pharmaceuticals and chemicals	2.38	2.59	2.48
Paper and Printing	1.47	0	0.73
Service and Real State	1.26	1.21	1.23
Cements	0.47	3.57	2.02
Leather and Tanneries	1.39	1.53	1.46

Note: Average means average over two years.

Table 4.5 shows that the average volume of CSR is highest in Pharmaceutical and Chemical corporations in Bangladesh. This is followed by the Jute and Textile, Cements, Engineering,and Leather and Tanneries industries. This suggests that these industries disclosed a higher volume of CSR compared to other industrial groups such as the Paper and Printing industry in Bangladesh. Moreover, this also indicates that the volume of CSR varies according to the industrial nature of the company. As most of the subsidiaries fall within these industrial groups, the next chapter examines their CSR according to their industrial average CSR found in Bangladesh.

Over all, It can be seen that the greatest amount of disclosure in Bangladesh is concerned with employee disclosure. Other popular areas of disclosure are community, environment and directors' issues in terms of proportion of pages occupied by such disclosures. Pharmaceutical and Chemical industries disclose the highest amount of CSR in Bangladesh. The next industries are Jute and Textile, Cement, Engineering and Food and Allied according to the volume of CSR they report in their annual reports. It is worth noting that these five industry groups, along with Leather and Tanneries, are known for their poor environmental performance and labour exploitation (particularly the Textile and Jute industries). In addition, Pharmaceuticals and Chemicals is the sector where most subsidiaries of MNCs operate in Bangladesh.

The overall trend of CSR in Bangladesh found in this study is similar to that found by Belal (1999) and Imam (2000), with a few exceptions. For example, both studies showed that 'employee disclosure' dominated CSR in Bangladesh and that disclosure is made on some common issues such as 'environmental' , 'community' and 'director information'. This is consistent with the findings of the present study. However, the findings of the present study also differ from Belal's (1999) and Imam's (2000) in terms of the level of total CSR. This is partly due to the different measurement unit used in this study compared to the two previous studies. While they measured by number of words, this study uses page proportion as its measurement. Previous studies did not include pictures and graphs in their measurements, and so may have missed many pictorial images of businesses' attitudes towards the greening of the environment, community help programmes and, most importantly, graphical presentation of value-added information. These are included when measuring page proportion. Moreover, previous studies do not focus very much on value-added data that can be disclosed in different forms such as full statement and revenue distribution forms (Roberts, 1990). The results of the present study are therefore an improvement on previous studies in that this study incorporates picture and graphs which capture social and environmental image of corporations in Bangladesh.

4.2 CSR of subsidiaries of MNCs

4.2.1 CSR in subsidiaries and domestic corporations

Table 4.6 gives information of companies which disclosed social and environmental issues in the year 1999 and 2000. It shows the percentage of companies from the study's sample – both subsidiaries and domestic corporations – that reported these issues in their annual report.

Table 4.6. Companies disclosing social and environmental in the annual report for the year 1999 and 2000 (Percentage of companies)

Particulars/ Year	1999		2000		AVG	AVG
	SUB	DOM	SUB	DOM	SUB	DOM
Environment	100%	66%	100%	71%	100%	69%
Consumer	28%	0%	28%	14%	28%	7%
Community	100%	66%	100%	100%	100%	83%
Employment	100%	100%	100%	100%	100%	100%
Directors	100%	100%	100%	100%	100%	100%
Corporate governance	-	-	14%	14%	10%	7%
Total company	7	6	7	7		

Note:

1. AVG means average of two years.
2. SUB includes seven subsidiaries of MNCs operating in Bangladesh (descriptions are provided in section 9.1).
3. DOM includes domestic corporations mentioned in figure 9.1 (section 9.1).

The above table shows that all companies - both subsidiaries and domestic corporations - disclose employee information in both years. Apart from employee disclosure, information regarding directors, community disclosure and environmental disclosure are the issues most commonly disclosed in annual reports. The least popular area of disclosure is customer information. This is similar to the general trend of CSR in Bangladesh, as illustrated in section 4.1. Table 4.6 also shows that one out of seven domestic corporations (14%) reported issues relating to corporate governance, like as one subsidiary reported on this issue in the year 2000. Graph 4.1, below, illustrates the CSR overtime in subsidiaries and selected domestic corporations. It shows that there is no major difference between these two groups in terms of companies reporting social and environmental issues over an average of two years. However, it shows that a higher percentage of subsidiaries than domestic corporations report environmental and community information.

Graph 4.1.

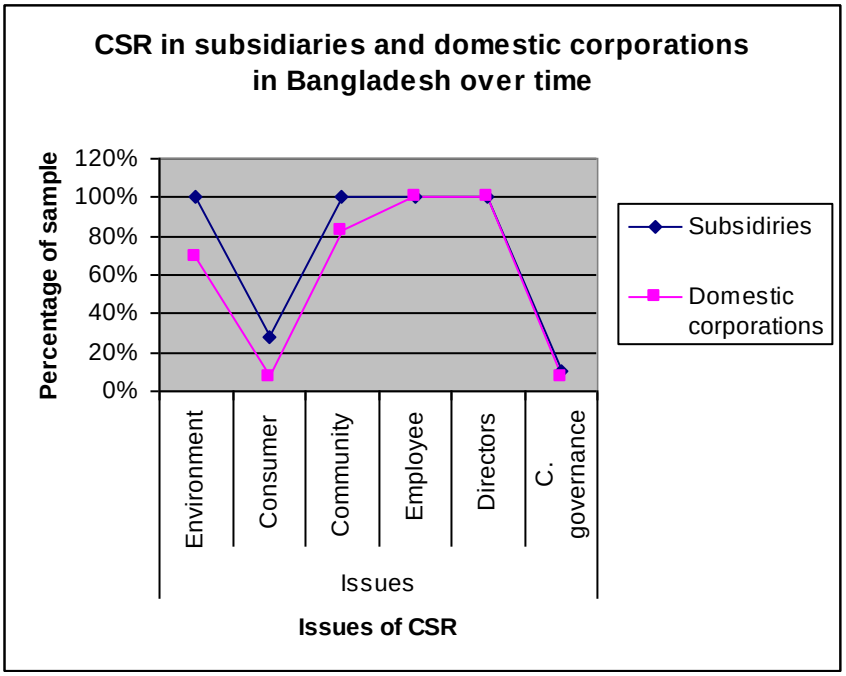


Table 4.7 shows issues of disclosure and the total page proportion devoted to CSR by each subsidiary for the years 1999 and 2000.

Table 4.7. Amount of page proportion devoted to CSR by subsidiaries for the years 1999 and 2000

Name of subsidiaries	1999	2000	AVG of two years	Industrial average
BOCB	1.68	1.61	1.64	2.48
BATAB	1.39	1.21	1.3	1.46
BATB	1.42	3.06	2.24	1.07
GSKB	5.02	6.44	5.73	2.48
FWFB	.94	1.0	.97	1.07
SB	1.11	.67	.89	1.23
RBB	1.90	2.02	1.96	2.48

Note: Industrial average is taken from (section 4.1).

Table 4.7 shows that GSKB reports the highest volume of social and environmental information in their annual reports; this is above the industrial average of the pharmaceutical sector in Bangladesh. Other subsidiaries in the pharmaceutical and chemical sector such as BOCB and RBB report social and environmental information below the industrial average. In the Food, Allied and Tobacco group, BATB reports more social and environmental information than the average across the sector. All other subsidiaries report at a level lower than the sector's average. This suggests that most of the subsidiaries are producing CSR at a level below their industrial average in Bangladesh.

Table 4.8 shows the average volume of information devoted to social and environmental issues by subsidiaries and domestic corporations in the years 1999 and 2000. It also shows the average volume of CSR recorded in Bangladesh overall.

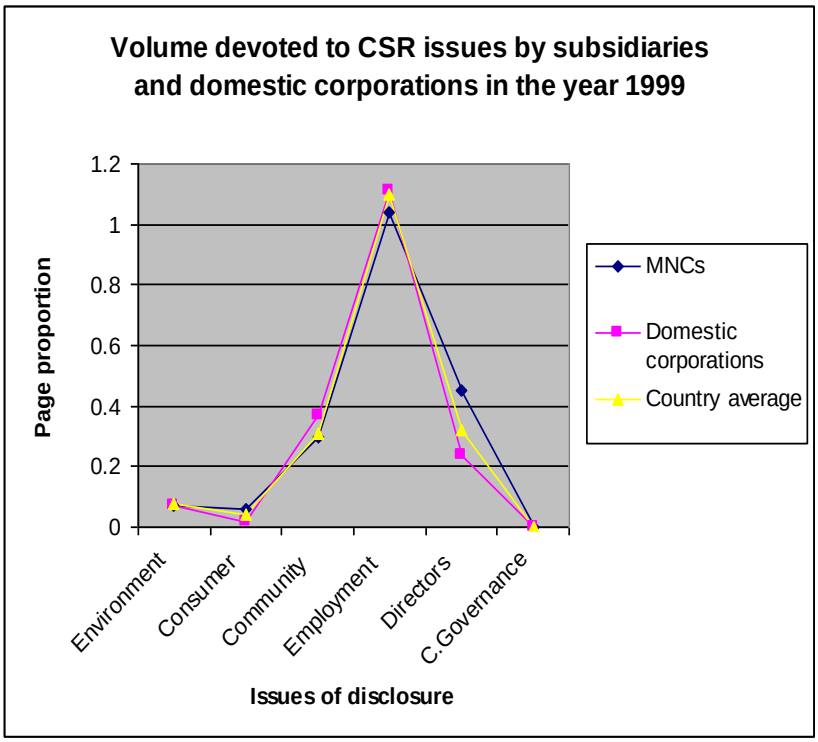
Table 4.8. Amount of page proportion devoted to each issue by subsidiaries and domestic companies for the years 1999 and 2000 (By proportion of pages)

Particulars/years	1999			2000		
	MNEs	DOM	Country average	MNEs	DOM	Country average
Environment	0.07	.07	.08	.05	.2	0.1
Consumer	0.06	0.02	.04	.02	0.0	0.01
Community	0.3	0.37	.31	.41	.27	0.3
Employment	1.04	1.11	1.1	1.23	1.29	1.2
Directors	0.45	0.24	.32	0.29	0.27	.3
C. Governance	0.0	0.0	0.0	0.28	0.04	.17
Average volume of CSR	1.92	1.81	1.85	2.29	2.07	2.08

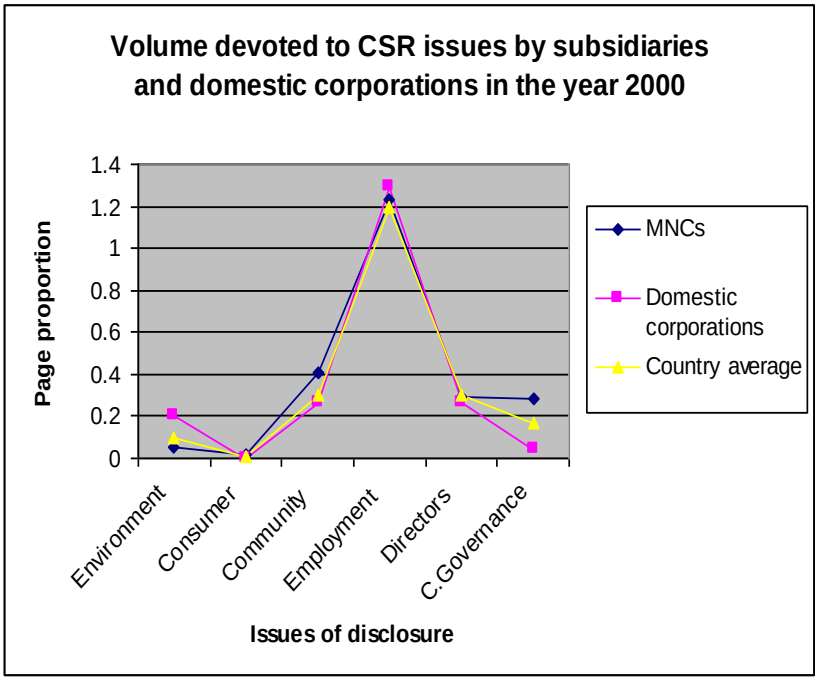
Note: Country average means average volume of CSR recorded in Bangladesh for the years 1999 and 2000.

Table 4.8 shows that the volume of social and environmental issues reported by subsidiaries is in line with that of domestic corporations. The average volume of CSR by subsidiaries (1.92 and 2.29 of a page) is, however, slightly higher than the average volume of CSR by domestic corporations (1.81 and 2.07) in the years 1999 and 2000. In both groups, the highest disclosure is made of employee issues: 1.04 of a page in subsidiaries and 1.11 of a page in domestic corporations in the year 1999. The trend is similar in the year 2000. In both groups, community, director information and environmental information are the second, third and fourth most popular/common areas of disclosure in terms of page proportions. It shows that in both groups, the lowest disclosure is made of consumer issues: only 0.06 of a page was made by subsidiaries in the year 1999 and 0.02 was made by subsidiaries in the year 2000. Table 4.8 also shows that subsidiaries reported social and environmental issues in line with the average volume of CSR recorded in Bangladesh. It shows that subsidiaries disclosed a slightly higher volume of director information (0.45 portion of a page) compared to the average volume of disclosure (0.32 portion of a page) found in Bangladesh overall for the year 1999. In the year 2000, subsidiaries also reported community issues (0.41 portion of a page) at a level above the country average (0.27 portion of a page). Graphs 4.2 and 4.3 illustrate the trend of average volume devoted to social and environmental issues by subsidiaries and domestic corporations in comparison with the pattern of CSR in Bangladesh overall.

Graph 4.2.



Graph 4.3.



These graphs show that subsidiaries disclose social and environmental information in line with domestic corporations in similar industrial groups. Their social and environmental disclosure is also in line with disclosure issues observed overall in Bangladesh. For example, the greatest amount of disclosure in Bangladesh concerns employees. Other popular areas of disclosure are community, environment and director issues, in terms of page proportion devoted to these issues. It is mentioned before that value-added disclosure, although a voluntary disclosure, takes up a major portion of employee disclosure in Bangladesh yet currently is not disclosed in the UK. Table 4.9 shows the proportion of value-added information in subsidiaries' employee disclosures.

Table 4.9. Proportion of value-added information in employee disclosure by subsidiaries for the years 1999 and 2000

Name of subsidiaries	1999			2000		
	EMP	VAS	PVAS	EMP.	VAS	PVAS
BOCB	1.24	0.76	.61	1.33	0.8	.60
BATAB	0.85	0.0	0.0	0.64	0.0	0.0
BATB	0.52	0.0	0.0	0.5	0.0	0.0
GSKB	2.36	1.0	.42	3.68	2.0	0.54
FWFB	0.15	0.0	0.0	0.56	0.0	0.0
SB	0.81	0.0	0.0	0.39	0.0	0.0
RBB	1.36	0.5	0.37	1.52	1.0	0.66
Total volume	7.29	2.26	.31	8.62	3.8	0.44

Note: EMP means total volume of employee disclosure
VAS means total volume of value-added information
PVAS means proportion of value-added information in employee disclosure

Table 4.9 shows that three out of seven subsidiaries report value-added data in their employee disclosures in both years. It can be noted that these three corporations are subsidiaries of UK MNCs and value-added data is rarely reported in the UK; more specifically, it was not reported by their parent corporations in the years 1999 and 2000.. More importantly, overall value-added data occupies 0.31 and 0.44 of the total volume of employee disclosures in the years 1999 and 2000 in Bangladesh. This suggests that subsidiaries are reporting social and environmental issues in line with issues reported in Bangladesh. More specifically, subsidiaries, in the same way as domestic corporations, devote the highest proportion of their CSR to value-added data in their employee reporting.

Table 4.10 shows the proportion of value-added information in domestic corporations' employee disclosures.

Table 4.10. Proportion of value-added information in employee disclosures by selected domestic corporations for the years 1999 and 2000

Name of domestic corporations	1999			2000		
	EMP	VAS	PVAS	EMP	VAS	PVAS
Beximoco Pharma.	3.02	1.0	.33	1.80	1.0	.56
Bionic Sea Food	0.41	0.0	0.0	-	-	-
Meghna Vegetable	-	-	-	1.13	0.0	0.0
IDLC	0.16	0.0	0.0	0.21	0.0	0.0
ACI	0.5	0.0	0.0	1.42	1.0	.70
Alpha Tobacco	1.12	0.0	0.0	0.64	0.0	0.0
Squire Pharma.	1.47	1.0	.68	1.62	1.0	.62
Apex Tanneries	-	-	-	1.6	1.0	.63
Total Volume	6.18	2.0	.32	8.42	4	.48

Note: EMP means total volume of employee disclosure
VAS means total volume of value-added information
PVAS means proportion of value-added information in employee disclosure
" - " means not included in the sample in respective year.

Table 4.10 shows that overall value-added data accounts for the highest portion of employee disclosure in both years (0.32 and 0.48 of a page respectively). This suggests that both selected domestic corporations and subsidiaries' CSR (shown in Table 4.8), in a similar industrial group is alike and follows the general trend in CSR observed in Bangladesh overall. As has been noted before, two years of data is not sufficient for establishing a trend. It is argued that the trend in subsidiaries' CSR in Bangladesh can be explained more through the industrial nature of the country where they report, than the subsidiaries' affiliation to their parent corporations or the country of their origin. The next section examines particular UK subsidiaries' CSR and their parent corporations' CSR for the years 1999 and 2000.

4.3 CSR of UK subsidiaries and parent corporations

This section examines CSR disclosure by the UK subsidiaries and their parent corporations in two different countries, namely, the UK and

Bangladesh. Out of seven subsidiaries, four subsidiaries - BOCB, BATB, RBB, and GSKB - are subsidiaries of UK MNCs. Their CSR - compared to their parent corporations – is now examined.

Table 4.10 and Table 4.11 show issues of CSR and the volume devoted to these issues under employee, director, corporate governance, environmental, consumer and community issues, by subsidiaries and their parent corporations in the UK and Bangladesh for the years 1999 and 2000. It should be noted that the concern here is not to compare the volume of disclosure by parent corporations in the UK and their subsidiaries in Bangladesh, because it was shown in the previous chapter that the volume of CSR varies greatly between these two countries. The main focus is on the issues of CSR and how they are disclosed differently by a parent corporation and its subsidiary according to the country context. Therefore, figures shown in Tables 4.10 and 4.11 are only important in showing that a particular issue has been disclosed. Table 4.10 shows issues disclosed under employee, director and corporate governance and Table 4.11 shows issues disclosed under environment, consumer and community disclosure, both in the parent corporation and the subsidiary's annual report.

