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Australia's 'two-strikes' rule and the pay-performance link: Are shareholders judicious?

Reza Monem *, Chew Ng

Dept. of Accounting Finance & Economics, Griffith Business School, Griffith University, 170 Kessels Road, Nathan, Qld 4111, Australia

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ABSTRACT

To improve accountability of executive compensation, Australia introduced the 'say-on-pay' legislation in 2011, which is widely known as the 'two-strikes' rule. We investigate the consequences of this new rule for the pay-performance link in Australian firms. Employing a matched-pair design, we find that pay changes of the chief executive officer and the key management personnel were not significantly positively related to the stock returns of the firms that registered a 'first strike' in 2011 under the 'two-strikes' rule. However, the relations improved significantly in 2012. Our results also suggest that the shareholders of the 'first-strike' firms may have been over-enthusiastic about their voting power in 2011 but exercised this power more judiciously in 2012. Our findings provide important insights for the global debate on governance of executive compensation.

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1. Introduction

In the Western world, executive compensation has been controversial since the 1990s (Jensen and Murphy, 2004) and has become more so with considerable media scrutiny and public anger toward executive compensation since the advent of the global financial crisis (e.g., Matolcsy et al., 2012; *The Australian Financial Review*, 23 November, 2011 and 5 March, 2013; *The New York Times*, 4 February, 2009). With the apparent aim to restrain executive compensation, effective from 1 July 2011, Australia introduced new legislation, *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011* (*Remuneration Amendment Act*, hereafter). Under the new legislation, if the remuneration report of a firm receives 25% or more dissent votes for two consecutive years (hence, 'two strikes'), the board of directors except the CEO may face re-election. This voting right to reject the remuneration report is new for the shareholders of Australian firms because previously, shareholder voting on the remuneration report had no specific and predictable consequences.

Since its inception, the *Remuneration Amendment Act* has been heavily criticized by corporate Australia (e.g., *The Australian Financial Review*, 10 December, 2012 and 10 January, 2013). We provide the first piece of evidence on the consequences of this controversial legislation. Using newly available data of 2011 and 2012, we investigate the effect of the *Remuneration Amendment Act* on the pay-performance link in two Australian samples. The pay-performance link in Australian firms is expected to improve as a consequence of the *Remuneration Amendment Act*. We consider pay at two levels: the CEO's total annual remuneration (CEO pay) and the key management personnel's total annual remuneration (KMP pay).[1,2] Particularly, we

* Corresponding author. Tel.: +61 7 373 53598.
E-mail address: r.monem@griffith.edu.au (R. Monem).

[1] We conducted a full analysis on both CEO pay and KMP pay; however, for brevity, we report only the results on CEO pay. The results based on KMP pay are qualitatively similar to those based on CEO pay. Hence, we discuss the KMP results only as part of robustness tests (Section 6). Full results on the KMP pay are available from the corresponding author on request.

[2] Section 300A of the *Corporations Act 2001* and *AASB 124 Related Party Disclosures* define key management personnel as 'persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity'.

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investigate whether shareholders exercise this newly acquired power judiciously[3] and whether the pay-performance link of the firms that received a 'strike' is weaker than that of a control group. Furthermore, we investigate whether the pay-performance link improves following the 'first strike'.[4] We also compare the pay-performance link of the 'first-strike' firms against that of the 'two-strike' firms.

A related study on shareholder oversight using the Australian setting is Clarkson et al. (2011). Clarkson et al. analyze a sample of 240 Australian Securities Exchange (ASX)-listed firms over the period 2001–2009 and find that increased shareholder oversight (through 'no' votes on the remuneration report) strengthens the pay-performance link and makes the pay setting process more accountable. A fundamental difference between this study and Clarkson et al. (2011) is that, prior to 1 July 2011, receiving 25% or more 'no' votes on remuneration reports did not have any predictable or specific consequence for the affected firms. In our sample, the firms that received 'two strikes' could be required to elect a new board of directors. Furthermore, all of the ASX firms with voting and remuneration data available over the period 2001–2009 were potentially eligible to enter into Clarkson et al.'s sample. In contrast, only the firms that received 25% or more dissent votes ('no' votes) on the remuneration report qualified to enter into our treatment sample. Finally, the sample in Clarkson et al. (2011) potentially suffers from survivorship bias due to the requirement of data continuity over a 9-year period; hence, the evidence may not be generalizable to other samples. We conduct a cross-sectional study, and our samples comprise mostly small and less-profitable firms where the pay-performance link is plausibly indeterminate.

