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Directors' remuneration: A comparison of Italian and UK non-financial listed firms' disclosure

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ABSTRACT

Directors' remuneration is a key issue for both academics and policymakers. It has caused enormous controversy in recent years. This study uses a comprehensive index to analyse the disclosure of directors' remuneration in Italian and UK listed firms. It finds that the level of voluntary disclosure is significantly associated with firm-specific incentives, such as the demand for information from investors and the need for legitimacy. It finds that the level of voluntary disclosure is significantly higher in the UK than in Italy and that firm-specific incentives to disclose voluntary information differ according to the institutional setting in which a firm operates. In the UK, firm-specific incentives mostly come from the demand for information, estimated with the level of ownership diffusion, and the need for legitimacy generated by poor market performance and shareholders' dissent. In Italy, firm-specific incentives seem to be represented by the need for legitimacy generated by media coverage. This study also provides evidence that, in both countries, the information disclosed in corporate documents does not allow readers to obtain a comprehensive picture of directors' remuneration. Bonuses are poorly disclosed even though they are a key element of directors' remuneration. This finding is clearly important for policymakers at European and national level.

1. Introduction

Directors' remuneration aims to align the interests of directors with those of shareholders, thereby reducing agency problems (Jensen & Meckling, 1976). However, directors' remuneration, of itself, could give rise to agency problems (Bebchuk, Fried, & Walker, 2002). This is one of the key areas where directors may have a conflict of interest and where due account should be taken of the interests of shareholders (EU Commission, 2004). Controversy surrounding directors' remuneration reflects the perception that payments have been excessive and that the lack of timely and adequate disclosure has resulted in increased information asymmetry and rent-extraction (Bebchuk et al., 2002; Jensen, Murphy, & Wruck, 2004). The demand for public disclosure arises from information asymmetry and agency conflicts between directors and outside investors (Healy & Palepu, 2001). Disclosure on directors' remuneration would help to resolve such problems. It can reduce information asymmetry on complex remuneration arrangements that can be an important mechanism to transfer wealth from shareholders to directors (Bebchuk et al., 2002; Laksmana, 2008; Nelson, Gallery, & Percy, 2010). Moreover,

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directors' remuneration has been blamed for playing a central role in many international corporate scandals, as well as having been a key factor that contributed to the global financial crisis (e.g., Bebchuk & Fried, 2005). Consequently, regulators have been concerned that directors should be accountable to shareholders by disclosing their remuneration policies. In particular, the EU Commission (2004, 2009) has issued two non-binding recommendations to its country members. Therefore, directors' remuneration disclosure is a topic relevant to both academics and policymakers. It also provides an appropriate setting to examine the disclosure of board practices and investigate potential drivers for providing voluntary disclosure (Laksmana, 2008).

By analysing a sample of 234 size- and industry-paired Italian and UK non-financial listed firms in 2009, this paper achieves two purposes. First, it explores how directors' remuneration practices[1] are disclosed in two major European economies, the UK and Italy, by developing a comprehensive disclosure index. Greater transparency enables shareholders to monitor the relationship between directors' remuneration and firm performance better and to verify whether remuneration is effectively designed to align directors' and shareholders' interests (Craighead, Magnan, & Thorne, 2004; Laksmana, 2008; Laksmana, Tietz, & Yanget, 2012). Second, this paper investigates which factors are associated with the level of voluntary disclosure provided by firms. It finds that both country-level and firm-specific factors, such as the demand for information from outside shareholders and the firms' need for legitimacy, are significantly associated with the level of voluntary disclosure of directors' remuneration.