Table 4.11. Issues disclosed and volume devoted to employee, director and corporate governance issues by subsidiaries and their parent corporations for the years 1999 and 2000 (By page proportion)

Disclosure issues / Years	1999								2000							
MNCs	BOC		BAT		GSK		RB		BOC		BAT		GSK		RB	
Parent / subsidiaries	P	S	P	S	P	S	P	S	P	S	P	S	P	S	P	S
Issues disclosed																
Cost and number information	1.16	0.12	0.66	0.16	2.0	0.4	0.42	0.22	0.84	0.16	0.56	0.14	0.64	0.3	0.52	0.16
Pension	3.10	-	1.10	-	2.0	-	0.64	-	3.14	-	0.24	-	1.48	-	1.14	-
Workers Profit Participation & Provident Fund	-	.08	-	0.43	-	0.48	-	.4	-	0.09	-	0.08	-	.72	-	0.16
Consult employee	0.36	-	.08	-	.08	-	0.06	-	0.26	-	0.09	-	.08	-	0.06	-
Disabled	0.12		-		.06		-		.08	-	0.04		.04		-	-
V A S	-	0.76	-		-	1.0	-	0.5	-	0.8	-	-	-	2	-	1.0
Health and Safety	1.45	.12	0.12	0.08	1.0	.04	-		1.80	-	-		.16	.06	0.20	-
Share employee	2.12	-	1.14	-	0.24	-	0.84	-	2.16	-	0.09	-	4.00	-	1.0	-
Equal opportunity	0.16	-	0.10	-	0.12	-	-	-	0.16	-	0.08	-	.08	-	0.06	-
Employee other	0.52	.16	0.04	0.18	0.26	0.44	0.46	0.24	0.92	0.14	0.04		.18	0.6	-	0.2
Director issues	5.0	.28	5.3	0.16	4.0	1.04	4.0	0.5	5.0	0.16	6.81	0.16	10.0	0.68	4.0	0.5
Corporate governance	4.5	-	4.0	-	4.0	-	2.24	-	6.55	-	3.28	2.0	5.0	-	3.26	-

Note: 'P' means parent corporations and 'S' means subsidiaries

Table 4.10 shows that while director information, employee number and cost, pension data and share of employee data accounts for the highest level of disclosure (in that order) in parent companies' annual reports, value-added information, director information, and *contribution to provident fund information* account for the highest volume of disclosure respectively in their subsidiaries' reports. It also shows that while subsidiaries devote a greater amount of reporting to value-added information within employee information in Bangladesh, none of their parent companies report such information in the UK. Moreover, while parent companies disclose issues such as 'consult with employees' and information regarding disabled people and equal opportunity, none of these issues are reported by their subsidiaries in Bangladesh. Overall, this confirms that in issues of employee disclosure, subsidiaries do not report information in the same way as do their parent companies, and that there is a different emphasis on which issues are reported. This is partly due to the different requirements for mandatory disclosure in Bangladesh and the UK. For example, disclosure of information regarding pensions is mandatory in the UK but not in Bangladesh. Voluntary disclosure also varies between parent corporation and subsidiary within an MNC. For example, while parent corporations report health and safety information in the UK, these issues are not reported so much by their subsidiaries in Bangladesh.

Table 4.12. Issues disclosed and volume devoted to environmental, consumer and community issues by subsidiaries and their parent corporations for the years 1999 and 2000 (By page proportion)

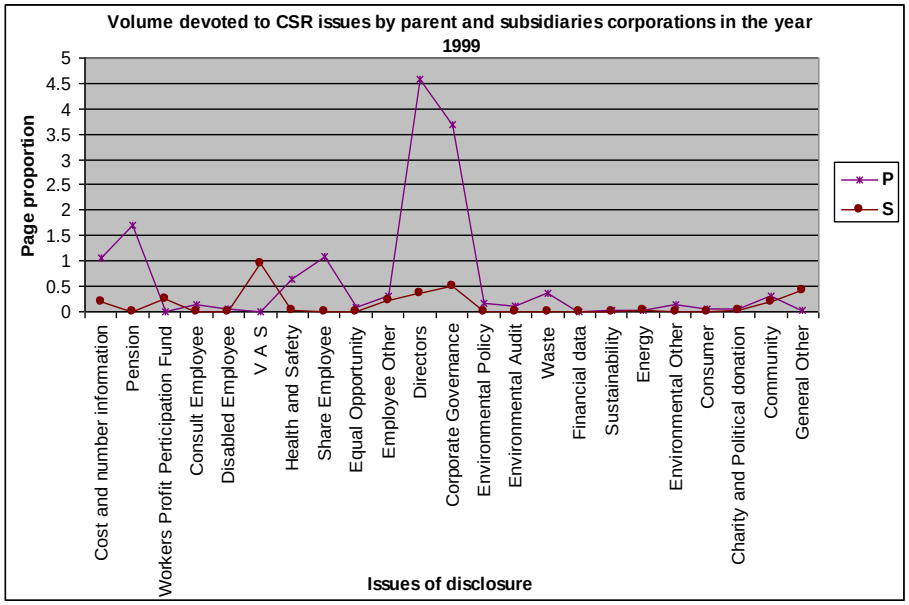
Disclosure issues / Years	**1999**								**2000**							
MNCs	**BOC**		**BAT**		**GSK**		**RB**		**BOC**		**BAT**		**GSK**		**RB**	
Parent / subsidiaries	**P**	**S**	**P**	**S**	**P**	**S**	**P**	**S**	**P**	**S**	**P**	**S**	**P**	**S**	**P**	**S**
Issues disclosed																
Environmental:							-									
Environmental policy	0.12	-	0.4	-	0.18	-	-		0.16	-	0.4	-	0.14	-	-	-
Environmental Audit and management	0.10	-	0.16	0.04	0.16	-	-	-	0.16	-	0.08	-	0.20	-	-	-
Waste	0.73	-	0.48	-	0.24	-	-	-	0.76	-	0.36	-	.5	-	-	-
Financial data	-	-	-	-	-	-	-	-	-	-	-	-	0.1	-	-	-
Sustainability	0.06	-	-	-	-	-	-	-	-	-	-	-	0.1	-	-	-
Energy	0.16	0.04	-	0.08	-	0.04	-	0.04	0.36	.04	-	0.04	-	0.04	-	-
Environmental other	0.18	0.04	0.16	-	0.2		-		0.12		0.2		.18		-	-
Consumer:	-	-	-	-	0.08	0.5	0.18	-	-	-	0.1	-	.32	-	-	-
Community:			-												-	-
Charity and political donation	0.08	0.08	0.10	0.04	0.08	0.04	0.06	-	0.06		0.04	-	.16	0.08	-	-
Community (purely community information)	0.48	0.48	0.16	0.02	0.5	-	0.10	-	0.74	-	0.24	0.16	2.84	0.6	-	-
General other	-	-	2.06	0.2	-	1.04	-	-	-	.08	-	0.2	1.76	1.4	-	-

Note: 'P' means parent corporation and 'S' means subsidiary

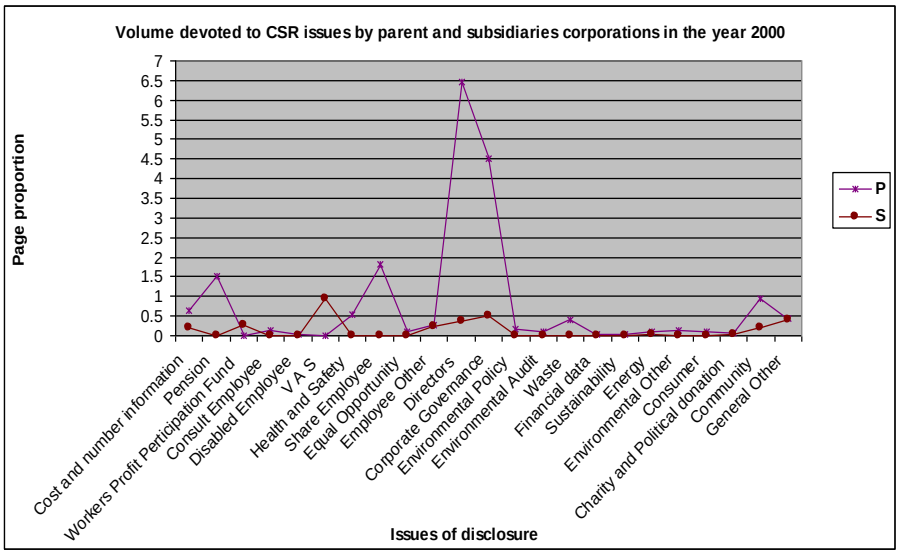
This is particularly relevant as many of their manufacturing units are also located in Bangladesh. Indeed, if the reason for CSR is to discharge their accountability, it is important to examine why subsidiaries are not providing accounts of health, safety and other employee issues which their parent corporations provide.

Table 4.12 gives details of environmental, consumer and community information reported by parent corporations and subsidiaries in the UK and Bangladesh in the years 1999 and 2000. It shows that while parent companies cover many issues in their environmental disclosure - such as disclosing environmental policy, environmental audit, waste, sustainability, energy and environmental other data - their subsidiaries' environmental disclosure in Bangladesh is very poor and only covers energy data and very general environmental other information. Such environmental other data usually includes only a very general statement, such as showing care to the environment and an intention to reduce environmental pollution. This also suggests that subsidiaries do not report on their parent company's environmental policy even if their parent corporations have their own environmental policy. Table 4.12 also shows that while in parent companies community disclosure is dominated by charity and purely community information, their subsidiaries disclose much less in purely community issues or charity and donation information. Community disclosure at the subsidiary level does not purely reflect the community activities that subsidiaries are involved with. Rather, it includes very general disclosure like mission statements or an accountability statement that implies in a more general sense that the company is responsible to the community or society. Graph 4.5 and 4.6 illustrate the average volume devoted to CSR issues by subsidiaries in comparison with pattern of CSR in their parent corporations.

Graph 4.5.



Graph 4.6.



These graphs show that subsidiaries do not disclose social and environmental information in line with their parent corporations' disclosure practice. Most importantly, their practices vary both in issues they disclosed and the level of discloser they made.

5. Summary and Conclusions

This paper describes CSR of all subsidiaries of MNCs that were listed on the Dhaka Stock Exchange during the study. It also examines CSR practices of particular UK subsidiaries and their parent corporations. Their CSR practices are examined and compared to the general CSR trend in Bangladesh. Their CSR practices are also compared to domestic companies within similar industrial groups.

The historical background of these subsidiaries suggests that they all have manufacturing units in Bangladesh. They employ labour from the local labour market and have the opportunity to exploit the cheap labour and natural resources that Bangladesh offers. Therefore, their operations have an impact, not only on the local economy but also on the natural environment and the local community. Moreover, they are located in industries that are targeted by the Bangladesh government as the most pollution-creating industries. Although their major shareholders are their own parent corporations, they have also local shareholders. This means that they are not only potentially accountable to their parent corporations and local shareholders, if only in a limited sense, but to the government and local community of Bangladesh as well. In effect, they are responsible to the government for abiding by the rules and regulations set by the government. However, this does not mean that they are not responsible to the local people for the social and environmental impact of their operations. This paper examines the CSR of these subsidiaries in more detail. It is observed that CSR of subsidiaries represents the general trend of CSR in Bangladesh. Moreover, it reveals that there is no major difference between the CSR of subsidiaries and selected domestic corporations in terms of volume and issues of reporting although the average volume of CSR reported by subsidiaries is slightly higher than that of domestic corporations (Table 4.8). Most specifically, value-added disclosure - which is a voluntary disclosure and a particular issue reported in Bangladesh and not common in Western countries such as the UK - accounts for a major portion of employee disclosure in subsidiaries' CSR. In particular, all subsidiaries of UK MNCs report value-added information while their parent corporations do not report any in the UK. Examining particular UK subsidiaries' CSR and their parent corporations' CSR for the years 1999 and 2000, the paper concludes by finding that subsidiaries do not report many of the same issues as their parent corporations, and that they have a different emphasis in terms of the social and environmental issues which they do report. Indeed, the same MNC reports different CSR issues and to a different extent, depending on the country in which they operate/are based. Mandatory disclosure regulation is only a partial explanation for this. The overall trend in subsidiaries' CSR in Bangladesh suggests that their CSR can be explained best by the nature of the industry and the characteristics/features of the country, rather than by the character of the MNC or the country of its origin. Future research can explore more what MNC subsidiary report and why they report in terms of CSR issues by interviewing managers at subsidiaries level. Moreover, as the paper is limited

in using two years data only, future research can use longitudinal data analysis to see the trend of CSR reporting by MNC subsidiaries.

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SUSTAINABILITY AND CORPORATE SOCIAL RESPONSIBILITY FROM BUSINESS ETHICS PERSPECTIVE

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Abstract

Sustainability or sustainable development has become commonplace in the economic literature and become increasingly relevant to the academic literature and widely discussed by numerous of the researchers into social and environmental responsibility or corporate social responsibility (CSR), both from an economic and moral perspective. However, the thorough discussion of CSR under business ethics perspective in a broad view from the international or global context, to the organisational responses, and to individual attitudes does not exist in the current literature. This paper attempts to discover ethical responses to CSR from international organisations, companies, and individuals. Especially, each response is explained by different ethical theory.

Keywords: Corporate Social Responsibility, Business Ethics, Corporate Governance

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Introduction

Although the idea of sustainable development or sustainability has become commonplace in the economic literature, it is worth noting that there is no clear definition of sustainable development or sustainability in the literature. In fact, the meaning or definition of sustainability that has been commonly cited in the literature was stated in the report entitled *Our Common Future* by the World Commission on Environment and Development (1987), that is 'meets the needs of the present without compromising the ability of future generations to meet their own needs' (p.24). This concept of sustainability has become increasingly relevant to the academic literature and widely discussed by many of the researchers into social and environmental responsibility or corporate social responsibility (CSR), both from an economic and moral perspective. This essay discusses sustainability from a business ethics perspective by examining the concept of sustainability on three levels: the international or global context, the organizational context or responses, and individual attitudes.

1. Sustainability in the global context

1.1. Underpinning theory

Economic theory suggests that globalisation associated with increased transnational competition can be a critical element for effective markets because companies pursue competitive strategies on a global basis (Edwards & Rees 2006). This process also has serious effects on business ethical behaviour, both favourable and negative. This section, firstly, outlines theory underpinning the sustainability concept and then discusses business ethical behaviour in a global context in relation to sustainability.

As already mentioned, the concept of sustainability, unfortunately, has not been clearly defined. Nonetheless, the academic literature has converged on a three dimensional definition of sustainability: economic performance, social performance, and environmental performance. Because pursuing success in economic performance is the nature of companies, corporate social responsibility could be a good proxy for discovering business ethics in the international context, organisational responses, and individual attitudes towards sustainability.

In terms of CSR, the academic literature, again, has offered numerous definitions. As discussed in Carroll's 1999 paper, around twenty five definitions of CSR can be found in the literature from the 1950s to 1990s. This work indicates that the CSR definition has evolved from an ambiguous level (which was referred to as social responsibility) to a specific concept (which has been framed by three main theories: stakeholder theory, business ethics theory, and corporate social performance (CSP). More specifically, Gray, Kouhy, and Lavers (1995b) summarize four main themes of CSR existing in the literature, including the natural environment, employees, communities, and customers. Concerning the theoretical framework, it is based on thoroughly examining the CSR practices of the top 100 U.K companies for a period of 13 years from 1979 to 1991. Gray, Kouhy, and Lavers (1995a) conclude that legitimacy theory and

stakeholder theory are more appropriate for explaining cases of companies' tendency towards CSR practices.

A number of researchers apply legitimacy theory to explain the reason why companies adopt disclosure practices which are considered as means of satisfying society's expectations. Milne and Pattern (2002) suggest that the additional and positive environmental disclosures of companies served as devices for achieving their organizational legitimacy. Similarly, by interpreting data obtained from interviews with managers of the selected Australian companies about choices of environmental disclosures, O'Donovan (2002) notes that companies adopt a particular disclosure approach so as to become more legitimate. More recently, Deegan and Blomquist (2006) assert that legitimising their activities is likely to induce the nine Australian selected minerals companies to follow the Australian Minerals Industry Code for Environmental Management, given that relevant environmental and social issues were clearly outlined in their environmental reports while WWF-Australia's assessment of those reports showed their were inadequacies in addressing the requirement of the Code.

One the other hand, stewardship theory and stakeholder theory have been also applied to predict and explain the phenomenon of CSR through the lens of business ethics. Based on stewardship theory, Donaldson and Davis (1991) assert that firms' managers are forced to 'do the right thing' regardless its detrimental effects to firms' economic performance, whilst Donaldson and Preston (1995), by thoroughly analysing stakeholder theory, strongly emphasised the moral and ethical dimensions of stakeholder theory, which is widely known as the normative case and opposite to the business case.

1.2. CSR and business ethics

When it comes to the linkages between CSR and business ethics, the normative case advises that companies should assume socially responsibilities since it is morally correct to do so (Branco & Rodrigues 2006). Jones (1995) concludes that the firm whose businesses heavily depends on trust and cooperation between firms and their stakeholders have incentives to behave trustingly, reliably, and cooperatively so as to achieve a competitive advantage over those that do not. Jones and Wicks (1999) analyse in depth stakeholder theory's applications existing in the latent literature and propose a convergent stakeholder theory that integrates both normative and supporting instrumental theory. With reference to Jones' 1995 work, the authors further discuss ethical theories underpinning a moral commitment to trust, trustworthiness, and cooperation in corporate stakeholder relations. Under deontological theory, firms pursue behaving trustingly and reliably because stakeholders should be treated as ends rather than merely as means to firms' ends. Employing virtue theory, firms should behave according to trust standard because trust is a virtue. Applying utilitarian theory, trust and cooperation will facilitate a firm to gain a competitive advantage.

Apart from a theoretical perspective, CSR is also related to ethical and moral issues because of the common belief that companies will perform or desist from activities depending whether those actions are beneficial or harmful to society (Branco & Rodrigues 2006). In addition, it is equally important to acknowledge that companies deliberately take CSR partly because of the link between CSR and corporate financial performance (CFP). Examining a CSP of a sample made up by 469 U.S companies, Waddock and Graves (1997) suggest that companies with available resources may chose to spend those resources on 'doing good by doing well' and those expenses, in turn, lead to improve CSP. The authors also report the positive association between CSP and CFP. More specifically, the findings show that the CSP of a company is positively associated with its return on assets and returns on sales as well, but negatively associated with debt-to-asset ratio. Analysing 524 U.S companies in the same data-setting with Waddock and Graves' 1997 research, McWilliams and Siegel (2000) find the evidence supporting the contention that CSP is positively related to research and development (R&D) investment. Given that R&D has a positive impact on a CFP, the work of McWilliams and Siegel implies the positive association between CSP and CFP. More recently, by analysing a sample of 63 Italian small and medium-sized enterprises, Mariolina, Matteo, and Alessandra (2005) conclude that, in the majority of the cases, enterprises have social responsibility not only because of the moral and ethical reasons for doing so, but also because of maintaining social responsibility contributing to the enterprises' growth thanks to improving the company image, maintaining customer loyalty, and strengthening employee and local community relationships.

1.3. Non-government organisation (NGO) responses to CSR

Currently, there are a variety of guidelines and principles which can serve as vehicles for implementing CSR or assessing CSP. However, because of the constraints of space, this paper does not attempt to discuss all of these, but rather focuses on the two universal voluntary frameworks: the United Nations Global Compact and the Global Reporting Initiatives (GRI) sustainability reporting guidelines.

The United Nations Global Compact that is established for the purpose of promoting responsible corporate citizenship is widely regarded as the most universal set of principles addressing CSR. Its principles are considered as catalysts for translating key corporate social responsibility commitments into organizational vision and mission. According to the Global Impact (2007), there are now around three thousand companies from more than 100 countries as signatories to the Global Compact.