We identified a sample of 104 firms that received a 'first strike' in 2011, the very first year the new legislation was introduced. We identified another 105 firms that received a 'strike' in 2012. Incidentally, 22 firms were common in these two samples. That is, these 22 firms received a 'second strike' in 2012. We matched each 'strike' (treatment) firm with a control firm. Our purpose was to achieve control groups that were very similar to the treatment groups in terms of firm and industry economic environments so that the effect of confounding factors could be minimized in our study. Hence, we matched control firms first by GICS-based economic-sector classification,[5] second by operating revenue, and third by fiscal year-end. We employed both multivariate and univariate tests to address our research questions.

We find that the CEO pay change was not significantly positively related to performance in the 'first-strike' firms in 2011. However, for these firms, CEO pay changes were negatively related to the level of shareholder dissent on the remuneration report. Furthermore, unlike in the control group, the pay-performance link has been increasing with the level of shareholder dissent in the 'first-strike' firms. This result suggests that shareholders of the 'first-strike' firms in 2011 may have been overenthusiastic in exercising their votes in the first year of implementation of the new legislation and 'punished' the 'first-strike' firms more severely than they deserved. In 2012, the pay-performance link was stronger compared with that in 2011 and positive both for the 'first-strike' firms and the control firms. The pay-performance link for the 'first-strike' firms of 2011 has been increasing in 2012 with lagged shareholder dissent. Furthermore, the firms that received the 'second strike' in 2012 had a weaker pay-performance link compared with that of the firms that received the 'first strike' in 2012. Finally, the pay-performance link in the 'second-strike' firms had been decreasing in the contemporaneous shareholder dissent level in 2012. Overall, our results provide evidence of the positive effect of the 'two-strikes' rule on the pay-performance link in Australian firms.

CEO compensation has received considerable attention from researchers in accounting, economics, finance, law, and management. Two strands of research that have emerged are as follows: the determinants of the level and structure of CEO compensation and the pay-performance link. It is documented that CEO pay is positively related to firm size (Core et al., 1999; Merhebi et al., 2006; Zhou, 2000), stock return (Clarkson et al., 2011; Merhebi et al., 2006; Zhou, 2000), and weak governance structure (Core et al., 1999). However, CEO pay is negatively related to firm risk (Core et al., 1999; Merhebi et al., 2006), CEO share ownership, and the presence of a large blockholder (Core et al., 1999). Higher CEO pay also suggests the demand for higher-quality CEOs (Chalmers et al., 2006). Furthermore, externally hired CEOs are paid more than internally hired CEOs (Deckop, 1988), although the latter outperform the former in terms of accounting and market-based firm performance (Ang and Nagel, 2013). In relation to CEO pay, although the pay-performance link is generally positive (Clarkson et al., 2011; Jensen and Murphy, 1990; Merhebi et al., 2006; Schaefer, 1998), the evidence is restricted to large and more successful firms. There is evidence that changing the CEO compensation structure from cash-based to equity-based compensation leads to a negative pay-performance link in the year following the change (Matolcsy et al., 2012). Moreover, if the CEO compensation is inconsistent with firm characteristics, the pay-performance link is weak (Matolcsy and Wright, 2011).

We contribute to the CEO compensation literature in general and the pay-performance link literature in particular by investigating the pay-performance link in the 'first-strike' firms and the 'two-strike' firms. First, we demonstrate how mandated governance regulation in the form of shareholders' 'say on pay' can enhance the CEO pay-performance link. Second, unlike Clarkson et al. (2011) who provide evidence of the pay-performance link in large and potentially more successful firms, our evidence comes from small and less-profitable firms. Third, to the best of our knowledge, this study provides

[3] We interpret the term 'judiciously' in a broader sense. Shareholders will be considered to be judicious if the level of shareholder dissent (proportion of 'no' votes on the remuneration report) reflects the weakness in the pay-performance link.

[4] The 'first strike' or a 'strike' occurs when 25% or more 'no' votes are cast against the adoption of a remuneration report in a company's annual general meeting (AGM) (Section 250U of the *Remuneration Amendment Act*). We use the terms 'strike' and 'first strike' interchangeably to refer to the same event. When a firm receives a 'strike' without any prior history, it is labeled as the 'first strike'.

[5] The Global Industry Classification Standard (GICS) has been jointly developed by Standard and Poor's and Morgan Stanley Capital International. Sector is the first level of industry classification in the GICS, which comprises 10 economic sectors, 23 industry groupings, 59 industries, and 122 sub-industries.

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