Corporate Governance and CEO Pay: Evidence from UK Travel and Leisure listed firms

Abstract

This paper investigates from the UK context, the impact of board and CEO characteristics on CEO compensation in Travel and Leisure firms. Namely we employ, board size, board independence and board meetings to reflect board characteristics. We also include two CEO features, CEO tenure and CEO age into our models. Using panel data analysis, the findings in this paper indicate that board size, board independence and CEO age are important factors affecting CEO pay. In addition, we report a positive non-linear relationship between CEO tenure and firm performance. Hence, using Travel and Leisure listed firms; we provide new evidence of the relationship between corporate governance and CEO compensation.

Keywords: CEO compensation, board characteristics, CEO characteristics, Travel and Leisure firms.

Introduction

Rewarding CEOs with bonus, salary and other benefits has been always a debate in the literature. From agency theory perspectives, even CEOs need to be motivated to meet firms' objectives by rewarding them. Previous studies, in CEO compensation, have mainly been focused on publicly listed firms (see Antle and Smith 1986; Ciscel and Carroll 1980; Jensen and Murphy 1990). However, we find limited evidence for this relationship within the tourism related firms (see for example, Skalpe, 2007). Our study hence aims to bridge this gap in the literature and to provide a more focused discussion using UK listed Travel and Leisure firms.

In this study we measure the importance of the CEO by CEO pay slice (CEO pay), which is the percentage of CEO compensation to the total cash compensation of top executives (Bebchuk et al., 2011). High CEO compensation can indicate that CEOs have superior qualifications or even capabilities. This will enhance CEOs contribution towards the firm. However, high "CEO pay" can be explained by the managerial power view point, and hence weak governance will lead to weak compensation contracts, and thus powerful CEOs can take such advantage for their own benefits.

The relationship between corporate governance factors and top management pay has gain much interest by researchers due to the growing concerns by the authorities regarding firms' internal monitoring activities (see, Cadbury report 1992; Smith report 2002). For example, Ozkan (2007) argues that corporate governance characteristics help in alleviating agency problems between management and shareholders and in turn have an impact on the CEO pay. Unlike previous studies, we provide a new evidence of the relationship between corporate governance mechanisms and top management pay in tourism related firms. This is an interesting setting given the differences in the governance structure for such context if

compared to other firms[1]. There is a general consensus that firms within the hospitality sector are more prone to agency related problems due to governance and ownership issues (Guillet et al., 2012). In addition, the real estate component of such industry would increase the capital intensity within the tourism related firms will lead to extra agency conflicts.

In the UK, the recommendations of Cadbury report (1992), Greenbury report (1995) and Hampel report (1998) were the base to formulate a part of London Stock Exchange Combined code (FRC, Combined Code, 2008). Therefore, if compared to US firms, CEOs of UK firms have relatively weaker influence over the remuneration committee when negotiating their compensation packages. Thus, UK firms, including tourism related companies, are more likely to compensate their CEOs based on their capabilities to enhance firm performance. It is worth noting that Ozkan (2011) has indicated that such reports, which linked CEO compensation with firm performance, are indeed not effective and thus reinvestigating the top management pay within the UK context and, in particular the tourism related firms would add significantly to the CEO compensation literature.

There is limited evidence of investigating the top pay for tourism related firms within the UK context and hence the main aim of this study is to complement the existing research in the CEO compensation area by investigating the role of governance mechanisms on the CEO pay within the UK tourism related firms. Tourism as a sector is important in the UK, since it is one of the six biggest industries and sectors (Government Tourism Policy, 2011).

[1] For example, we compare our sample of Travel and Leisure listed firms with other non-financial firms listed in FTSE 350, we find that on average board size is relatively smaller in our sample (around 9) compared to around 10 for the non-financial counterparts (for the same period). CEO tenure is on average around 4.6 years in our sample while it is 5.70 years in other non-financial firms. CEO compensation for our sample is relatively smaller than their non-financial counterparts (0.39 vs 0.42).

Skalpe (2007) reports that the gender wage gap is higher in tourism related firms if compared to their manufacturing counterparts, since the female CEOs in tourism related firms are employed in small firms (compared to manufacturing firms). Al-Najjar (2014, 2015) also denotes that tourism related firms might have some differences in their corporate governance and ownership structure. This study, thus, expands the work of Skalpe (2007), in CEO compensation with tourism related firms, and shed a new light on the relationship between corporate governance characteristics and CEO pay using UK Travel and Leisure listed firms.

Accordingly, our contribution has two folds. First, we examine how corporate governance variables such as board size, board independence and board meetings will affect CEO pay. Secondly, we examine the role of CEO characteristics, such as CEO tenure and CEO experience on CEO compensation within the listed tourism firms' context.

The organization of the paper is as follows: Section 2 presents the theoretical framework; Section 3 provides the discussion of the hypotheses; Section 4 describes the data and methodology; Section 5 presents the empirical findings and Section 6 concludes.