Unlike the Global Compact that mainly provides a practical means for achieving CSR, the GRI provides guidance on how organisations can disclose their sustainability performance. The GRI framework is also considered as the most relevant institution in the sustainability context, given that the increased number of sustainability reporting prepared is based on GRI sustainability reporting guidelines (Moneva, Archel & Correa 2006). Nowadays, nearly one thousand organisations from sixty countries around the world have officially declared their use of GRI sustainability reporting guidelines (The Global Compact & The Global Reporting Initiatives 2007). Basically, GRI guidelines (2006) provide six sets of performance indicators on which reporting preparers base their creation of sustainability reporting. Beyond economic performance indicators, the remaining indicators completely cover an organization's responsibility towards its stakeholders that is reflected in such aspects as society, environment, product responsibility, labour practices and decent work, and human rights. Given this, GRI sustainability reporting is considered synonymous with triple bottom line reporting and CSR.

Given that the Global Compact offers principles for implementing CSR, while the GRI provides a means for assessing CSR progress, those frameworks well complement each other. That could be the reason why the Global Compact and the GRI are now working together and provide shared guidelines for preparing sustainability reporting under the GRI framework as well as for preparing a United Nations Global Compact Communication on Progress (known as COP).

Under business ethics paradigm, the responses of NGOs to CSR can be justified by employing utilitarian theory, which is developed based on an account of Mill (a nineteenth century thinker) in his book entitled *Utilitarianism* (Mill 1806-1873) According to Mill's theory, action is judged to be ethical if it brings the greatest happiness of the greatest number. As was discussed earlier, the literature has documented the association of CSR and CFP. However, it is worth noting that this association is not definitely proved, but rather mixed results are widely acknowledged. Given this, rigid regulations or requirements on CSR do benefit the majority of companies' stakeholders rather than companies' shareholders. In other words, the responses of NGOs fit well into utilitarian theory of business ethics.

2. Sustainability at the organizational level

It could be argued that there are two alternative ways that can be used for assessing organization's responses to the sustainability issue. Organizational responses to sustainability issues can be reflected by an organization's compliance with available sustainability reporting guidelines, for example GRI sustainability reporting guidelines, United Nations Global compact principles, or OECD Guidelines for Multinational Enterprises[44], and so on. On the other hand, the extent to which organizations address sustainability concerns can also be reflected in the organizations' own codes of conduct (and ethics) because it is widely recognised that codes of conduct served as a vehicle to guide organizational behaviour in which moral impacts of business decisions are taken into consideration. As stated by Murphy (1995), the institution of codes of ethics is viewed as a clear signal that companies are committed to ethical practices. Especially, Adams, Tashchian, and Shore (2001) provide empirical evidence proving that employees working in companies where codes of ethics exist tend to behave more ethically than those working in companies that do not have formal codes.

From a theoretical aspect, as mentioned earlier, what CSR exactly means to organisations and how organisations, consequently, bear this responsibility is not easy to absorb. In this context, the contribution of Schouten and Remmé's 2006 paper could be a deserving work. The authors employ theory of sensemaking to make sense of CSR. Based on Weick's account of sensemaking, which can be understood both as obtaining an understating of particular situations by the use of language and as using it as a springboard for actions, the authors clarify several main reasons for having CSR in an organizational context. Firstly, the organization, as a member of society, should share CSR because it has an impact on the community and environment in which its operations are conducted. Further, as profit-making organizations play a significant role in society, they have a responsibility for taking into consideration their role in decision-making processes. Besides, since business organizations are expanded and grown in an interdependent system built up by a number of stakeholders, a moral

[44] The full text of United Nations Global Compact Principles can be assessed at www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html, and that of OECD Guidelines for Multinational Enterprises can be downloaded at www.oecd.org/dataoecd/56/36/1922428.pdf

nature should be thoroughly considered when making decisions.

Turning to stakeholder theory, as was mentioned previously, stakeholder accountability or CSR can be established only when other normatively legitimate stakeholders are clearly recognised rather than merely shareholders (Phillips, Freeman & Wicks 2003). The legitimate reason for that is, as indicated by Collison (2003), company managers naturally assume their enforceable duties to only the shareholders which is equivalently stated in an typical form as 'the business of business is business' (Friedman 1970). Further, different perceptions of sustainability or sustainable development also result in the diverse CSR definitions. Societal actors have defined sustainability as the intersection of the economic, social-equity, and environmental principles, whilst organizations' perceptions of sustainability are primarily about economic priorities (Bansal 2002). Hence, a clear definition of CSR, or making sense of CSR, is needed to achieve CSP.

Regrading voluntary guidelines about CSR, the increase in the number of organizations applying those guidelines has been recorded. For instance, only around seven hundred reporters from 43 countries stuck to GRI guidelines in 2005 (Moneva, Archel & Correa 2006). Impressively, the number of organizations adopting GRI guidelines has rapidly grown; in early 2007, roughly one thousand organizations from sixty countries have adopted GRI guidelines for preparing CSR (The Global Compact & The Global Reporting Initiatives 2007). Besides, organizations also adopt ISO 14001 - the international standard for environment management system to deal with the issues of CSR.

As for the mechanism for supervising CSR, TBL is one of the most common tools used for assessing CSR progress. In essence, TBL is now regarded as a base for sustainability accounting (Lamberton 2005; Moneva, Archel & Correa 2006). In addition to the general concept of TBL, corporations also may self-discipline TBL to their own situation which is perfectly suited to their business goals. In this sense, ShoreBank Enterprise Cascadia's (SBEC) disciplined approach to TBL is noteworthy. With the aim of supporting sustainable practices, SBEC has advanced TBL theory by creating its own metrics methodology that aligns with its business strategy and goals (Gable 2007)[45].

As for codes of ethics (conduct), companies formulating their own codes of ethics (conduct) and polices have been increasing in number since the 1970s, as was well documented in business ethics literature. More recently, Murphy (1995) reports that almost all 253 responding companies in the author's 1992 survey conducted in the U.S setting have a written codes of ethics. Further information about the prevalence of ethics codes from 1980 to 1992 in U.S, European, and Canadian data-settings can be found in Weaver's 1993 paper. As far as ethics codes' content is concerned, the common themes do not only focus on company-specific issues (e.g. creating and maintaining company's value and culture, building trust and confidence within a company, deterring unethical behaviour, and so on), but also on employees' issues (e.g. improving their morale, providing moral guidance to them and regulating their behaviours, expressing their obligations, and so on), as well as on environmental issues (satisfying external stakeholders, building trust and confidence with external group and organizations - suppliers, customers, competitors, and union, and so on) (Weaver 1993). Importantly, the implementation of company's codes makes it possible for people in the company to consider seriously their mission and their obligations to their clients, customers, and society as a whole (George 1999).

Given the increasing trend of organizations adopting voluntary guidelines to CSR and increased willingness of companies to promulgate ethics codes, as well as the relevance and the importance of company's codes to CSR, it can be reasonable to conclude that companies are increasingly responsive to the issues and concerns of CSR.

Based on the comprehensive picture presenting an organization's responses to the issues and concerns of CSR as outlined above, this section arrives at the conclusion as to which ethical theories can be appropriate for explaining responses to CSR from organizations perspective. Apart from theory of sensemaking applied to the reasoning of CSR at organizational level, deontology and utilitarianism are also convincing for explaining organizational responses to CSR.

Applying deontological theory, it can be understood that if a company considers that it belongs to society as a whole, it then must deter or refrain from any activities that harm its whole body. Because the company itself is a component of an interdependent system, it would treat the other components of this system as ends rather than only as means to its own ends. As a result, a company is not allowed to make profits as the expenses of the other society's members. In this case, CSR reporting and codes of ethics (conducts) of the company is properly regarded as substantive management techniques, according to Ashforth and Gibbs (1990), which reflects actual changes in the organizational mechanisms and goals, as well as operational and social activities.

On the other hand, it is also important to note that companies actively respond to, and accept,

[45] According to SBEC's methodology, sustainable development or CSR is measured by three metrics including economic metrics, environmental metrics, and social equity metrics. Because of space constraint of this essay, more detail about SBEC's methodology and its application can be found in Gable's 2007 paper.

CSR could be motivated by their economic performance. The economic literature has documented the association between a company' stakeholder satisfaction, and its increased share value. Ogden and Watson (1999) provide empirical evidence as to the positive relation between customer service satisfaction and shareholder return. Mc Williams and Siegel (2001) suggest that maintaining an appropriate level of CSR, which can be determined based on cost-benefit analysis, will maximise profits. Chatterjee (1998) notes that a good ethical reputation is a company's competitive advantage which leads to attract business opportunities and potential qualified employees as well. Additionally, legitimacy theorists argue that companies may use social and environmental disclosure and other similar techniques, so-called symbolic management techniques, as vehicles for legitimising their activities so that their behaviours seem consistent with society's expectation (Ashforth & Gibbs 1990; Mitchell, Agle & Wood 1997). Legitimacy theory also emphasizes on the potential consequences that companies may suffer if they fail to meet societal expectations, such as the imposition of sanctions from society, the limitation of resources being provided, and the reduction of demand for their products. In this sense, one could argue that utilitarian approach based on balancing the costs and benefits of taking CSR is more appropriate for explaining companies' responses to CSR.

3. Sustainability – individual responses

In terms of individual responses to ethical issues with respect to sustainability, this section mainly discusses the attitudes of managers, investors, employees, and customers towards CSR.

As for the responses of companies' manager to CSR, the literature has documented the two main reasons behind managers' promotion of CSR, either for their own benefits or for the company's benefits. Friedman (1970) argues that the corporate executive may spend the company's money on promoting CSR in his own interest at the expense of company's shareholders. The work of Frye, Nelling and Webb (2006) indicates that socially responsive firms pay their executives higher annual salaries on average than do non-socially responsive firms as a means of retaining highly skilled employees. Given this, one may argue that managers are motivated to promote CSR so as to receive higher compensation. Besides, based on the theory of the firm or strategic perspective which hold that the ultimate objectives of the firm is maximizing its profits by balancing a supply and demand, McWilliams and Siegel (2001) argue that there is a optimal level of CSR investment at which the firm can maximise its profits and simultaneously satisfy stakeholders' demand for CSR.

Research into CSR shows that social responsibility issues, from standpoint of investors and customers, have been greatly taken into account when making investment and purchase decision (DeTienne & Lewis 2005). More specifically, in a national consumer survey conducted in 1996, McCabe (2000) notes that the majority of shoppers avoid purchasing garments that were made in sweatshops. In the same vein, Branco and Rodrigues (2006) state that consumers commonly prefer socially responsive firms to non-socially responsive ones. Epstein and Freedman (1994) reveal that individual investors expect more CSR information than is currently supplied. In addition, Klassen and McLaughlin (1999) confirm that public announcements of environmental awards had a positive influence on the firms' market valuation while environmental crises, for instance, oil-spills, had immediately significant negative impacts on their stock value. Taken together, companies are induced to provide more detailed and attractive CSR reporting.

Concerning employees' attitudes towards CSR, Branco and Rodrigues (2006) argue that firms with a good social reputation may attract better employees and strengthen current employee's motivation, morale, commitment, and loyalty to the firm. This argument can be reasonably supported by the view that employee commitment is contingent on the ethicality of the organization itself (Collier & Esteban 2007). Moreover, Collier and Esteban (2007) emphasise only employees whose values and vision are aligned with those of organization will be committed to the effective delivery of CSR practices.

Considering ethical theories, virtue ethics appears to be the best for explaining individual responses to sustainability, except in the case of managers or executives. Because managers or executives are the agents who act in the interests of the firm, i.e. shareholders, ethical theories applied for explaining their responses to CSR could be in line with those explaining organizational responses to CSR, as was earlier discussed. The encouraging responses of investors, customers, and employees to CSR could be stemming from their own virtues, such as fairness or equality. Accordingly, firms with substantial CSR investment deserve to receive support from its community.

4. Conclusion

There is no doubt that the concept of sustainability and CSR has become increasingly relevant to the economic literature. At the global level, numerous NGOs have promulgated voluntary guidelines for CSR reporting whose motivation properly emanates from a utilitarian perspective. When it comes to an

organizational level, it seems that both utilitarian theory and deontological theory can be appropriate for explaining organizations' handling of CSR issues, which depends on the actual motivation of organization behind their responses. At the individual level, the utilitarian approach, not surprisingly, appears logical to explain managers' attitudes towards the issues and concerns of CSR, given that the manager is the agent of the firm or shareholders; while the virtue approach could be more useful for seeking the reasons why investors, customers, and other employees have a favourable attitude towards adoption of CSR. Given the divergent approaches to CSR issues, as a typical example, it is strongly recommended that companies should have practical initiatives on ethical issues in their business environment. The initiatives should balance the global view on business ethics issues, the company-specific factors, and the attitudes of companies' stakeholders towards business ethics issues.

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РАЗДЕЛ 3 КОРПОРАТИВНОЕ УПРАВЛЕНИЕ В АВСТРАЛИИ

SECTION 3 CORPORATE GOVERNANCE IN AUSTRALIA

MANAGERIAL SHARE OWNERSHIP AND DISCRETIONARY ACCRUALS IN AUSTRALIA: DO INDEPENDENT AND EXECUTIVE DIRECTORS HAVE DIFFERENT INCENTIVES?

Arifur Khan*, Paul Mather**

Abstract

We examine the relation between managerial share ownership (MSO) and discretionary accruals in Australia. We find a positive relation between MSO and discretionary accruals up to a certain level of MSO followed by a negative relation (inverse U-shaped). We suggest that these unique results are a result of certain Australian institutional features that are markedly different to those in the US and the UK and imply that the ownership-discretionary accruals relation is context specific with the wider corporate governance systems influencing the theorised incentive effects. We also posit that executive directors and independent directors have different ownership-discretionary accruals incentives and report results consistent with this proposition.

Keywords: Managerial Share Ownership, Discretionary Accruals, Incentive Alignment, Entrenchment

JEL classification: G32, G34, M41

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1. Introduction

It is argued that increased levels of managerial share ownership (hereinafter MSO) in a firm helps to align the interests of owners and managers, therefore, mitigating agency problems (Jensen and Meckling 1976). Arguing that such incentive alignment has contracting implications, Warfield, Wild and Wild (1995), posit that corporate stakeholders impose more restrictive contractual constraints denominated in accounting numbers as MSO and therefore, incentive alignment, declines. The presence of accounting based constraints in turn provides managers with incentives to use accounting discretion to help alleviate these constraints. An alternative theoretical argument, not considered by Warfield et al. (1995), is that high MSO may result in managerial entrenchment (Demsetz, 1983; Fama and Jensen, 1983). The argument is that the extra voting power enables

them to secure their position in the firm thereby insulating them from certain disciplining mechanisms which in turn creates agency problems. The potential for entrenchment as MSO increases may also have contracting implications. Accordingly, this paper explores the relation between MSO and discretionary accruals in Australia during the period 2000-2006.

Extant research suggests that managers have incentives to manage earnings to avoid reporting earnings decreases and losses since various contracts are based on accounting numbers (see for example, Healy and Wahlen, 1999 for a survey of this literature). Warfield et al. (1995) posit and find that MSO in the US and the magnitude of discretionary accruals are inversely related. They attribute this to a posited inverse relationship between MSO and accounting based contractual constraints. Similarly, Yeo, Tan, Ho and Chen (2002) find that at low levels of MSO, the level of income increasing discretionary accruals has a negative relation with MSO in Singapore. However, at higher levels of MSO the relation reverses suggesting that stakeholders contracting with firms recognise the potential for managerial entrenchment and contract accordingly. In a related study, Gabrielsen, Gramlich and Plenborg (2002) fail to find any statistically significant relation between MSO and discretionary accruals in Danish firms. In short, there is no consistent evidence on the relation between MSO and earnings management measured by discretionary accruals.

Several factors motivate this study. First, it is argued that features of the Australian legal system, market for corporate control, ownership characteristics and other corporate governance features means that the Australian corporate governance system is markedly different from that of the US and the UK. For example, Australian companies have high levels of ownership concentration with La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999) reporting that 45% of a sample of the largest Australian companies had a shareholder holding more than 10% of the equity whilst only 10% of the largest companies in the UK and 20% of the largest US companies had a shareholder owning more than 10% of the equity. Moreover, Australian block holders are relatively passive in monitoring of management (Dignam and Galanis, 2004). The market for corporate control is an important mechanism to discipline management but the Australian market for corporate control is less active than those in the US and UK.[1] Additionally, the proxy voting by the shareholders in Australian companies is lower than the US and the UK companies (Bethel and Gillan, 2002).[2] In view of the above, it is suggested that Australian shareholders do not need a particularly large shareholding to maintain "practical control" (Lamba and Stapledon, 2001). These institutional differences may have an effect on the relation between MSO and discretionary accruals, for example, managerial entrenchment effects associated with "practical control" may take place at lower levels of ownership. In spite of the differences, there is no recent study that directly examines the relation between MSO and discretionary accruals in Australia.[3]

Second, prior research that suggests managerial incentives to manage earnings does not distinguish between the incentives of executive and non-executive directors, in particular the independent directors. We argue that executive and independent directors have different incentives that are likely to influence their behaviours. For example, the executive directors are responsible for the day to day operation of the business and it is likely that their reputation in the managerial labour market is more closely tied to the firm's profitability and value maximising activities. On the other hand, there are economic incentives for independent directors to focus on their monitoring role in order to enhance the value of their human capital in the managerial labour market (Fama and Jensen, 1983). It is likely that these reputation effects will overshadow any incentive alignment or entrenchment effects that may otherwise arise as a result of their owning shares in the firm.[4]

Third, it is possible that the levels of MSO may be endogenously determined as part of the firm's broader operating and financing arrangements (Demsetz, 1983).[5] Accordingly, firms with larger and/or less reliable accruals and/or greater earnings volatility may choose governance structures, such as higher levels of MSO to reduce agency costs. The inconsistent results reported by prior studies may be the result of their failure to address the possibility that MSO is endogenously determined.

Our principal tests shows a nonlinear (inverse U-shaped) relation between managerial ownership and the absolute value of discretionary accruals. Specifically, we find a positive relation between MSO and discretionary accruals up to a certain point followed by a negative relation. Our analyses reveal a similar relation between ownership and the value of discretionary accruals for executive directors as for managerial ownership as a whole. We also find that these results are driven by firms with income increasing, as opposed to income decreasing, discretionary accruals. However, we find no significant relation between share ownership by the independent directors and the value of discretionary accruals. Our results are robust to the alternative estimates of discretionary accruals, potential size effects, as well as concern for autocorrelation, heteroskedasticity and multicollinearity. Thus, in contrast to the US and Singapore, we find a positive relation between MSO and discretionary accruals at lower levels of ownership which is consistent with entrenchments

effects commencing at lower levels of MSO. After a certain level of ownership is attained, we see a negative relation consistent with reduced discretionary accrual adjustments associated with the incentive alignment.

We contribute to the literature in a number of ways. First, we report unique results which we argue is consistent with the wider Australian corporate governance setting that may allow managers to maintain "practical control" and gain private benefits at relatively low levels of ownership which is reflected in contracting behaviour. The fact that the results are driven by firms with income increasing discretionary accruals is consistent with the posited contracting behaviours. Our results remain consistent after addressing the possibility that MSO is endogenously determined. Second, whilst prior work focuses on MSO as a whole, we argue that executive and independent directors have different incentives. The results from examining the relation between executive director share ownership (hereinafter ESO) as well as independent director share ownership (hereinafter ISO) and discretionary accruals supports such differential incentives.

The paper is structured as follows: section 2 provides the theoretical background. Section 3 describes the research design, while section 4 reports the main results. Section 5 summarises and draws conclusions.