Italy and the UK were chosen because they can be characterised as being at opposite ends of a spectrum. UK firms are considered as having the best practices in Europe (e.g., Ferrarini, Moloney, & Ungureanu, 2010; RiskMetrics, 2009), while Italian firms have been seen as exemplifying bad practice (Ferrarini et al., 2010; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; Patel, Balic, Bwakira, Bradley, & Dallas, 2003). UK listed firms are usually seen as having an agency problem between executives and shareholders (Mallin, 2010), while Italian listed firms are characterised by an agency problem between controlling and outside shareholders (Melis, 2000). These different agency problems might have different influences on disclosure practices (e.g., Patelli & Prencipe, 2007). While the UK belongs to the common law group of countries, generally characterised by high disclosure, Italy is included in the civil law countries (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1999), which are characterised as oriented toward “legal compliance”, with low disclosure (e.g., Meek & Thomas, 2004). Finally, Italy and the UK provide a distinct institutional setting in which to study the influence played by shareholders' votes on directors' remuneration disclosure, as they are among the few countries in which listed companies are mandated to let shareholders vote on directors' remuneration (‘Say on pay’). However, this shareholder vote on remuneration has mainly an advisory role (UK Company Act 2006, Italian Civil code, art. 2363 bis).

Our study contributes to the voluntary disclosure literature in four ways.

First, by focussing on directors' remuneration disclosure it examines a voluntary disclosure decision that reflects a potential conflict of interest between directors and outside shareholders (e.g., Bebchuk et al., 2002). By contrast, most of the extant literature focuses on the explanations for disclosure where shareholders' and directors' interests are not likely to be in conflict (e.g., Archambault & Archambault, 2003; Botosan, 1997; Markarian, Parbonetti, & Previts, 2007; Patel et al., 2003; Prencipe, 2004).

Second, this study extends the emerging literature on voluntary disclosure on directors' remuneration (e.g., Byrd, Johnson, & Porter, 1998; Laksmana, 2008; Schiehll, Soares Terra, & Gomes Victor, 2013). We developed a more comprehensive disclosure index than those used in previous studies (Laksmana, 2008; Liu & Taylor, 2008). This covers all the relevant directors' remuneration components, as confirmed by active institutional investors. By contrast, previous studies mainly focused on specific remuneration components, such as share-based remuneration (Liu & Taylor, 2008; Schiehll et al., 2013), termination payments (Liu & Taylor, 2008), and remuneration peer groups (Byrd et al., 1998).

Third, by conducting a comparative analysis, this paper explores the potential variation of directors' remuneration disclosure in two major European economies and contributes to the debate on whether voluntary disclosure is associated with country-level characteristics and/or firm-specific factors (e.g., Archambault & Archambault, 2003; Cheng & Courtenay, 2006; Doidge, Karolyi, & Stulz, 2007; Durnev & Han Kim, 2005). It provides new evidence that voluntary disclosure is driven by a combination of institutional and firm-specific factors.

Fourth, by shedding light on directors' remuneration disclosure in European firms, this study contributes to our understanding of the extent to which the findings of previous studies, which mainly focused on US firms (e.g., Byrd et al., 1998; Laksmana, 2008), can be generalised in other institutional settings. This paper shows that previous findings related to US firms are mainly confirmed in an institutional setting which shares similar characteristics (e.g. Anglo-American market-oriented setting, like the UK), but are less applicable to a non-Anglo-American institutional setting (e.g. relationship-based setting, like Italy). This result represents an important contribution to the more generic corporate disclosure literature (e.g. Archambault & Archambault, 2003; Botosan, 1997; Cheng & Courtenay, 2006; Giner Inchausti, 1997; Markarian et al., 2007; Marston & Shrives, 1991; Patel et al., 2003; Prencipe; 2004). The demand for information is an important driver for voluntary disclosure only in Anglo-American settings, while its importance in other institutional settings seems to be limited. Although the extent of voluntary disclosure is associated with the search for legitimacy in both institutional settings, this

[1] Directors' remuneration comprises both executive and non-executive remuneration. This paper considers the disclosure of both. However, given the material difference in the overall amounts generally paid to executive and non-executive directors, concerns about directors' disclosure are usually about executive directors' remuneration. See Table 2 for a full list of items considered.