Theoretical Framework

Our main theoretical framework in this study is based on two stands: rent extraction theory and incentive alignment theory (see, Chalmers et al. 2006). The rent extraction theory states that any increase in equity holdings would be in line with the expected good news and would be used by top managers (with private information) for their own interests. Yermack (1997), Carpenter and Remmers (2001) and Bebchuck al. (2002) provide support for this theory. This theory, hence, questions the efficiency of the boards as they depend on CEOs for information and their limited access for stock returns. This leads CEOs to over control their compensation even if it exceeds the optimal shareholders compensation. In addition, less active governance

monitoring will lead to more agency conflicts that might affect firm's prospectus (Chalmers et al., 2006). Bebchuck et al. (2002) argue that because top managers can control their compensation, they can affect the amount and timing of equity arranged by the board to maximize their own wealth regardless to shareholders' wealth. If a firm is to be sold, the rent extraction theory argues that any grants provided to top management before the sale are intended to enrich the top managers. Narayanan and Seyhun (2005) and Lie (2005) argue that top management would use private information and influence their compensation to maximise the equity awards. Core et al. (1999) argue that strong CEOs are more able to extract rents from the compensation process. Hence, rent extraction arises in weakly governed companies.

In contrast, the incentive alignment theory suggests that any increase in equity holdings would lead top managers to take actions to enhance shareholders' wealth. This theory states that governance factors affect the efficiency of monitoring management and executives and hence linking management decisions to firm benefits. This theory, hence, suggests that the reward structure is formed to provide incentives to managers to take decisions within the interests of shareholders and thus reducing agency conflicts. Different studies have supported the incentive alignment theory such as Fich and Shivdasani (2005), Hanlon et al. (2003) and Hall and Murphy (2002). Chalmers et al. (2006) using a sample of Australian firms find a support for the incentive alignment theory viewpoint and report a weak evidence of the rent extraction theory. It is also argued that if a firm is to be sold, then the "incentive alignment" would mean that any agreed options to the top management before finalising the deal will aim to at enhance firm value since the CEOs will aim to get the best possible price.

Hypotheses Development

We discuss in this section the hypotheses of our main variables:

Board Size and Independence: Board size is one of the key corporate governance aspects. The board is comprised of executive and independent directors. Board size can be seen as an efficient tool for monitoring firm's management (see Fama and Jensen 1983). However, it is suggested that large boards are inefficient because of the expected difficulties in the collaboration among the board members. Conyon and Peck (1998) argue that there is a positive relationship between board size and CEO compensation. Core et al. (1999) argue that firms with large boards are inefficient in monitoring. Hence, small boards might have more control and thus low CEO pay. Given the contradictory evidence on the role of board size in listed tourism related firms, as reported by Al-Najjar (2014); we posit that board size has an impact on CEO pay in our context.

In addition, board independence is a major mechanism which helps in alleviating agency problems. Having a high percentage of independent directors on boards is regarded as an indicator for proper corporate governance. This is because they are in a position to effectively control and monitor management (Hermalin and Weisbach,1998). Core et al. (1999) suggest that weak corporate governance (such as less board independence) is positively related to CEO compensation. As sustained by Fama and Jensen (1983), independent directors have the ability to strictly monitor top management. Conyon and Peck (1998) argue that if high salaries are linked to agency problems then, higher level of board independence will eventually reduce compensation. Nevertheless, there is some evidence that independent boards do not effectively influence CEO compensation (see Mangel and Singh, 1993). From tourism listed firms view point, Al-Najjar (2014) detects that board independence is positively related to firm performance and hence can be seen as an effective governance tool

in such context. Therefore, we posit a negative relationship between board independence and CEO compensation. This is consistent with the incentive alignment theory perspective, and hence we posit that:

H1: There is a relationship between board size and CEO compensation.

H2: There is a negative relationship between board independence and CEO compensation.

Board meetings:

Vafeas (1999) examines the relationship between the frequency of board meetings, board activity and firm financial performance. His results show that boards can react to poor performance by having more board meetings. He reports that more frequent board meetings can enhance firm performance. Hence, we can conclude that the frequency of board meetings is seen as an important feature in firms' governance and might affect the compensation packages, as such packages are linked to firm performance. Brick et al. (2006) report a positive association between board meetings and compensation of directors, given that directors are paid for each meeting. Board meetings as a governance tool is under-researched in listed tourism firms, we expect it might have an impact on CEO pay as a governance mechanism. Hence, we expect that:

H3: There is a relationship between board meetings and CEO compensation.

CEO Characteristics: We investigate two CEO features on CEO pay. First we consider CEO tenure which is measured as the CEO experience. Several empirical studies have analyzed CEO tenure as a determinant of CEO compensation (see Leonard, 1990; Cordeiro and Veliyath, 2003). Hill and Phan (1991) show that the longer a CEO holds his/her position, the more experience he/she has, and thus constructing an experienced career which entails the CEO to be highly compensated. The second investigated CEO feature is CEO age. It is

expected that older CEOs, with adequate years of experience and expertise, are more likely to be rewarded for their work. Thus, a positive link is expected for CEO age. Madura et al. (1996) suggest that old aged CEOs and those with more experience (tenure) are highly compensated. In tourism related firms, there is some evidence of the relationship between CEO characteristics and CEO payment, for example Skalpe (2007) detects a positive association between CEO age and CEO gender pay gap. Hence, in line with rent extraction theory, we posit that CEO tenure and CEO age are positively related to CEO pay.