2. Theoretical background

MSO results in a manager who owns a fraction of a firm's share directly assuming the consequences of their actions thus aligning their incentives with other shareholders (Jensen and Meckling, 1976). Hence, managers owning shares in a firm are likely to strive to make better investment decisions and maximise value. It is also less likely that the managers will engage in opportunistic behaviour hence, as MSO increases, the demand for accounting based contractual constraints will decline (Warfield et al., 1995). However, after some point, high levels of MSO can result in managers becoming entrenched (Demsetz, 1983).[6] The argument is that the extra voting power helps secure their positions in the firm thereby protecting them from certain disciplining mechanisms (for example, the managerial labour market and the market for corporate control) which may have an adverse effect on their behaviour. Hence the initial theory largely developed in the ownership-performance literature would suggest a negative relation between MSO and discretionary accruals consistent with incentive alignment up to some turning point followed by a positive relation when the costs associated with entrenchment exceed the incentive benefits of managerial ownership (see for example, Morck, Shleifer and Vishny, 1988; McConnell and Servaes 1990). It is also possible that the previously discussed wider corporate governance system may have an effect on the relation between MSO and discretionary accruals. For example, managerial entrenchment effects associated with "practical control" may take place at lower levels of ownership in Australia.

Warfield et al. (1995) argue that there is a systematic relation between MSO and the levels of discretionary accruals and find an inverse relation between the levels of MSO and discretionary accruals in the US. They argue that firms with low MSO are subject to more accounting based contractual constraints as stakeholders perceive a lack of incentive alignment. These contractual provisions in turn provide incentives for managers to use accrual adjustments to circumvent such constraints. Whilst, Yeo et al. (2002) report similar results to Warfield et al. (1995) at low levels of MSO, they show that at higher levels of MSO the relation reverses suggesting that stakeholders contracting with firms recognise the potential for managerial entrenchment and contract accordingly.

Theory suggests some combination of incentive alignment and entrenchment effects and therefore, a nonlinear relation between MSO and discretionary accruals. Prior studies that identify an entrenchment effect in the ownership-performance literature document it commencing at varying levels – for example, MSO of 5% in the US (Morck et al., 1988) and 7% in the UK (Davies, Hiller and McClogan, 2005). Yeo et al. (2002) report an entrenchment effect commencing at an MSO of 25% when examining the ownership-discretionary accruals relation in Singapore. It was previously argued that features of the wider corporate governance system may mean that managers may achieve "practical control" at relatively low levels of MSO in Australia. Accordingly, whilst a precise pattern is hard to predict, we posit that entrenchment effects are likely to be present at lower levels of the MSO-discretionary accruals relation than previously documented.

Previous research in this area does not differentiate between the roles of the managers owning shares. We argue that executive directors and non-executive directors (particularly the independent directors) are likely to have different incentives as will the effect of any shares they hold. Executive directors are more closely involved in the operations of the business and it is likely that their reputational capital is more closely tied to their value maximising activities including strategic as well as operational decisions. Hence it is argued that for any given level of share ownership executive directors, in comparison to independent directors, are more susceptible to the effects of incentive alignment and entrenchment.

On the other hand, it is argued that the economics of the managerial labour market

provides incentives for the non-executive directors, more specifically the independent directors, to be effective monitors in order to enhance their reputation and the value of their human capital (Fama and Jensen, 1983). Similarly, Gilson (1990) asserts that, whilst inside directors are also managers of the firms, outside directors have no continuing professional relation with the firm other than as directors and are responsible for monitoring the management. Future directorships may be a function of the reputation they develop as effective monitors. In case of independent directors, concern for their reputation as effective monitors is likely to outweigh any issues relating to incentive alignment or entrenchment that may otherwise arise as a result of owning shares in the firm. Accordingly we expect the relation between executive directors and discretionary accruals to be as posited in the case of MSO as a whole but we expect no relation between independent director share ownership and discretionary accruals.[7]

3. Research design

3.1 Data

We identified the top 300 Australian companies by market capitalisation at two dates, 30 June 1999 and 30 June 2006. Consistent with the prior literature, we exclude banks, financial institutions, trusts and utility firms (49 firms) which have different disclosure requirements and/or different corporate governance structures. We exclude another 63 firms due to missing information. The final sample comprises of the remaining firms with a total of 1173 firm-year observations over the seven year period.[8] As evident in Table 1, the sample firms belong to 21 Global Industrial Classification Standard Sectors (GICS) Industry Groups. We collect the required accounting information from Aspect Fin Analysis and Connect 4 databases. The ownership and other corporate governance data was hand collected from the corporate governance disclosures, shareholding information and directors' report contained in annual reports.[9]

Table 1. Sample Description

Panel A: Sample selection		
Number of firms		300
Less:		
Financial and utility companies		49
Companies without necessary information for corporate governance and control variable data		63
Total		188
Panel B : Analysis of sample by GICS sectors and industries		
GICS sector	**GICS industry group**	
Material	Chemicals	3
	Construction material	5
	Metal & mining	22
	Paper & forest products	6
Industrial	Capital goods	16
	Commercial service & supplies	9
	Transpiration	5
Health care	Health care equipment & supplies	10
	Health care providers & services	6
	Pharmaceutical, biotechnology & life science	8
Telecommunication	Diversified telecommunication	4
Consumer staples	Food & staple retailing	5
	Food, beverage & tobacco	15
Consumer discretionary	Automobiles & components	7
	Consumer durables & apparels	6
	Consumer services	11
	Media	17
	Retailing	10
Information technology	Software & services	7
	Technology hardware & equipment	6
Energy	Oil and gas	10
Total		188

3.2 Measuring discretionary accruals

Previous research has used different tests to measure discretionary accruals including changes in earnings, discretionary accruals, accounting policy changes (see for example, Dechow, Sloan and Sweeney, 1995). We use a parsimonious model used by Chan, Chan, Jegadeesh and Lakonishok (2006) to estimate discretionary accruals.[10] The model is:

$$E_t(TACC_{it}) = \frac{\sum_{k=1}^{5} TACC_{it-k}}{\sum_{k=1}^{5} Sales_{it-k}} Sales_{it} \quad \textbf{(1)}$$

Where:

$E_t(TACC_{it})$ = Expected total accruals of firm i in year t; $TACC_{it-k}$ = Total accruals[11] of firm i in year t-k; $Sales_{it-k}$ = Sales revenue of firm i in year t-k.

Discretionary accrual is then given by

$$DACC_{it} = TACC_{it} - E_t(TACC_{it}) \quad \textbf{(2)}$$

Where:

$DACC_{it}$ = Discretionary accruals of firm i in year t ; $TACC_{it}$ = Total accruals of firm i in year t; $E_t(TACC_{it})$ = Expected total accruals of firm i in year t

The level of total accruals has been related to current sales. To smooth any kind of transitory fluctuations the proportion as the ratio of a moving average of past five years total accruals to a moving average of sales has been estimated. The discretionary component is estimated by taking the difference between actual and estimated total accruals as calculated in equation (2).

We predict a nonlinear relation between managerial ownership and discretionary accruals. Accordingly, we use quadratic specifications for all the managerial ownership variables – MSO, ESO and ISO.

We use the following equation to examine the relation between MSO and discretionary accruals using an OLS regression technique.[12]

3.3 Model Specification

$$\text{DACC} = \beta_0 + \beta_1 \text{MSO} + \beta_2 \text{MSO}^2 + \beta_3 \text{USUBSP} + \beta_4 \text{LEV} + \beta_5 \text{BIND} + \beta_6 \text{AUD} + \beta_7 \text{MB} + \beta_8 \text{LTACC} + \beta_9 \text{LOSS} + \beta_{10} \text{ASST} + \beta_{11 to 17} \text{GICS Sectoral dummies} + \beta_{18 to 23} \text{Year dummies} + \varepsilon \quad \textbf{(3)}$$

where:

DACC	Absolute value of discretionary accruals
MSO	Managerial share ownership
USUBSP	Unaffiliated substantial share ownership
LEV	Leverage
BIND	Board independence
AUD	Auditor dummy variable
MB	Market to book
LTACC	Lagged total accruals
LOSS	Loss dummy variable
ASST	Size proxied by the book value of assets

Table 2 summarises the definitions of all the variables employed in this paper.

Table 2. Definition of variables

Variable	Definition	Detailed explanation	Expected sign
MSO	Managerial share ownership	Percentage of ordinary shares owned by the directors of the board	?
ESO	Executive directors' share ownership	Percentage of ordinary shares owned by the executive directors of the board	?
ISO	Independent directors' share ownership	Percentage of ordinary shares owned by the independent directors of the board	?
USUBSP	Unaffiliated substantial share ownership	Percentage of ordinary shares owned by the unaffiliated (excluding the directors) substantial shareholders	–
LEV	Leverage	Ratio of book value of debt and book value of total assets	+
BIND	Board independence	The number of independent directors scaled by the size of the board	–
AUD	Auditor dummy variable	A dummy variable 1 if the firm is audited by a big 4 auditor and otherwise 0	–
MB	Market to book ratio	Market value of equity divided by the book value of shareholders' equity	?
LTACC	Lagged total accruals	Prior year total accruals scaled by the prior year total assets	–
LOSS	Loss dummy variable	A dummy variable 1 if the firm has negative earnings and otherwise 0	+
ASST	Size	Natural log of book value of assets	?

3.4 Control variables

The different control variables used in this study include unaffiliated substantial shareholdings, leverage, board independence, big 4 auditor, market to book ratio, lagged total accruals, loss and size of the firms. We also control for the GICS industrial sectors and years.

We include ownership by the unaffiliated substantial shareholders to control for the monitoring effect (Peasnell, Pope and Young, 2005). Unaffiliated shareholdings are measured by taking the percentage of share ownership by the unaffiliated substantial shareholders (other than directors). Managers have incentives to use accounting discretion when they are close to a debt covenant violation and leverage may capture such incentives (Klein, 2002). We measure leverage by the ratio of book value of debt and book value of total assets. Board independence can have a monitoring effect constraining discretionary accruals. We estimate board independence by taking the proportion of independent directors on the board. Previous research suggest that large audit firms (big 4) are considered to be more effective monitors of financial reporting process compared to the smaller firms (Francis and Krishnan, 1999). Therefore, a dummy variable is used to control for the effect of auditor on the level of discretionary accruals. Following previous studies we take market to book ratio as one of our control variables and measured as market value of equity divided by the book value of shareholders' equity (Klein, 2002). Accruals are mean reverting, with the majority of the mean reversion occurring within a year (Dechow et al., 1995). A high level of lagged total accruals will probably reduce managers' ability to manage current period reported earnings upward and vice versa. Therefore, we control for the total accruals of the previous period (Koh, 2003). Firms with negative earnings are associated with greater discretionary accruals (Wang, 2006). Hence we use a dummy variable when a firm has negative earnings in a particular year. Finally we follow previous studies and control for the size by taking a natural log of book value of assets (see for example, Klein, 2002; Wang, 2006).

4. Results

4.1 Descriptive statistics

Panel A of Table 3 reports the descriptive statistics. It shows that the average DACC is 0.064. The average MSO is 12.55% which is similar to the average MSO of 12.4% in the US (Cho, 1998) and 13.02% in the UK (Davies et al., 2005). The average ESO and ISO are 6.29% and 2.32% respectively. The unaffiliated substantial shareholders, on average, hold 37.15% of total shares outstanding of the sample observations.

Panel B of Table 3 represents the correlation matrix using Pearson correlation. DACC is positive and significantly correlated with MSO and ESO. ESO is negative and significantly correlated with ISO and BIND. It suggests that high ESO firms are less likely to have independent board as well as high ISO. Firm size is negatively correlated with MSO and ESO, suggesting that directors' as well as executive directors' equity interests decrease as the firm size increases. The positive correlation between firm size and leverage suggests that large firms have high leverage. The larger firms are also more likely to have big 4 auditors. A negative

correlation between MSO and the auditor variable indicates that directors have greater equity interests in firms audited by non-big 4 firms which is likely to be driven by firm size.

Table 3. Descriptive statistics

The following table reports the descriptive statistics. Different notations used in the table are defined as follows: MSO = Percentage of ordinary shares owned by the directors of the board; ESO = Percentage of ordinary shares owned by the executive directors of the board; ISO = Percentage of ordinary shares owned by the independent directors of the board; USUBSP = Percentage of ordinary shares owned by the unaffiliated (excluding the directors) substantial shareholders; BIND = Board independence calculated as the number of independent directors scaled by the size of the board; LEV = Leverage, calculated as the ratio of book value of debt to book value of total assets; ASST = Natural log of book value of assets; MB = Market to book ratio; AUD = A dummy variable 1 if the firm is audited by big 4 auditors; A dummy variable 1 if the firm has negative earnings; LTACC = Prior year total accruals.

Panel A

	Mean	Stdev	Median	Q1	Q3
MSO (%)	12.554	18.421	2.460	0.211	18.758
ESO (%)	6.325	13.261	0.241	0.025	3.121
ISO (%)	2.321	7.305	0.118	0.024	0.771
USUBSP (%)	37.158	22.558	34.68	19.05	54.88
DACC	0.064	0.076	0.039	0.0161	0.0811
BIND	0.57	0.20	0.60	0.40	0.75
LEV	0.241	0.245	0.234	0.114	0.332
ASST	8.778	0.716	8.782	8.283	9.271
MB	3.545	3.441	2.520	1.478	4.662

Panel B

	DACC	AUD	ESO	ISO	LEV	ASST	LOSS	LTACC	MSO	USUBSP	BIND	MB
DACC	1.000											
P value	-----											
AUD	-0.052	1.000										
P value	(0.079)	-----										
ESO	0.107	-0.128	1.000									
P value	(0.000)	(0.000)	-----									
ISO	-0.009	-0.074	-0.052	1.000								
P value	(0.769)	(0.014)	(0.083)	-----								
LEV	0.039	0.063	-0.083	-0.014	1.000							
P value	(0.189)	(0.034)	(0.005)	(0.650)	-----							
ASST	-0.201	0.153	-0.183	-0.023	0.263	1.000						
P value	(0.000)	(0.000)	(0.000)	(0.441)	(0.000)	-----						
LOSS	0.116	0.011	0.017	0.036	-0.104	-0.321	1.000					
P value	(0.000)	(0.716)	(0.576)	(0.224)	(0.001)	(0.000)	-----					
LTACC	-0.042	-0.054	0.088	0.046	0.064	-0.030	-0.023	1.000				
P value	(0.164)	(0.069)	(0.003)	(0.126)	(0.034)	(0.309)	(0.438)	-----				
MSO	0.118	-0.138	0.670	0.587	-0.042	-0.192	0.088	0.100	1.000			
P value	(0.000)	(0.000)	(0.000)	(0.000)	(0.163)	(0.000)	(0.003)	(0.001)	-----			
USUBSP	-0.032	-0.009	0.022	0.003	0.006	-0.013	-0.059	0.050	0.026	1.000		
P value	(0.286)	(0.754)	(0.452)	(0.926)	(0.841)	(0.658)	(0.050)	(0.091)	(0.381)	-----		
BIND	-0.084	0.053	-0.021	-0.033	-0.012	0.132	0.031	0.025	-0.009	0.094	1.000	
P value	(0.005)	(0.076)	(0.081)	(0.269)	(0.679)	(0.267)	(0.301)	(0.410)	(0.768)	(0.002)	-----	
MB	0.025	-0.068	0.116	-0.018	-0.004	0.058	-0.175	0.007	0.035	-0.001	-0.025	1.000
P value	(0.398)	(0.023)	(0.000)	(0.538)	(0.883)	(0.050)	(0.000)	(0.818)	(0.238)	(0.965)	(0.395)	-----

4.2 Managerial share ownership and discretionary accruals

Table 4 presents the estimation of OLS regression results. In Panel A we report the results relating to MSO and discretionary accruals. The first model (no control variables) shows a positive significant coefficient of MSO (0.000) and a negative significant coefficient of MSO^2 (0.000). In the second model (with control variables) we find significant P values of the coefficients MSO (0.007) and MSO^2 (0.010). The signs of MSO and MSO^2 are positive and negative, respectively. In other words, we find a positive relation between MSO and discretionary accruals up to a certain point followed by a negative relation. It implies an inverse U-shaped, relation between MSO and the absolute value of discretionary accruals. The positive relation between MSO and discretionary accruals suggest that in Australia an entrenchment effect sets in at lower levels of ownership. After a certain level of ownership is attained, we see a relation consistent with incentive alignment.

Table 4. Relation between MSO and discretionary accruals

The following table reports the regression results regarding managerial ownership and discretionary accruals. Different notations used in the table are defined as follows: DACC = Absolute value of discretionary accruals; $DACC_{+ve}$ = Absolute value of income increasing discretionary accruals; $DACC_{-ve}$ = Absolute value of income decreasing discretionary accruals; MSO = Percentage of ordinary shares owned by the directors of the board; USUBSP = Percentage of ordinary shares owned by the unaffiliated (excluding the directors) substantial shareholders; LEV = Leverage, calculated as the ratio of book value of debt to book value of total assets; BIND = Board independence calculated as the number of independent directors scaled by the size of the board; AUD = dummy variable 1 if the firm is audited by big 4 auditors; MB = Market to book ratio; LTACC = Lagged total accruals; LOSS = Loss dummy variable ; ASST = Natural log of book value of assets. The reported results are heteroskedasticity and autocorrelation consistent. Figures in the parentheses are P values.

Panel A

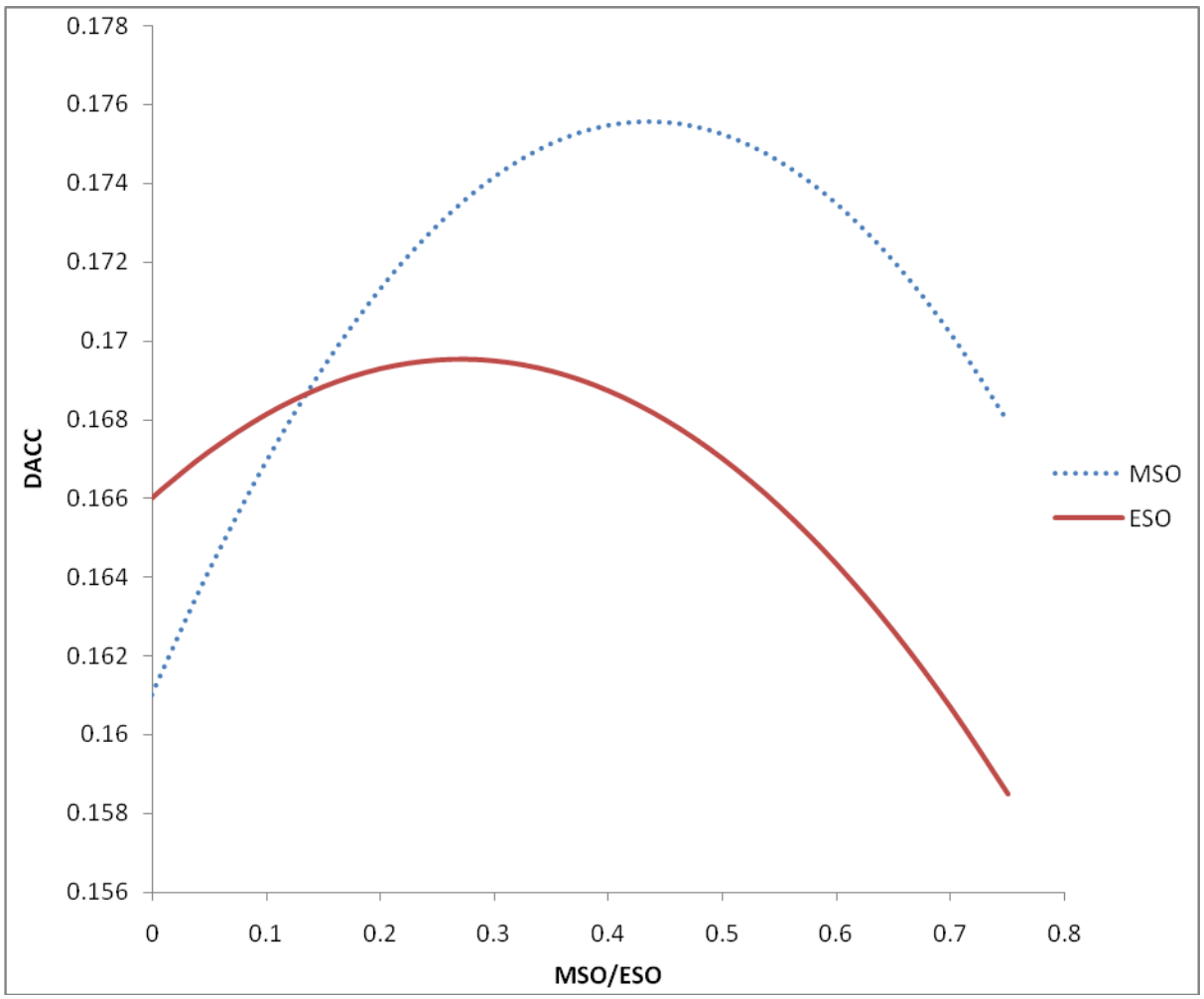
	Model 1		Model 2	
	Coefficient	**P value**	**Coefficient**	**P value**
MSO	0.109	(0.000)	0.067	(0.007)
MSO^2	-0.142	(0.000)	-0.077	(0.010)
USUBSP			-0.006	(0.491)
LEV			0.002	(0.034)
BIND			-0.026	(0.016)
AUD			-0.004	(0.784)
MB			$0.248X10^{-4}$	(0.648)
LTACC			-0.027	(0.131)
LOSS			0.017	(0.041)
ASST			-0.011	(0.008)
Intercept	0.091	(0.000)	0.161	(0.000)
Adj. R^2		0.028		0.066

Panel B

	$DACC_{+ve}$		$DACC_{-ve}$	
	Coefficient	**P value**	**Coefficient**	**P value**
MSO	0.098	(0.000)	0.017	(0.054)
MSO^2	-0.113	(0.005)	-0.023	(0.178)
USUBSP	-0.003	(0.779)	-0.010	(0.402)
LEV	0.008	(0.075)	-0.005	(0.732)
BIND	-0.029	(0.019)	-0.029	(0.065)
AUD	-0.006	(0.199)	-0.001	(0.861)
MB	0.001	(0.078)	-0.002	(0.014)
LTACC	-0.070	(0.002)	0.009	(0.697)
LOSS	0.035	(0.000)	-0.019	(0.137)
ASST	-0.010	(0.022)	-0.015	(0.000)
Intercept	0.134	(0.003)	0.206	(0.000)
Adj. R^2		0.087		0.072

We estimate the turning points in the inverse U-shaped relations between ownership and discretionary accruals from the results reported in Table 4. Figure 1 presents the graph of the estimated relation between MSO and the absolute value of discretionary accruals. The estimated turning point for MSO and discretionary accruals is 43.5%.

Figure 1. The relation between MSO, ESO and discretionary accruals



The fact that the coefficients of some other control variables are statistically significant suggests that discretionary accruals are also influenced by other factors. Specifically, discretionary accruals are positively related to loss (LOSS) and leverage (LEV) and negatively related to board independence (BIND) and firm size (ASST). All other control variables are insignificant. A positive significant coefficient of loss (LOSS) is consistent with the findings of Wang (2006). A positive significant coefficient of leverage (LEV) implies that managers may manage earnings in highly levered firms (Klein, 2002). The negative significant coefficient of board independence (BIND) suggests that monitoring effect constrains the use of discretionary accruals.

The sample firm-years are also divided into two sub-samples according to the sign of the discretionary accruals, and for each sub-sample we regress the absolute value of the discretionary accruals on MSO and control variables. The regression results are presented in Panel B of Table 4. Observations with positive (negative) discretionary accruals are consistent with income-increasing (income-decreasing) accrual adjustments and $DACC_{+ve}$ ($DACC_{-ve}$) indicates the absolute value for positive (negative) discretionary accruals.[13] For the $DACC_{+ve}$ regression, all coefficients of the MSO variables are statistically significant with the expected signs, that is, consistent with the main regression. For the $DACC_{-ve}$ regression, all coefficients of the MSO variables have the expected signs, but, the coefficients of the MSO variables are not statistically significant. Taken together, this suggests that MSO is significantly associated with

income-increasing but not income-decreasing accrual adjustments. The difference in relations is consistent with the contracting argument posited in this paper.

We argued that different groups of managers have different incentives and relation between MSO and discretionary accruals may vary depending on whether shares are owned by the executive or independent directors. We now examine the relations of ownership by the executive directors and discretionary accruals. We report the results in Panel A of Table 5. The first model (no control variables) shows a positive significant coefficient of ESO (0.004) and a negative significant coefficient of ESO^2 (0.046). The second model (with control variables) shows significant P values of the coefficients ESO (0.038) and ESO^2 (0.072). The signs of ESO and ESO^2 are positive and negative, respectively which implies an inverse U-shaped relation between ESO and discretionary accruals. The positive (negative) relation between ESO and discretionary accruals implies an entrenchment (incentive alignment) effect. Once again, our empirical findings suggest that an entrenchment effect dominates at lower level of executive director ownership. After a certain level of ownership is attained, we see a relation consistent with incentive alignment. The significant coefficients of some of the control variables suggest that discretionary accruals are also influenced by other factors. That is, discretionary accruals are positively related to a loss and negatively related to board independence and firm size.

Figure 1 also presents the graph of the estimated relation between ESO and the absolute value of discretionary accruals. We estimate the turning point in the inverse U-shaped relations between ESO and discretionary accruals at 27.1%.

Once again, the sample firm-years are also divided into two sub-samples according to the sign of the discretionary accruals and we re-run our analysis. We report the results in Panel B of Table 5. For the $DACC_{+ve}$ regression we find that all the coefficients of the ESO variables are statistically significant with the expected signs, that is, consistent with the results for ESO as a whole. However, the coefficients for the ESO variables in the $DACC_{-ve}$ regression are not significant. Thus ESO is also associated with income-increasing but not income-decreasing accruals.

We previously argued that independent directors are less likely to be influenced by the effects of incentive alignment or entrenchment and hence we expect no relation between ISO and discretionary accruals. We replicate for ISO the analysis conducted for ESO and we fail to find any significant relation between ISO and discretionary accruals. We also use a linear specification of ISO to examine the same relation and fail to find any significant result as well. We do not tabulate the results in the interest of brevity.[14]

4.3 Endogeneity of MSO

We argue that the levels of MSO may be endogenously determined as part of the firm's broader operating and financing arrangements (Demsetz, 1983). Firms with larger and/or less reliable accruals and/or greater earnings volatility may choose governance structures, such as higher levels of MSO to reduce agency costs To address this potential problem, we use the instrumental-variable (IV) procedure to re-estimate equation 3. Following Hermalin and Weisbach (1991), we create a lagged ownership variable (lagged by one year) and use it as an instrument for measuring MSO. Our results (not tabulated) as per IV regressions are consistent with the analysis using OLS regressions.

Table 5. Relation between ESO and discretionary accruals

The following table reports the regression results regarding managerial ownership and discretionary accruals. Different notations used in the table are defined as follows: DACC = Absolute value of discretionary accruals; $DACC_{+ve}$ = Absolute value of income increasing discretionary accruals; $DACC_{-ve}$ = Absolute value of income decreasing discretionary accruals; ESO = Percentage of ordinary shares owned by the executive directors of the board; USUBSP = Percentage of ordinary shares owned by the unaffiliated (excluding the directors) substantial shareholders; LEV = Leverage, calculated as the ratio of book value of debt to book value of total assets; BIND = Board independence calculated as the number of independent directors scaled by the size of the board; AUD = ; MB = Market to book ratio; LTACC = Lagged total accruals; LOSS = Loss dummy variable ; ASST = Natural log of book value of assets. The reported results are heteroskedasticity and autocorrelation consistent. Figures in the parentheses are P values.

Panel A

	Model 1		Model 2	
	Coefficient	**P value**	**Coefficient**	**P value**
ESO	0.079	(0.004)	0.026	(0.038)
ESO ^{2}	-0.129	(0.046)	-0.048	(0.072)
USUBSP			-0.005	(0.501)
LEV			0.003	(0.631)
BIND			-0.028	(0.014)
AUD			-0.005	(0.883)
MB			$0.4488X10^{-4}$	(0.909)
LTACC			-0.025	(0.186)
LOSS			0.012	(0.031)
ASST			-0.017	(0.014)
Intercept	0.061	(0.000)	0.166	(0.000)
Adj. R^2		0.028		0.066

Panel B

	$DACC_{+ve}$		$DACC_{-ve}$	
	Coefficient	**P value**	**Coefficient**	**P value**
ESO	0.013	(0.025)	0.019	(0.697)
ESO ^{2}	-0.021	(0.071)	-0.027	(0.272)
USUBSP	-0.002	(0.818)	-0.009	(0.442)
LEV	0.003	(0.532)	-0.006	(0.747)
BIND	-0.027	(0.020)	-0.032	(0.121)
AUD	-0.002	(0.578)	-0.001	(0.798)
MB	0.008	(0.162)	-0.002	(0.015)
LTACC	-0.067	(0.005)	0.010	(0.691)
LOSS	0.038	(0.000)	-0.018	(0.126)
ASST	-0.013	(0.053)	-0.014	(0.003)
Intercept	0.140	(0.002)	0.204	(0.000)
Adj. R^2		0.080		0.074

4.4 Further analysis

First, we use the model used by Warfield et al. (1995) as an alternative method to estimate the discretionary accruals. According to this model, discretionary accruals are equal to the difference between the current period accrual and expected normal accrual and the expected normal accrual is estimated by using a five year firm specific average of prior periods' accounting accruals. We rerun all the regressions to examine the relations between the different managerial ownership variables and discretionary accruals. Our results suggest no qualitative differences to the results reported previously.

Second, Himmelberg et al. (1999) argue that MSO may also be endogenously determined by the unobserved firm heterogeneity. Therefore, we repeat all the analyses using a random effect model and fail to find any qualitative difference to our main findings. We then split our sample into four different sub-samples based on time periods – from 2000 to 2003, 2004 to 2006 as well as 2000 to 2002 and 2003 to 2006 - and replicated the original

analysis. The purpose of splitting the sample is to test any impact of the major corporate regulatory changes (for example, the introduction of ASX corporate governance guidelines in 2003) that took place during our study period. The results for these sub-samples are qualitatively similar to the original results.

Third, recognising that the levels of independent director ownership may be too low to affect their incentives, we also examine the impact of ownership by all non-executive directors that is, independent directors and affiliated (grey) directors, on discretionary accruals.[15] We rerun all the regressions that we use for ISO. Our results that have not been tabulated suggest that there is no relation between discretionary accruals and ownership by the non-executive directors.

Fourth, we use an alternative approach to control for the industry differences. Consistent with the Australian economy, around 16% of our sample are resource companies. Accordingly, we also use a resource dummy in all regressions and document a significantly positive coefficient for this variable. It suggests that the resource companies are more likely to manage earnings than the non-resource companies but our results relating to the managerial ownership variables (MSO, ESO and ISO) remain unchanged.

Fifth, as we find a significant coefficient for the size (ASST) variable, we examine the size effects on the level of discretionary accruals. We partition the sample into large and small firms based on the median size of our overall sample and run all regressions on the sub-samples. Our results for both large and small firms show no qualitative differences to the results reported previously.

5. Conclusion

We examine the relation between managerial share ownership and discretionary accruals in Australia. We posit that executive directors and independent directors have different incentives and also examine the ownership-discretionary accruals relation between ESO and ISO, separately. Our investigation shows a nonlinear relation between MSO and the absolute value of discretionary accruals. Specifically, we find a positive relation between MSO and discretionary accruals up to a certain point followed by a negative relation (inverse U-shaped). Our analyses reveal a similar relation between ownership and absolute value of discretionary accruals for executive directors as for managerial ownership as a whole. However, we find no significant relation between share ownership by independent directors and discretionary accruals.

Our finding a nonlinear inverse U-shaped relation between MSO and discretionary accruals is in marked contrast to prior research. Various Australian institutional features including large but relatively passive block holders and very low participation in shareholder proxy votes suggest that managers do not need a particularly large shareholding to derive private benefits of control. Consistent with the above, our empirical findings suggest that, in Australia, a positive ownership–discretionary accrual relation dominates at lower levels of ownership. After a certain level of ownership (43.5% and 27.1% in respect of MSO and ESO, respectively), we see a negative relation consistent with incentive alignment.

Whilst the prior research examining the ownership-discretionary accruals relation focuses on MSO as a whole, we also contribute to the literature by arguing that executive and independent directors have different incentives that may impact the relation between ownership and discretionary accruals. Our results support such differential incentives and imply that independent directors in Australia may be truly independent and are not influenced by the theorised incentive alignment or entrenchment effects associated with share ownership.

Notes

[1] For example, Dignam (2005) found that the proportion of successful Australian takeover bids that were hostile during the period 1992-2001 was 7.2%. He contrasts this with the comparable proportion of successful hostile bids in the US and the UK being 21% and 20%, respectively.

[2] The evidence on voting indicates that 86% - 88% of shares are voted in the US companies, around 50% in the UK but only 39% - 41% in Australia.

[3] A study by Gul, Lynn and Tsui (2002) examines the impact of audit quality on this relation using a smaller sample drawn from the period 1992-3.

[4] The ASX Corporate Governance Recommendations deem that a director may be considered independent even if he or she holds up to 5% of the shares in that company. This is not dissimilar to the New York Stock Exchange rules which state that director share ownership itself is not a bar to an independence finding.

[5] There is empirical support for this proposition in the related area of the managerial ownership-performance relation. Studies controlling for endogeneity document different results from those that do not (see for example, Demsetz and Villalonga, 2001).

[6] It is also possible to argue that entrenchment is not just a consequence of voting power. Some managers, by virtue of their tenure with the firm, status as a founder, may be entrenched with relatively small stakes. On the other hand, managers with higher ownership stakes in firms with an active outside block holder or strong independent directors may not be as entrenched (Morck et al. 1988).

[7] We specifically identify non-executive directors who meet the criteria for independence as set out in the Investment and Financial Services Association definition that was subsequently adopted by the ASX Corporate Governance Council, (2003), *Principles of Good*

Corporate Governance and Best Practice Recommendations.

[8] We also do the same analysis after trimming the top and bottom 1% observations based on the key variables, that is, MSO and DACC. Our results are not qualitatively different from those reported in the paper.

[9] An independent judge checked a random selection of the ownership and corporate governance data used in this study.

[10] A commonly used model to estimate discretionary accrual is the modified Jones model (Dechow et al., 1995). The time series version of the modified Jones is data intensive. Similarly, a problem with using the cross sectional model is that some of the industries classified under the two digit ASX code do not have ten observations (firms). Accordingly, using these models would have resulted in a considerable reduction of our sample size. As further analysis, we also use the model in Warfield et al. (1995) to estimate discretionary accruals.

[11] Total accruals = $\Delta CA - \Delta CL - DEP$ where ΔCA is the change in non-cash current assets (change in current assets less change in cash), ΔCL is the change in current liabilities excluding short term debt (change in current liabilities less the change in debt included in current liabilities and minus the changes in income tax payable) and DEP is depreciation and amortization (Dechow et al., 1995).

[12] We use the same equation to examine the relations between executive as well as independent directors and discretionary accruals replacing MSO by ESO and ISO respectively.

[13] The number of observations for the income increasing discretionary accruals and income decreasing discretionary accruals are 736 and 437 respectively.

[14] Detailed results are available on request.

[15] The mean level share ownership by all non-executive directors in our sample is 6.2% in contrast to 6.3% owned by executive directors.

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TESTS OF TWO OPTIMAL INCENTIVE MODELS FOR EXECUTIVE STOCK OPTIONS

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Abstract

Using a unique data set, we test theoretical propositions relating to grant size and exercise price in determination of optimal executive compensation. For Hall and Murphy, pay-performance sensitivity does not behave as predicted with respect to CEO risk aversion and diversification, but the latter supports observed grant size while ATM grants exhibit positive abnormal returns as predicted. Consistent with Choe, exercise price is found inversely related to leverage. The unexpected positive relation between grant size and stock volatility is conjectured driven by CEOs' influencing large grants, which are found associated with weak corporate governance but ameliorated by outside directors.

Keywords: Executive, Stock Options, Optimal, Grant Size, Exercise Price, Influence

JEL Classification: G39, G34

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Introduction

While evidence of a positive association between pay-performance sensitivity and firm performance has been documented, there is scant evidence on the relative impact of exercise price and grant size (for example, Jensen and Murphy, 1990; Hall and Liebman, 1998; Guay, 1999 and Core and Guay, 2005). This paper adds to the empirical literature on executive compensation by testing for the first time key propositions of Hall and Murphy (2000, 2002) and Choe (2003).

Hall and Murphy (2000, 2002) and Choe (2003) both derive an optimal exercise price but differ in their treatment of grant size and in the domain of argument: Hall and Murphy internalize the private characteristics of executives, whereas Choe internalizes firm characteristics impacting on return volatility. In general, the incentive imparted by executive stock option grants (as measured by the option delta) is expected to benefit shareholders. The extent of this benefit depends on the level of investment opportunities available to the firm, and on the extent to which they are accepted by executives. Pay-performance sensitivity (delta multiplied by grant size) is increasing in the value of these investment opportunities. Hall and Murphy argue that pay-performance sensitivity is optimized when the exercise price is set in relation to the executive's risk aversion and degree of private diversification. For example, for a given grant size low risk aversion and high private diversification imply an out-of-the-money (OTM) grant (i.e., a premium option), while high risk aversion and low private diversification imply an in-the-money (ITM) grant (i.e., a discounted option). This implies that after controlling for risk aversion, private diversification and grant size, pay-performance sensitivity is inversely related to the exercise price. However, at-the-money (ATM) grants are more likely optimal because deeper discounts rapidly become too costly and increasing premiums rapidly erode incentive for common values of risk aversion and private diversification. They show analytically that optimal exercise price relative to the stock price declines (i.e., grant discounts are deeper) as risk aversion and under-diversification increase. On the other hand, OTM grants are predicated only for low risk aversion coupled with higher personal diversification.

On the other hand, Choe (2003) argues that pay-performance sensitivity implied by grant size and exercise price choices is adjusted for exogenous changes in stock price volatility and leverage to maintain a preferred incentive. Choe distinguishes change in stock volatility induced by acceptance of new investments from change induced by changed financial risk when debt financing is used. When new investment is riskier than existing assets, for a given grant size the exercise price is increased to maintain a desired pay-performance sensitivity, while for a given exercise price grant size is reduced. On the other hand, if leverage is increased to finance new investment, the higher financial risk results in a larger grant for a given exercise price, while for a given grant size the exercise price is reduced. However, Choe's model predicts that increased stock volatility induces smaller grants but does not impact on the exercise price, while increased leverage induces a lower exercise price but does not impact on grant size.

Neither model countenances the wealth implications of CEO influence over the exercise price or grant size, or both; in short, agency problems of equity. Self-interested CEOs have an incentive to increase pay-performance sensitivity to increase their payoff but without adding value for shareholders. A lower exercise price or larger grant than shareholders require to deliver a given incentive also increases pay-performance sensitivity, but not optimally. Thus, empirical evidence on the pay-performance sensitivity/shareholder wealth relation is deficient to the extent the potential for CEO influence is not adequately recognized.

Our primary objective is to test the key propositions of both models. We employ an Australian data set because in the Australian institutional setting (principally in the 1990s) exercise prices and grant sizes were free to vary: exercise prices were not constrained by disclosure or taxation considerations, while stakeholders were considerably less pro-active than at present in monitoring or challenging large grants to CEOs. The common U.S. practice of awarding executives ATM options means exercise prices are constrained (eliminating all but a few discounts and premiums), thereby preventing a complete test of the theoretical propositions. For U.S. firms, Hall and Murphy (2002) report that 94 per cent of options granted to CEOs of S&P 500 companies in 1998 were granted at-the-money. Narayanan and Seyhun (2006) suggest two reasons why ITM grants are rare in the U.S.: first, FASB rules require ITM options (as distinct from option value) to be expensed and, second, ITM options are not deductible under the Internal Revenue Code if an executive's total non-performance-based compensation exceeds $1 million a year. A secondary objective is to examine the extent to which CEO influence over their grants might impair application of these models through an adverse effect on pay-performance sensitivity.

There are several empirical findings. First, our descriptive statistics show that CEO stock option grants are found to generate approximately zero cumulative abnormal returns (CARs) for a [-1, 1] window around grant announcement. However, this aggregate masks positive CARs found associated with small grants (i.e., below-median) and ATM grants, and also masks negative CARs associated with large, OTM grants. Second, the Hall and Murphy (2000, 2002) model receives little empirical support. The motivating arguments of CEO risk aversion and CEOs' private diversification do not influence pay-performance sensitivity in the predicted directions, and there is no evidence of grant size and exercise price being determined interactively. Supporting evidence is confined to an inverse relation between private diversification and grant size, plus association of positive grant CARs with ATM grants. Third, the Choe (2003) model fares somewhat better. Choe relates the exercise price and grant size choices to expected change in stock return volatility and financial leverage to maintain a given pay-performance sensitivity. We find that exercise prices vary negatively with financial leverage as predicted, but that stock volatility is not inversely related to grant size. We attribute the observed positive relation between grant size and stock volatility to CEO influence over their award conditions, indicating an agency problem of equity which neither model incorporates. The inference is that stock option grants are larger than necessary to maintain a given pay-performance sensitivity when stock volatility is high and smaller when stock volatility is low. Fourth, further analysis reveals that grant size is significantly influenced by governance variables: CEO control of voting stock (positively), the proportion of outside directors (inversely) and CEO turnover (inversely). Evidence that the exercise price is inversely related to the proportion of outside directors suggests that as outside monitoring increases, the exercise price falls to compensate for smaller grants. This latter finding provides additional empirical support for Choe (2003).

This study therefore makes two contributions to the empirical literature on executive option grants. First, we conduct the first empirical tests of the key propositions of Hall and Murphy (2000, 2002) and Choe (2003). A successful test requires a data set where the exercise price and grant size are unconstrained by institutional requirements, and where grant backdating is not a problem. These criteria are satisfied by our use of Australian data. The second contribution is the finding that CEO influence is exerted through grant size and not the exercise price. The remainder of the paper is

organized as follows. Section 2 reviews present understanding and evidence on the relations between compensation structure, grant moneyness, incentive and CEO performance. The data, sample and measures used are described in Section 3, which is followed in Section 4 by the analysis. Finally, conclusions are presented in Section 5.

2. Literature review

Executive stock option plans both in Australia and the U.S. typically set the parameters under which subsequent grants are made. Plans usually specify the term, the vesting period (and rationing, if any), a hurdle price, other restrictions (e.g. staging exercise of ITM options), a schedule (if any) and often capping the number of options that can be granted over a fixed interval (e.g. a moving five-year total)[46]. Such plans require shareholder approval. Typically, the exercise price is determined in relation to a formula with some imbedding discounts or premiums, while some companies grant full discretion to the compensation committee[47]. The size of a grant is usually less restricted and is sometimes capped at a given number on a rolling basis for a fixed interval[48]. The timing of a grant is least restricted, with most plans granting shareholders the right to award as they see fit, but lack of a timing constraint can also be exploited by CEOs. In other words, compensation committees are able to use their discretion in making grants under the auspice of a given plan. A risk facing shareholders is that a self-interested CEO exerts influence on the deliberations of the compensation committee to secure grant terms favoring the CEO at shareholder expense. If so, stock price responses to grants would tend negative.

Announcements of adoption of executive stock option plans are associated with small positive abnormal stock returns (DeFusco, Johnson and Zorn (1990), Morgan and Poulsen (2001), Martin and Thomas (2005)), and are construed as evidence that stock option plans beneficially increase top management incentive. Yermack (1997) and Aboody and Kaznick (2000) report higher market-adjusted stock returns following grants, Chauvin and Chenoy (2001) report lower adjusted stock returns prior to grant, while Narayanan and Seyhun (2006) report both. All four studies therefore report non-negative shareholder returns after the notional grant date. However, all obtain their grant dates from subsequent proxy statement filings, so grant announcements can lag effective grants by several weeks or months. Hence, the stock market is likely to have become informed during this interval, as evidenced by the flat stock returns around SEC insider filing dates (Narayanan and Seyhun, 2006).

Furthermore, the positive stock price response to grant announcements may not reflect an incentive effect. Narayanan and Seyhun (2006) attribute the stock price reversal (a prior stock price decrease followed by after grant by a stock price increase) to executive influence on grant timing (including backdating) because prior to Sarbanes-Oxley Act of 2002 investors did not usually observe grants around the issue date[49]. Narayanan and Seyhun find the degree of the stock price reversal is increasing in grant size and the seniority of the manager. The former regularity is consistent with, but not conclusive evidence of, CEOs timing option grants (through influence on their compensation committee) prior to stock price runups because grant size is smaller at other times, while the relation with manager seniority suggests influence. However, Yermack (1997) finds that post-grant abnormal returns have no association with grant size. Narayanan and Seyhun also find that abnormal stock return reversals are greater for unscheduled than scheduled grants, consistent with CEO influence on grant timing.

In a more recent paper, Billett, Mauer and Zhang (2006) examine monthly stock and bond price reactions to first-time grants of options and/or restricted stock to CEOs. First grants are argued to have a higher probability of information content than second and subsequent grants. They find significantly positive stock price reactions and negative bond price reactions. The stock price gain is pervasive across CEO pre-grant stock ownership (limited to beneficial interests), while the loss to bondholders is lower for higher CEO stock ownership. However, when grants coinciding with other major announcements are omitted from the sample the positive stock price response disappears. They test the Coles, Daniel and Naveen (2006)

[46] Australian executive stock option plans are partially surveyed in Rosser and Canil (2004) and Taylor and Coulton (2002), while U.S. executive stock option plans are partially surveyed in Hall (1999).

[47] For example, North Limited, ICI Australia Limited and Ashton Mining Limited prescribe an exercise price being the average of the stock price for the prior 5 trading days, with some companies (e.g., Energy Equity Limited) adding a requirement for a premium to market and others (e.g., Orbital Engine Limited) adding a requirement for a discount. Amcor Limited and BRL Hardy Limited, for example, grant full discretion to their compensation committees.

[48] One plan states that "the total number of unissued shares… shall not exceed 7.5 per cent of the company's total number of shares on issue from time to time" (F H Faulding & Co Limited Employee Share Option Plan: Plan Rules as of 18 February, 1988).

[49] Prior to August 29, 2002, back-dating in U.S. grants cannot be ruled out because the intent of SOX accelerated disclosure requirements (Section 403) did not come into effect until this date. Before this date, Form 4 beneficiary ownership reports were filed within 10 calendar days following the end of month in which the options were granted, while Form 5 filings could have been delayed until 45 days following fiscal year end.

proposition that risk-averse and under-diversified managers are encouraged to avoid more risky (and potentially valuable) new investment when their compensation has high pay-performance sensitivity (as measured by delta). In contrast, when option compensation has high sensitivity to stock volatility (as measured by vega), managers have an incentive to accept more risks. Hence, the stock price response is expected negatively related to delta but positively related to vega, which is supported by the evidence of Billett, Mauer and Zhang (2006).

Two studies examine the relation between pay-performance sensitivity and the propensity for risk-taking. First, Guay (1999) finds that stock options significantly increase the sensitivity of CEO wealth to equity risk, and interprets the result as consistent with managers receiving incentives to invest in risk-increasing projects, particularly when the potential loss from underinvestment is greatest. The positive relation between stock volatility and pay-performance sensitivity (measured by delta multiplied by grant size) increases the convexity of the relation between manager's wealth and the stock price. Second, Aggarwal and Samwick (1999) find that pay-performance sensitivity necessarily decreases in the variance of firm performance, i.e., more volatile stocks require lower executive pay-performance sensitivity to maintain a given incentive.

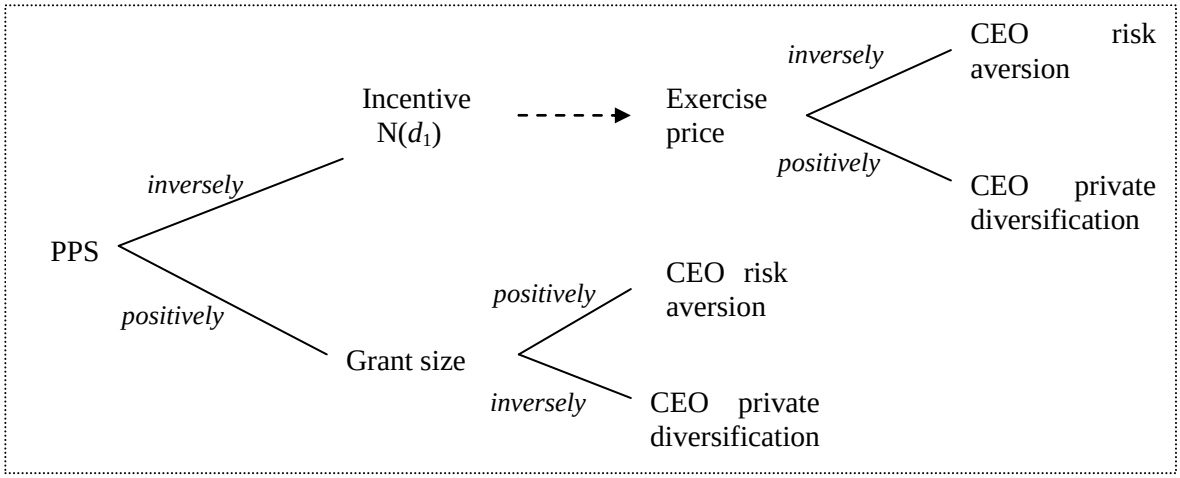
Hall and Murphy (2000, 2002) and Choe (2003) propose different incentive-optimization mechanisms that nonetheless are complementary. In the Hall and Murphy model, pay-performance sensitivity (measured by delta multiplied by grant size) is influenced by the degree of executive risk aversion and private diversification, whereas in Choe changes in stock volatility and financial leverage determine the level of pay-performance sensitivity. Assuming add-on grants in the Hall and Murphy model, increasing risk aversion and/or lower private diversification require higher incentive (delta) *via* a lower exercise price, for a given grant size. For example, for risk aversion of three and 50 per cent private investment in company stock a grant discount of approximately 35 per cent to market is implied. Alternatively, for a given grant size, decreasing risk aversion and/or higher private diversification require lower incentive (delta) *via* a higher exercise price. For example, for a risk aversion value of 2 and 50 per cent private investment in company stock a grant premium of approximately 20 per cent is implied. Thus, for given risk aversion and private diversification, Hall and Murphy argue that pay-performance sensitivity is increasing in exercise price/stock price. Since their model has shallow convexity of pay-performance sensitivity in exercise price/stock price, they recommend ATM or near-ATM grants[50,51]. ATM grants are generally expected to be the most efficient means to create incentive because the probability of exercise is balanced by the change in pay-performance sensitivity. For OTM grants, the lower probability of exercise induced by a higher grant premium is more than offset by the fall in pay-performance sensitivity. On the other hand, discounted grants increase the probability of exercise but do not deliver a commensurate increase in pay-performance sensitivity. Hall and Murphy also consider early exercise and show that for a fixed grant size early exercise is increasing in delta across grant moneyness. Hence, the propensity for early exercise is higher for executives with more risk aversion and less private diversification. Since add-on option grants never lower pay-performance sensitivity, abnormal returns observed around grant announcement are expected non-negative. Given optimization of grant size and exercise price for given levels of risk aversion and private diversification, Hall and Murphy would predict (i) generally positive abnormal returns on unanticipated grant announcements, and (ii) a positive relation between these positive returns and pay-performance sensitivity.

Hall and Murphy's argument is depicted in Figure 1. Pay-performance sensitivity (PPS) varies inversely (positively) with incentive (grant size). Incentive through the exercise price varies inversely with risk aversion and positively with private diversification. Higher risk aversion and lower private diversification require lower exercise prices to maintain a given PPS. On the other hand, grant size varies positively with risk aversion and inversely with private diversification. Higher risk aversion and lower private diversification require larger grants to maintain a given PPS.

[50] Alternatively, when stock option grants substitute for some component of existing compensation, Hall and Murphy (2000, 2002) show that the optimum policy shifts to stock options with a zero exercise price, or restricted shares, which increase executive incentive relative to options. Thus, ATM substitute grants are less efficient than restricted shares and also inferior to ATM add-on grants. Substitute grants also do not lower incentive because CEOs do not rationally exchange cash benefits for lesser option value.

[51] Hall and Murphy (2000, 2002) also recognize the executive valuation and incentive consequences of early exercise, the right to which increments executive value towards the Black-Scholes value.

Figure 1. Schema of Hall and Murphy's argument



Choe (2003) generates a complementary set of compensation predictions with respect to financial characteristics without recourse to risk aversion and private diversification arguments. He argues that pay-performance sensitivity implied by grant size and exercise price choices is adjusted for exogenous changes in stock price volatility and leverage to maintain the optimum pre-existing incentive. These predictions can be directly tested assuming that current stock return volatilities and leverage do not change. Changes in leverage and stock volatility induced by acceptance of a desired new investment cause the exercise price or grant size to adjust to arrive at the optimal pay-performance sensitivity necessary to capture new investment opportunities[52]. Two scenarios are identified. The first draws upon the positive relation between stock volatility and option value. An increase in stock volatility (caused by acceptance of riskier investments) increases option value, so for a given exercise price grant size is reduced to maintain optimal pay-performance sensitivity[53]. Alternatively, when grant size is given, a higher exercise price is necessary to maintain optimal pay-performance sensitivity when volatility is increased. The second scenarios introduce the two-edged impact of leverage on option value. Higher leverage (e.g., from financing the proposed investment) reduces the residual claim of equity and increases financial risk, so for a given exercise price grant size is increased. Alternatively, for a given grant size the exercise price is reduced. Hence, ITM (OTM) grants are expected more likely when stock volatility is lower (higher) and/or debt is higher (lower).

Paraphrasing these arguments in relation to pay-performance sensitivity (i.e., delta multiplied by granted options) leads to the prediction that pay-performance sensitivity is (i) decreasing in stock volatility and (ii) not decreasing in financial leverage. With respect to (i), for an all-equity firm the argument is that a fall in volatility can be compensated by either a lower exercise price (conditional on grant size) which increases delta, or by a larger option grant (conditional on the exercise price), such that pay-performance sensitivity is restored. However, to generate the pay-performance sensitivity necessary to capture given investment opportunities, adjusting the exercise price is ruled out in favor of operating on the grant size. An increase in stock volatility (consequent on accepting a new project) increases delta and hence pay-performance sensitivity, without intervention. However, reducing the exercise price (for a given grant size) is counter-productive because a lower exercise price reinforces the higher volatility effect[54]. Hence, the only alternative for shareholders is to increase grant size.

With respect to (ii), leverage impacts on both the exercise price and financial risk. Since equity-related compensation ranks after debt, the effective

[52] The argument is consistent with Guay (1999) who finds that stock options significantly increase the sensitivity of CEO wealth to equity risk, where the sensitivity is positively related to fims' investment opportunities.

[53] Carpenter (2000) has constructed a model that optimizes the portfolio choice problem of a risk-averse manager compensated with call options that she cannot hedge. One of the predictions is that giving the managers more options causes her to reduce the volatility of the marginal investment, which is opposite to Choe (2003). Thus, a positive relation between grant size and stock volatility (proxying for future stock volatility) supports Choe, whereas a negative relation supports Carpenter.

[54] Carpenter (2000) has a related proposition that deep OTM grants possibly provide incentive for excessive risk-taking to increase the probability of exercise. However, Carpenter's approach differs from that of Choe (2003) in at least two respects: first, grant size is not optimized to maintain a given pay-performance sensitivity, and second, Carpenter (contrary to Choe) models a change in the exercise price as impacting on stock volatility.

exercise price is increased by the face value of new debt that requires an increase in pay-performance sensitivity. On the other hand, higher financial risk requires a downward adjustment to pay-performance sensitivity *via* either a higher exercise price or a smaller grant. The dual impacts of leverage are therefore offsetting with respect to pay-performance sensitivity. Since the exercise price effect dominates the financial risk effect, a lower exercise price is expected because increasing grant size at the higher exercise price (due to higher leverage) is less effective in increasing pay-performance sensitivity. Hence, for a given pay-performance sensitivity, Choe posits an inverse relation between the option exercise price and leverage.

Both Hall and Murphy's (2000, 2002) and Choe's (2003) optimal contracting models tacitly assume that CEOs do not influence the terms and conditions of their option grants. Bertrand and Mullainathan (2000) and Bebchuk and Fried (2003), among others, marshal evidence suggesting that CEOs are able to influence their compensation contracts and extract rents as a result of ineffective board monitoring. For example, Bebchuk and Fried argue that senior executives indirectly influence the exercise price in their favor by controlling both the timing of grants and the timing of corporate information disclosures. The presence of CEO influence is suggested by (i) exercise prices are set lower than optimally, and/or (ii) larger option grants than shareholders require. Both factors result in higher pay-performance sensitivity than optimal, implying that self-interested CEOs have an incentive to increase pay-performance sensitivity at shareholder expense. Since Choe's model does not depend on risk aversion and private diversification arguments, the marginal impact of influence on pay-performance sensitivity can be directly observed because financial leverage and stock volatility are independent of CEO influence.

3. Data, sample and measures

Testing the propositions of Hall and Murhpy (2000, 2002) and Choe (2003) ideally requires an institutional setting in which both grant size and exercise are free to vary. Since U.S. stock option grants are typically ATM, an Australian data set is an ideal setting because both decision variables are observed to be unrestricted. In Australia, as in the United States, shareholders must approve CEO stock option plans put to them by company compensation committees, usually in the Annual General Meeting. The procedure for granting options comprises the following steps: (i) notice of a shareholder meeting to approve a grant is issued, (ii) if approved, execution of the grant is usually left to the discretion of the compensation committee and notified to the ASX in the *Notice of Directors' Interests* (pursuant to the then *Corporations Act*, Section 235). For the duration of our sample period the notice was to be lodged within 14 days of the grant (Section 205G) [55]. Any issue of securities (including options) to a director of a company must be approved by shareholders of the company prior to the issue (ASX *Listing Rule* 10.11). The grant announcement date is the date on which the ASX publishes the notification by the granting company, and is the date used for determining abnormal returns. To avoid the problem of information leakage, the sample was confined to grants occurring only on the announcement date or subsequently, thereby excluding all cases where grants were made prior to announcement[56]. Hence, our sample is free of backdating. The grant date was used to calculate CEO gains (i.e., discounts and premiums). Exercise details were obtained from the ASX *Additions to the Official List*.

Following Morgan and Poulsen (2001), a three-day window [-1, 1] is employed to capture grant announcements made after the close of trading on day zero[57]. Cumulative abnormal returns are the cumulative differences between expected and raw (or observed) stock returns, where expected returns are calculated from application of the market model, with the S&P/ASX All Ordinaries Accumulation Index used to proxy market returns on the market portfolio. Beta factors for this model are estimated using the excess return form of the market model (Brown and Warner, 1980). CARs are aggregated across the sample with each case being equally-weighted.

Hall and Murphy (2000, 2002) measure pay-performance sensitivity by $\delta V_e(n)/\delta S$, where $V_e(n)$ is the executive's valuation and n is the number of granted options. Executive value is determined after taking into account risk aversion and diversification but not early exercise, which is treated as a separate adjustment[58]. Theoretically, executive value should be adjusted for all three factors. However, for add-on grants, Hall and Murphy (2002, p. 25) show that $\delta V_e(n)/\delta C_{BS}(n)$ is approximately constant

[55] More recently, disclosure rules in both the U.S. and Australia have been tightened. In the U.S., in line with Section 403 of the *Sarbanes-Oxley Act* of 2002, the SEC amended the disclosure rules for beneficiary ownership reports to be filed under Section 16(a) to be reported within two business days of receiving notification of the grant. In Australia, ASX *Listing Rule* 3.19A introduced in 2001 requires any change in directors' interests to be notified within 5 business days of the change.

[56] Announcement and grants occurred on the same day in 56.5 per cent of sampled cases, with 29.6 per cent within four weeks.

[57] Daily abnormal returns for a week either side of this window are not statistically significant.

[58] Ingersoll (2006) presents an algorithm for adjusting the Black-Scholes call value for all three factors.

over a wide range of grant discounts/premiums. In any event, no data on private diversification is available. Since in our sample, the interval to actual exercise is clustered around a median off 3.33 years and time to maturity has a median of five years, we consider there is also no need to adjust executive value for early exercise. We derive further support from the fact that Australian maturities are about half those in the U.S. (five years vs. ten years), so executive values are closer to the Black-Scholes value and hence there is smaller error in not adjusting $N(d_1)$ for early exercise. Incentive is therefore measured by the partial derivative of the Black-Scholes call value with respect to the stock price, $\delta C_{BS}/\delta S$ or $N(d_1)$, adjusted for dividends. Grant size and risk aversion are controlled through explanatory variables. Risk aversion is measured by $MRP/.01(\sigma^2)$ where the market risk premium (*MRP*) is set at eight per cent and σ is the standard deviation of stock returns for a given company[59]. In the absence of a direct measure of CEO diversification on private account, private diversification is proxied by $ln(1/\text{Percentage of stock held})$, given by the intuition that private diversification increases as the percentage of firm stock held by the CEO decreases.

CEO influence over the conditions of their award is proxied by their control of voting stock, comprising the sum of beneficial and non-beneficial interests held. Typically, CEOs own a tiny portion of their company's stock in their own name but exert considerably more voting influence by virtue of trustee and family ownership structures (i.e., non-beneficial interests). Non-beneficial interests therefore also include insider blocks controlled by the CEO. Although a beneficial equity interest nominally aligns a CEO's interest with shareholders'[60], non-beneficial interests are typically much greater: in the present sample, the median non-beneficial interest exceeds the median beneficial interest by a factor of 56.72. In the absence of other disciplinary influences, an extensive non-beneficial interest creates an opportunity for CEO self-interest to dominate the alignment property of direct equity ownership. In the absence of a corporate governance index for Australian companies in the style of Gompers, Ishii and Metrick (2003), we employ two measures of governance quality: CEO turnover and proportion of outside directors on the board, both suggested by Weisbach (1988). Turnover is measured by the number of CEO appointments in a given interval divided by the interval in years, commencing three years before the first option grant and ending three years after the last grant where there are several grants. For a single grant the turnover index is therefore 0.167 years. A turnover index close to unity suggests a higher degree of entrenchment[61]. A higher proportion of outside directors (i.e., not employed within the corporate group) strengthens board independence which also lowers the probability of CEO entrenchment. Thus, high CEO turnover and a high proportion of outside directors suggest a lower probability of CEO influence over the terms of their option grants.

The sample period is 1987-2000. This period was chosen to ensure that ITM and OTM grants were voluntary choices and not influenced by subsequent controversy concerning the accounting treatment of non-ATM grants. In Australia, the expensing debate was unresolved until July, 2004 when AASB 2 became effective. Prior accounting debate in Australia can be traced back to the release of the International Accounting Standards Board (IASB) in mid-2002 which stated that all share-based payments should be recognized in the financial statements of issuing companies[62]. Hence, to avoid any anticipation of expensing requirements, cases were not selected after the year 2000.

[59] Our measure appears satisfactory because a regression of risk aversion so measured on delta and stock volatility yields a strong fit (adjusted R^2 = 0.526) with delta and stock volatility positively and negatively signed, respectively, and both achieving significance at better than 1 per cent.

[60] Jensen and Murphy (1990) and Hall and Liebman (1998) both report a positive pay-performance relation between CEO and shareholder wealth.

[61] Kuhnen and Zweibel (2007), Berger, Ofek and Yermack (1999) and Morck, Shleifer and Vishny (1988) show that entrenchment is costly to shareholders.

[62] A useful summary of the Australian debate on accounting for executive stock options may be found in the March, 2002 issue of the *Australian Accounting Review*.

Number of hits from 'options' keyword search	1162
less deletions for non-CEO stock options and quoted stock options	395
less all occurrences of companies for which an option plan was unavailable	257
less observations where grant date occurs prior to announcement date	98
	412
less further deletions for data deficiencies:	
Inadequate or inconsistent date and related disclosures	(186)
Grants made within 3 days of other major announcements	(58)
Final sample	168

Since no Australian executive compensation database is available for this period, all grant data were obtained from an 'options' keyword search of all ASX-listed companies included in *Huntleys' DatAnalysis* service. Of the 1,162 hits obtained, 395 hits attributable to non-CEO stock options (e.g., employee options) and quoted stock options were discarded. A further 257 observations representing 107 companies that did not provide a copy of the underlying option plan were also deleted, as were observations for which grant dates preceded announcement dates. These filters resulted in an initial selection of 412 observations, representing 104 companies. After further deletions for data deficiencies, including inadequate or inconsistent date and related disclosures along with grants made within 3 days of other major announcements (such as earnings releases), the final sample comprised of 168 stock option grants made by 51 companies to 65 CEOs[63]. The sample derivation is summarized thus:

The 168 cases represent a wide range of industrial sectors. Resource stocks make up almost 18 per cent of the selection, while industrial stocks (including manufacturing, engineering, conglomerate and technology stocks) account for the remainder. No distinction was made between first and subsequent grants to the same CEO. In other words, grants are treated as independent observations even if two grants are made in the same calendar year to the same CEO. Where portions of a grant are exercised or lapse on different dates, each portion is counted as a separate grant. Grant moneyness is determined with reference to the stock price on the grant date, while shareholder returns were determined around the grant announcement date. As in the U.S., compensation committees in Australia typically have discretion as to the frequency, the size and timing of grants along with determination of the exercise price[64]. The quality of Australian disclosure is on a par with the U.K. data of Conyon and Sadler (2001)[65]. Of the 168 grants 74 were multiple grants, being associated with other grants made on the same date but differentiated either by expiry date or exercise price. Spreads in exercise prices and exercise dates were intended to increase the probability that at least one of the grants would be exercise. Otherwise, such grants have the same properties as single grants. Compensation specialists in Australia consider that nearly all stock option grants made during this period were add-ons and not substitutes. Add-on grants are also common in the U.S., as indicated by Hall and Murphy (2002) and Baranchuk (2006) who notes simultaneous growth in option grants along with CEO salaries, bonuses and other benefits. Regular grants are grants made annually for at least three consecutive years to the same CEO and with a maximum variation of two months; the remainder are defined as irregular.

An OTM grant is defined to occur when the stock price at grant exceeds the exercise price by five or more per cent; likewise, an ITM grant occurs when the stock price falls below the exercise price by the same percentage. Notional ITM grants/OTM grants below five per cent are therefore classified as ATM awards. The resulting ten per cent spread is considered wide enough to classify virtually all ATM grants correctly, i.e., Type 1 error is believed negligible[66]. A wide spread also captures many near-ATM grants that are desirable given the non-exactitude of the Hall and Murphy (2002) predictions. The likelihood of Type 2 error (misclassifying non-ATM grants) is therefore likely higher than Type 1 error. Thus, grants classified as ITM or OTM are almost certainly not due to noise in stock prices. Further, the risk of classifying some non-ATM grants as ATM grants is not a problem for the Hall and

[63] Given CEO turnover, many companies granted stock options to different CEOs during the sample period.

[64] Few plans specify grant frequency schedules; most leave this to the discretion of the compensation committee. Scheduled *versus* unscheduled grants in the U.S. are examined by Collins, Gong and Li (2005).

[65] In the U.K., Urgent Issue Task Force (UITF) Abstract 10 of the Accounting Standards Board forms the basis of executive stock options disclosure, and is similar to the Australian disclosure rules as embodied in s.205G of the *Corporations Act*.

[66] The analysis was also performed with a two per cent cut-off, i.e., with a four per cent spread. Although not reported, the results were not significantly different.

Murphy (2002) predictions of add-on optimality because their model does not present corner solutions. Rather, their model permits some variation in moneyness around exact ATM without materially affecting their predictions. If their prediction were to hold only for exact ATM grants, such evidence would not be supportive of their position.

4. Analysis

Grant characteristics are described in Table 1 by grant moneyness. There are marginally more ITM grants (65) than ATM grants (55) and marginally fewer OTM grants (48) than ATM grants. There is little evidence that once an ITM (OTM) grant is made that the same moneyness status is maintained in subsequent grants[67]. Grants by companies in the resource sector make up just 17.9 per cent of all grants, but these percentages are makedly lower for ITM grants (12.6 per cent) and higher for OTM grants (29.2 per cent). Since resource stocks are riskier than industrial stocks, with therefore have an early indication that OTM grants are more characteristic of resource stocks. Irregular grants dominate the sample (73.8 per cent), with ITM grants exhibiting the highest percentage (80.0 per cent) and OTM grants the lowest (66.7 per cent). Since irregular grants imply more timing flexibility than regular grants, a higher loading on ITM grants is interesting because it suggests either that shareholders are able more closely to time incentive with need, or alternatively that self-interested CEOs are more able to influence the timing of their grants. The percentage of subsequent exercised options is 60.7 per cent for the whole sample and approximately 64 per cent for both ITM and ATM grants, but not surprising is lower for OTM grants (52.1 per cent). For the whole sample, the median CEO gain at grant is 0.013 (or 1.3 per cent) relative to the stock price on the grant date. For ITM grants, the median CEO gain is 0.186 (or 18.6 per cent) relative to the stock price on the grant date, while for OTM grants the median CEO gain is -0.151. Reassuringly, ATM grants show a median CEO gain very close to zero (0.010). The median grant size is 0.145 per cent of outstanding ordinary shares prior to grant. ITM and OTM grants both exhibit a higher median grant size percentage (about 0.200 per cent), while the median ATM grant is about half that size. Thus, the smallest grants are seen associated with ATM grants. In Australia, the regular maturity (expiry) of executive stock option grants is five years and the regular vesting period is two years. The median maturity for the whole sample is in fact 5.00 years, while the actual interval to exercise is 3.33 years indicating early exercise but not necessarily the day after vesting[68]. There is little variation in maturity by grant moneyness: not surprisingly however, OTM grants take longer to exercise.

Pre-grant firm characteristics are analyzed by grant moneyness in Table 2. Relative to ATM grants, ITM and OTM grants exhibit higher stock volatility and are awarded by smaller firms. ITM grants have higher marker-to-book ratios (proxying for growth opportunities) than either ATM or OTM grants. The implication is that shareholders are prepared to grant ITM options when growth opportunities are high. There is no discernible impact by financial leverage on grant moneyness. The finding that ATM grants are associated with lower stock volatility and large firm size suggest ATM grants are preferred by shareholders of large firms. The lower volatility characterizing ATM grants implies a lower likelihood of exercise relative to non-ATM grants, but we do not observe a compensating increase in grant size (refer Table 1). The higher volatility of non-ATM grants relative to ATM grants implies that ITM and OTM grants are reserved for awards in more volatile scenarios, which we construe as an initial piece of evidence in support of Choe (2003). On the other hand, and against Choe, financial leverage appears insensitive to grant moneyness choices.

Table 3 reports selected governance characteristics by grant moneyness. There is virtually no difference in CEO turnover (sample median 4.5 years) according to grant moneyness, but OTM grants are associated with a lower proportion of outside directors than ATM grants. Finally, evidence of lower CEO control of voting stock over ATM grants suggests that non-ATM grants are more likely subject to CEO influence. If so, ITM grants would appear driven by the opportunity for higher payoffs for a given level of effort, whereas OTM grants are rationalized in an influence context by the argument that shareholders would not have otherwise permitted an option grant.

Table 4 shows incentive and performance measures of incentive by grant moneyness. For the whole sample, the median incentive (delta) value is 0.971. ITM grants have a higher median delta (0.994) than OTM grants (median delta = 0.807); this is attributed to the disparity in moneyness because as noted in Table 1 the maturities for ITM and OTM grants are similar. In contrast, pay-performance sensitivity (defined as delta multiplied by the number of granted options) is virtually flat across grant moneyness, indicating that grant size counter-balances the incentive effect. At this stage,

[67] There were six cases in the data of multiple (more than two) ITM grants by the same company in the same year, and three cases of multiple OTM grants.

[68] Performance vesting is not at all common in our sample: $44/168$ of grants have hurdle requirements, of which 40 relate to stock price thresholds with the remainder specifying earnings performance hurdles.

we cannot discern whether the trade-off is prompted by shareholders or self-interested CEOs. Raw shareholder returns at grant for a three day event window [-1, 1] are virtually zero for the whole sample except that OTM grants attract significantly lower returns. The corresponding CARs are also effectively zero for the whole sample, but are positive for ATM grants and negative for OTM grants[69]. Thus, shareholders appear not to benefit from ITM grants, lose when OTM grants are made, and benefit only from ATM grants. These early results are broadly not supportive of Hall and Murphy (2000, 2002), but partial support is evident for ATM grants which exhibit positive CARs.

Table 5 presents a breakdown of CARs by above- and below-median grant size (small and large, respectively). On a priori grounds, positive CARs are expected in all intersections because shareholders adjust grant conditions, including exercise price and grant size, to arrive at the desired pay-performance sensitivity. Unexpectedly, positive CARs are not pervasive. There are several regularities of interest. The first is that, sample-wide, shareholders benefit from small grants (median CAR = 0.43 per cent) and not from large grants (insignificantly different from zero). This regularity is unexpected because, other things equal, large grants do not reduce incentive. The second regularity is that all ATM grants show positive CARs, along with small ITM grants. The positive CARs for ATM grants are general across small and large grants, providing early support for Hall and Murphy (2000, 2002). The positive CARs associated with small, ITM grants (median CAR= 1.08 per cent) suggest that the incentive created by the ITM grant is not offset by its cost, whereas the effectively zero CARs associated with large ITM grants imply the incentive is balanced by the cost of the discount. Lastly, large OTM grants are costly to shareholders (median CAR = -2.74 per cent), implying that any disincentive of OTM grants is exacerbated by larger grants. Further, OTM grants that are small have no shareholder wealth effect that implies the disincentive effect of an OTM grant offsets the lower cost to shareholders. Of these regularities, the negative CARs for large OTM grants demand the closest analysis.

Tests of the key propositions of Hall and Murphy (2000, 2002) are reported in Table 6. Their basic proposition is that pay-performance sensitivity is negatively related to exercise price/stock price and positively related to grant size. More risk-averse and less-diversified CEOs demand higher pay-performance sensitivity *via* lower exercise prices or larger grants, or both, while less risk-averse and more highly-diversified CEOs require lower pay-performance sensitivity. In regression (1), pay-performance sensitivity is regressed directly on CEO risk aversion and private diversification with an expectation of an inverse relation with risk aversion and a positive relation with private diversification. The results show almost the opposite. Since pay-performance sensitivity is the product of delta and grant size, the inference is that either or both is not adjusting as Hall and Murphy specify. To pursue the anomaly, two 2SLS regressions are performed with exercise price/stock price and grant size specified as the dependent variables, respectively. The set of equations estimated in regression (1A) is

[69] Daily CARs for the week following grant announcement are generally insignificantly different from zero.

$$Grant\ size = \alpha_0 + \alpha_1\ Risk\ aversion + \alpha_2\ Private\ diversification + \varepsilon \quad (1)$$

$$Exercise\ price/stock\ price = \beta_0 + \beta_1\ Grant\ size + \beta_2\ Risk\ aversion + \beta_3\ Private\ diversification + \varepsilon \quad (2)$$

and in regression (1B) is

$$Exercise\ price/stock\ price = \alpha_0 + \alpha_1\ Risk\ aversion + \alpha_2\ Private\ diversification + \varepsilon \quad (3)$$

$$Grant\ size = \beta_0 + \beta_1\ Exercise\ price/stock\ price + \beta_2\ Risk\ aversion + \beta_3\ Private\ diversification + \varepsilon \quad (4)$$

The estimation for regression (1A) is unsuccessful, indicating that the Hall and Murphy specification does not hold empirically. Regression (1B) fares a little better in that private diversification is negatively signed, as predicted by Hall and Murphy. However, risk aversion is incorrectly signed (negative) and grant size is unrelated to the exercise price, indicating zero interaction between grant size and exercise price. We conclude that grant size rather than the exercise price is operated on, even after recognizing the fact that (in Australia, at least) exercise prices are more flexible. These results are closely corroborated by OLS regressions of equations (2) and (4), not reported, further indicating that exercise price and grant size choices are made independently of each other and not simultaneously.

We test also to see if these relations are reflected in abnormal returns around grant announcement. First, we regress grant CARs on the components of pay-performance sensitivity: incentive (measured by delta) and grant size, with both coefficients expected positive. Regression (2) of Table 6 shows that grant CARs are increasing in incentive, as expected, but decreasing in grant size. The latter result (consistent with Table 5) is puzzling because, for a given incentive, larger grants are implied detrimental to shareholders. This outcome is anomalous because larger grants cannot lower incentive. Second, to distinguish the contribution of the exercise price to incentive creation, we regress grant CARs on grant size and exercise price/stock price in regression (3). Surprisingly, exercise price/stock price is found unrelated to grant CARs, suggesting that exercise prices are determined by factors other than incentive. Finally, in regression (4) we provide superficial support for Hall and Murphy (2000, 2002) in that grant CARs are found higher for ATM grants. The implication is that for ATM grants, grant size is close to optimal, whereas for OTM grants grant size appears larger than the OTM grant would suggest.

Tests of Choe's (2003) model are presented in Table 7. Choe predicts that pay-performance sensitivity is decreasing in stock volatility and not decreasing in leverage. His argument is that for a given exercise price stock volatility and grant size are inversely related, while for a given grant size leverage and the exercise price are also inversely related. Regression (1) confirms that pay-performance sensitivity is positively related to financial leverage and inversely related to stock volatility. The latter relation is consistent with Aggarwal and Samwick (1999) but not with Guay (1999). In regression (2), exercise price/stock price is shown to be inversely related to financial leverage and unrelated to stock volatility after controlling for grant size, as predicted. In regression (3) grant size is found unrelated to financial leverage and exercise price/stock price as expected, but is found to be positively related to stock volatility (expected negative). A positive relation implies that CEOs benefit at the expense of shareholders because grants are larger (smaller) when options are more (less) valuable, contrary to what is required to maintain pay-performance sensitivity[70]. This cannot be seen from the pay-performance sensitivity test of Hall and Murphy (2000, 2002) (Table 6, regression 1) because grant size is predicted linear with pay-performance sensitivity. The behavior of grant size explains the poor showing of stock volatility in regression (1) because the grant size component of the dependent variable does not decline in volatility as much as predicted by Choe (2003). Overall, apart from the grant size anomaly, Choe's model receives broad empirical support.

Earlier descriptive evidence (Table 5) suggests that adverse wealth transfers occur with large grants. Taken together, these findings suggest shareholders are more concerned with CEOs being rewarded for no effort (Type II error) than failing to provide sufficient incentive (Type I error). Specifically, as stock volatility increases grant size should decline, but the observed increase coupled with negative abnormal returns for large grants indicates shareholders lose only when option value is driven by higher stock volatility. Given an incentive motive, granting fewer options than optimal as stock volatility declines should also result in negative abnormal returns, but does not (Table 5).

[70] Regressions (2) and (3) were recast as 2SLS in recognition of the positive relation between leverage and stock volatility: financial leverage was omitted from regression (2) and stock volatility was omitted from regression (3). The results were generally inferior to those of the reported OLS regressions and hence do not affect our interpretation.

Our remaining task is to establish whether large grants are an outcome of undue CEO influence. In general, we expect governance factors to be correlated with CEO influence: well- (poorly-) governed firms should exhibit less (more) CEO influence. Specifically, higher CEO control of voting stock, lower CEO turnover and smaller proportions of outside directors are all characterize poor corporate governance, i.e., higher agency costs of equity. As a consequence, CEOs of poorly-governed firms are expected to exhibit larger grants. Further, to the extent financial leverage disciplines self-interested managers (Jensen, 1986), financial leverage is expected negatively signed with respect to grant size. Regression (1) of Table 8 confirms empirically that grant size is at least in part determined by governance factors contrary to shareholders' interests. Leverage alone is insignificant, suggesting an absence of a disciplinary role attributed to debtholders. In contrast, when exercise price/stock price is substituted for grant size as the dependent variable (reported as regression (2)) the significance of the governance variables fades, except for the proportion of outside directors. The negative coefficient on this variable suggests outside directors are more likely to approve ITM grants when grants are small. In other words, shareholders through independent outside directors are effectively compensating CEOs for smaller grants with a discount. Such a trade-off is consistent with Choe (2003). The inverse relation (albeit weak) between the exercise price and leverage is also consistent with Choe. On balance, the evidence bestows qualified support for Choe *vis à vis* Hall and Murphy (2000, 2002).

5. Conclusions

We report the first tests of the key incentive-related propositions contained in the models of Hall and Murphy (2000, 2002) and Choe (2003). Our use of Australian data is justified on the dual grounds of (i) freely-adjusting exercise prices and grant size, and (ii) a sample period 1987-2000 that in Australia pre-dates not only executive stock option expensing requirements but also more sophisticated contracting techniques. Descriptively, we find that ATM grants are associated with positive abnormal returns at grant, while large OTM grants attract negative abnormal returns. The latter result is difficult to rationalize given that options do not have negative payoffs.

In Hall and Murphy (2000, 2002), the degree of executive risk aversion and private diversification determine pay-performance sensitivity. To the extent higher pay-performance sensitivity leads to higher new investment, stockholder returns are expected to increase in grant size and decrease in exercise price/stock price. ATM grants are generally expected to be the most efficient means to create incentive because the probability of exercise is balanced by the change in pay-performance sensitivity. ITM grants increase the probability of exercise but do not deliver a commensurate increase in pay-performance sensitivity. Conversely, the lower probability of exercise induced by a higher OTM grant is more than offset by the fall in pay-performance sensitivity of an OTM grant. However, empirical tests support only the general proposition of the optimality of ATM grants and otherwise provide little empirical support for the internal arguments of Hall and Murphy. Abnormal returns around grant test the effectiveness of the incentive provided by stock option grants in capturing new investment opportunities. ATM grants are generally found to exhibit higher (and positive) grant CARs than non-ATM grants, as suggested by Hall and Murphy. Controlling for pay-performance sensitivity, grant CARs are found decreasing in the grant size and exercise price/stock price. While the latter result reflects shareholders' predicted adjustment of exercise prices, the negative impact of grant size is anomalous with respect to their model.

In a complementary model, Choe (2003) develops a set of arguments linking optimal incentive creation with firm characteristics. In Choe's model, pay-performance sensitivity increases with changes in financial leverage and decreases with changes in stock volatility. Further, for a given exercise price, grant size is predicted to increase as option value (implied by lower stock volatility) decreases. On the other hand, for a given grant size the exercise price is predicted decreasing in leverage. Choe's propositions receive broad empirical support. The most anomalous result is the observed positive relation between stock volatility and grant size, suggesting grants are larger than shareholders require, but only when stock return volatility is high. While CEOs are found often to influence grant size, we uncover no evidence of undue influence on the exercise price because the negative relation between the exercise price and grant CARs is consistent with both optimal incentive compensation models.

The tests of Choe (2003) indicate an incentive problem with grant size: grants appear to be smaller than optimal for shareholders when stock volatility is low but appear larger than necessary when stock volatility is high. We trace the propensity for large grants to weak corporate governance. Further research is required to identify the agency problems that drive CEOs to influence grant size in their own interest. A possible solution is for shareholders to restrict individual grant sizes through the executive option plans rather than rationing (if at all) option grants during a given calendar interval. A restriction of this nature involves optimizing a trade-off between incentive creation and flexibility:

larger grants may be necessary when shareholders adjudge that more incentive is needed, but at the increased risk of wealth transfers flowing to influential CEOs.

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Table 1. Grant characteristics by moneyness

An in-the-money (ITM) grant occurs when exercise price on the grant date exceeds the stock price by 5 or more per cent; an out-of-the-money (OTM) grant occurs when the stock price on the grant date exceeds the exercise price by 5 or more per cent. Irregular grants are grants not made annually for at least three consecutive years to the same CEO and with a maximum variation of three months. Contingent CEO gain is the stock price at grant *minus* the exercise price, divided by the stock price at grant. Grant size is the number of granted options divided by the number of outstanding ordinary shares prior to grant (expressed as a percentage).

	Whole sample	ITM grants	ATM grants	OTM grants
Number of grants	168	65	55	48
Number of granting companies	51	25	28	29
Percentage of companies in resource sector	17.9	12.6	18.2	29.2
Percentage of irregular grants	73.8	80.0	72.7	66.7
Percentage of subsequently exercised options	60.7	64.6	63.6	52.1
Contingent CEO gain at grant				
mean	0.015	0.182	0.003	-0.196
median	0.013	0.186	0.010	-0.151
Grant size (%)				
mean	0.340	0.427	0.169	0.420
median	0.145	0.206	0.116	0.196
Term to expiry (years)				
mean	4.60	4.53	4.86	4.41
median	5.00	5.00	5.00	5.00
Interval to actual exercise (years)				
mean	3.18	2.90	3.17	3.67
median	3.33	3.07	3.41	3.72

Table 2. Firm characteristics by grant moneyness

An in-the-money (ITM) grant occurs when exercise price on the grant date exceeds the stock price by 5 or more per cent; an out-of-the-money (OTM) grant occurs when the stock price on the grant date exceeds the exercise price by 5 or more per cent. All book data are calculated with respect to the most recent fiscal year pre-grant. Stock volatility is measured by the annualized standard deviation of pre-award monthly stock returns (in percentage terms) over a minimum of 36 months prior to grant. Firm size is measured by *ln*(total assets). Market-to-book of assets is the sum of the market value of equity at grant plus the book value of debt, both divided by total assets of book. Financial leverage is the ratio of total debt to total assets, all at book.

	Whole sample	ITM grants	ATM grants	OTM grants
Number of grants	168	65	55	48
Stock volatility				
mean	12.33	13.63	11.23	11.85
median	9.90	10.80	7.40	10.76
Group differences:				
t statistic		2.100††		2.102††
Z statistic		2.516†††		2.103††
Firm size				

mean	5.912	5.480		6.667	5.593
median	5.947	6.057		6.315	5.717
Group differences:					
t statistic			3.687†††		3.329†††
Z statistic			3.234†††		2.539††
Market-to-book of assets					
mean	1.297	1.528		1.056	1.283
median	1.043	1.140		0.929	0.954
Group differences:					
t statistic			2.806†††		0.980
Z statistic			3.658†††		0.198
Financial leverage					
mean	0.190	0.201		0.195	0.171
median	0.180	0.191		0.207	0.138
Group differences:					
t statistic			0.270		0.946
Z statistic			0.831		1.729†

††† indicates two-tailed statistical significance at the 0.01 level.
†† indicates two-tailed statistical significance at the 0.05 level.
† indicates two-tailed statistical significance at the 0.10 level.

Table 3. Selected governance characteristics by grant moneyness

CEO turnover index is the number of CEO appointments for a given interval divided by the interval in years, where the interval commences three years before the first option grant and ends three years after the final option grant in the event of multiple grants. The proportion of outside directors is the number of directors not employed within the corporate group divided the number of directors on the board. CEO control of voting stock is the sum of beneficially and non-beneficially held stock divided by the number of outstanding ordinary shares, expressed as a percentage.

	Whole sample	ITM grants	ATM grants	OTM grants
Number of grants	168	65	55	48
CEO turnover index				
mean	5.222	5.753	4.933	4.934
median	4.500	5.000	4.500	4.000
Group differences:				
t statistic		1.193		0.001
Z statistic		-1.768†		-0.581
Proportion of outside directors				
mean	0.395	0.398	0.423	0.359
median	0.375	0.375	0.500	0.375
Group differences:				
t statistic		-0.929		-2.090††
Z statistic		-1.118		-1.899†
CEO CONTROL OF VOTING STOCK (%)				
mean	1.960	1.521	0.803	3.879
median	0.036	0.115	0.007	0.083
Group differences:				
t statistic		1.963†		2.370††
Z statistic		3.756†††		3.276†††

††† indicates two-tailed statistical significance at the 0.01 level.
†† indicates two-tailed statistical significance at the 0.05 level.
† indicates two-tailed statistical significance at the 0.10 level.

Table 4. Incentive and performance measures by grant moneyness

CEO gain is the stock price at grant *minus* the exercise price, divided by the stock price at grant. An in-the-money (ITM) grant occurs when exercise price on the grant date exceeds the stock price by 5 or more per cent; an out-of-the-money (OTM) grant occurs when the stock price on the grant date exceeds the exercise price by 5 or more per cent. The value per CEO granted option is the Black-Scholes call value adjusted for dividends. Incentive is the partial derivative of the call value with respect to the stock price. Pay-performance sensitivity is incentive multiplied by the number of granted options. [-1, 1] raw shareholder returns at grant comprise a three-day stock return around the grant date, which is day 0; all stock returns are adjusted for capitalization changes and dividend payments occurring during the event window. [-1, 1] cumulative abnormal returns (CARs) at grant are determined by subtracting expected stock returns from observed returns for this interval, where the expected returns are given by the market model.

	Whole sample	ITM grants	ATM grants	OTM grants
Number of grants	168	65	55	48
Incentive (delta)				
Mean	0.877	0.965	0.944	0.682
median	0.971	0.994	0.974	0.807
Group differences:				
t statistic		-1.819†	5.263†††	
Z statistic		-1.968††	4.648†††	
Pay-performance sensitivity				
Mean	0.479	0.568	0.470	0.369
median	0.196	0.249	0.200	0.133
Group differences:				
t statistic		-.0656	-0.873	
Z statistic		-0.340	-1.567	
[-1, 1] raw shareholder returns at grant				
Mean	-0.0001	0.0023	0.0094	-0.0143**
median	-0.0001	-0.0006	0.0076	-0.0052
Group differences:				
t statistic		-0.962	-2.530††	
Z statistic		-1.876†	-2.903†††	
[-1, 1] CARs at grant				
Mean	0.0021	0.0063	0.0140**	-0.0171**
median	0.0018	0.0021	0.0114**	-0.0150**
Group differences:				
t statistic		0.927	2.935†††	
Z statistic		1.573	3.091†††	

*** indicates two-tailed statistical significance at the 0.01 level.
** indicates two-tailed statistical significance at the 0.05 level.
††† indicates two-tailed statistical significance at the 0.01 level.
†† indicates two-tailed statistical significance at the 0.05 level.
† indicates two-tailed statistical significance at the 0.10 level.

Table 5. Cumulative abnormal returns around stock option grant

An in-the-money (ITM) grant occurs when exercise price on the grant date exceeds the stock price by 5 or more per cent; an out-of-the-money (OTM) grant occurs when the stock price on the grant date exceeds the exercise price by 5 or more per cent. Grant size is the number of granted options divided by the number of outstanding ordinary shares prior to grant (expressed as a percentage). [-1, 1] cumulative abnormal returns (CARs) at grant are determined by subtracting expected stock returns from observed returns for this interval, where the expected returns are given by the market model.

	Whole sample	ITM grants	ATM grants	OTM grants
Below-median grant size				
Number of cases	84	29	35	20
mean	0.0114**	0.0199**	0.0120**	-0.0019
median	0.0043**	0.0108**	0.0114**	-0.0063
Above-median grant size				
Number of cases	84	36	20	28
mean	-0.0072	-0.0047	0.0175**	-0.0279**
median	-0.0088	-0.0088	0.0106*	-0.0274**
Group differences:				
t statistic	2.362††	2.271††	-0.426	1.948††
Z statistic	2.257††	2.061††	0.263	1.969††

** indicates two-tailed statistical significance at the 0.05 level.
* indicates two-tailed statistical significance at the 0.10 level.
†† indicates two-tailed statistical significance at the 0.10 level.

Table 6. Tests of Hall and Murphy (2000, 2002)

Pay-performance sensitivity is incentive multiplied by the number of granted options, where incentive is the partial derivative of the call value with respect to the stock price adjusted for dividends. CARs are [-1, 1] cumulative abnormal returns at grant. Grant size is the number of granted options divided by the number of outstanding ordinary shares prior to grant. Risk aversion is $MRP/.01(\sigma^2)$ where the market risk premium (MRP) is set at 8 per cent and σ is the standard deviation of stock returns for a given company. Private diversification is proxied by $ln(1/Percentage of stock held)$. Incentive is the option delta adjusted for dividends. At-the-money (ATM) grants are those where the stock price at grant minus the exercise price, divided by the stock price at grant, is within ± 5 per cent of the stock price at grant. *t* statistics are shown in parentheses. All regressions are White-corrected for heteroskedasticity.

Dependent variable: *n=168*	OLS (1) Pay-performance sensitivity	2SLS (1A) Exercise price/stock price	2SLS (1B) Grant size	OLS (2) [-1, 1] CARs at grant	OLS (3) [-1, 1] CARs at grant	OLS (4) [-1, 1] CARs at grant
Adjusted R^2	0.035	0.003	.099	0.086	0.072	0.020
F	4.019	1.772	10.763	8.836	7.517	4.415
Probability	.020	.173	.000	.000	.000	.037
CONSTANT	0.316 (2.871)	1.175*** (11.835)	0.613*** (3.561)	-0.038 (-1.572)	0.027** (2.106)	-0.004 (-0.727)
Grant size		-0.005 (-0.068)		-0.014* (-1.744)	-0.016* (-1.862)	
Exercise price/stock price			-0.007 (-0.068)		-0.018 (-1.440)	
Risk aversion	0.018** (2.482)	-0.005* (-1.735)	-0.008** (-2.223)			
Private diversification	-0.012 (-0.590)	-0.015 (-1.374)	-0.056*** (-3.139)			
Incentive (delta)				0.051** (2.030)		
ATM grant (=1)						0.018** (2.202)

*** indicates two-tailed statistical significance at the 0.01 level.
** indicates two-tailed statistical significance at the 0.05 level.
* indicates two-tailed statistical significance at the 0.10 level.

Table 7. Tests of Choe (2003)

Pay-performance sensitivity is incentive multiplied by the number of granted options, where incentive is the partial derivative of the call value with respect to the stock price adjusted for dividends. Grant size is the number of granted options divided by the number of outstanding ordinary shares prior to grant. Financial leverage is the ratio of total debt to total assets, all at book. Stock volatility is measured by the annualized standard deviation of pre-award monthly stock returns (in percentage terms) over a minimum of 36 months prior to grant. *t* statistics are shown in parentheses. All regressions are White-corrected for heteroskedasticity.

	OLS (1)	OLS (2)	OLS (3)
Dependent variable:	Pay-performance sensitivity	Exercise price/ stock price	Grant size
n=168			
Adjusted R^2	.089	.039	.021
F	9.190	3.727	2.191
Probability	.000	.023	.091
CONSTANT	0.315***	1.275***	-0.024
	(2.679)	(11.812)	(-0.128)
Financial leverage	1.633***	-0.989**	0.482
	(3.279)	(-2.488)	(0.721)
Stock volatility	-0.012**	-0.003	0.015**
	(-2.059)	(-0.653)	(2.410)
Grant size		0.050	
		(0.763)	
Exercise price/ stock price			0.078
			(0.733)

*** indicates two-tailed statistical significance at the 0.01 level.
** indicates two-tailed statistical significance at the 0.05 level.

Table 8. Effects of CEO influence

Grant size is the number of granted options divided by the number of outstanding ordinary shares prior to grant. Financial leverage is the ratio of total debt to total assets, all at book. CEO control of voting stock is the sum of beneficially and non-beneficially held stock divided by the number of outstanding ordinary shares, expressed as a percentage. The proportion of outside directors is the number of directors not employed within the corporate group divided the number of directors on the board. CEO turnover index is the number of CEO appointments for a given interval divided by the interval in years, where the interval commences three years before the first option grant and ends three years after the final option grant in the event of multiple grants. *t* statistics are shown in parentheses. All regressions are White-corrected for heteroskedasticity.

	(1)	(2)
Dependent variable:	Grant size	Exercise price/stock price
n=168		
Adjusted R^2	.080	.066
F	4.650	3.940
Probability	.001	.004
CONSTANT	0.531**	1.381***
	(2.399)	(8.085)
Financial leverage	0.659	-0.696*
	(1.154)	(-1.926)
CEO control of voting stock (%)	0.038**	0.015
	(2.145)	(1.392)
Proportion of outside directors	-0.725**	-0.533**
	(-2.062)	(-2.115)
CEO turnover index	-0.335**	0.014
	(-2.091)	(0.096)

*** indicates two-tailed statistical significance at the 0.01 level.
** indicates two-tailed statistical significance at the 0.05 level.
* indicates two-tailed statistical significance at the 0.10 level.

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