H4: There is a positive relationship between CEO tenure and CEO compensation

H5: There is a positive relationship between CEO age and CEO compensation

Data & Sample

Our sample is based on Travel and Leisure listed firms in FTSE 350. FTSE 350 index includes the largest 350 companies by market capitalisation having their primary listing at the London Stock Exchange. This index is formed by the combination of the FTSE 100 index (the largest 100 companies) and the FTSE 250 Index (the next largest 250 firms). Thus, FTSE 350 index refers to the largest firms listed at the London Stock Exchange.

From this index, we have a sample of 260 firm year observations from 27 Travel and Leisure listed firms (un-balanced panel data) that provided the required information for the period from 2003 to 2012. This period provides us with the most complete set of data (especially for the governance related data for our sample).

Table 1 reports the descriptive statistics for the dependent variable (CEO compensation) and our independent variables (corporate governance, CEO features and firm specific variables). The mean of CEO compensation ratio-CEO pay slice- is around 0.39 and hence the CEO pay slice, compared to top directors' compensation, is around 39% of the top paid

directors. The average board size is 9 with a maximum of 17 directors in our sample. Moreover, board independence is about 64% of the sample. Concerning the CEO characteristics, it is found that on average a CEO is 52 years of age in the sample. Furthermore, on average a CEO has about 5 years of experience.

<<Insert Table 1 about here>>

Table 2 shows the Pearson correlation matrix for the independent variables used in the analysis. It can be observed form the Table that there are no high correlations among the variables and hence multicolinearity is not of a concern in our models.

<<Insert Table 2 about here>>

Methodology

In order to investigate our hypotheses, we estimate the fixed effects models[2] as well as the cross sectional –time series models using two ways clustering (firms and years), as a robust check, for our panel data of 260 firm year observations. Our model to be examined is defined below:

$$CEOcomp_{it} = \beta_0 + \beta_1 Board\_size_{it} + \beta_2 Board\_Independence_{it} + \beta_3 Board\_meetings + \beta_4 CEO\_Age + \beta_5 CEO\_Tenure + \beta_6 Leverage_{i,t} + \beta_7 size_{i,t} + \beta_8 ROE_{i,t} + year\_dummies + \varepsilon_{it}$$

Where CEOcomp is the dependent variable, CEO pay slice, which is the percentage of the total cash compensation of the CEO to the top executives compensation; Board_size is the number of board directors; board_independence is the ratio of number of independent directors to total number of directors on the board; Board meetings frequency is measured by

[2] The Lagrange Multiplier indicates that the random effects models are more appropriate than the pooled models in our analysis. In addition, the Hausman test indicates that the fixed effects models are more appropriate than the random effects models. Hence, we report in this study the fixed effects models.

the number meetings in a year; CEO_Age is the age of the CEO and CEO_Tenure is the number of years the CEO is serving in his/her position. We control for leverage (total debt to equity ratio), size (natural logarithm of total assets) and ROE (measured by net income divided to total equity). To capture the trend and other un-included elements we include year dummies in our models, and for parsimony we do not report them in our tables.

Results

The fixed effects models regressions are reported Table 3, while the two way clustered errors are reported in Table 4. Four models are presented and year dummies are included wherever is mentioned in the Tables. Models 1 and 2 exclude the control variables while Models 3 and 4 include them.

It can be observed that board size has a significant negative sign in all the models. This indicates that firms with large boards are more hesitant to pay a high compensation to their CEOs. This result is in line with our first hypothesis and represents the importance of large boards (in our setting) in determining the CEO pay. This result can be seen as evidence that CEOs will not be able to control large boards, leading to lower CEO compensation. We also report a significant positive sign in all the models for board independence and thus indicating that independent directors are seen as a week monitoring tool. This result contradicts our second hypothesis. It may be possible, to argue, as sustained by Zajac and Westpal (1994) that board independence might be ineffective as they have low percentage of shares owned. Hence, this leads to a decrease in the required control and monitoring and thus rewarding CEOs are more prevalent, as there is less control of top management. This positive association is consistent with the findings of Ozkan (2007) who also reports that the higher the percentage of independent directors in a firm, the less effective they are in monitoring management operations. This result is in line with the rent extraction theory viewpoint.

The results in Tables 3 and 4 do not show significant evidence for board meetings on CEO compensation. As regards CEO characteristics (CEO age and CEO tenure), our results in Table 4 indicate that there is positive effect of CEO age on CEO compensation in Models 1, 2 and 4. Thus, older CEOs are better remunerated than younger CEOs (Smith and Watts, 1982), which is consistent with *H5*. We also report that there is a positive association between firm size and profitability in firm performance, these results are reported in Panel A, Table 3.

<<Insert Table 3 about here>>

<<Insert Table 4 about here>>

Accordingly, we provide further evidence -using Travel and Leisure firms- regarding the association between corporate governance and CEO compensation, in which we find that board size, board independence and CEO age affect CEO compensation.

It is worth noting that the Hausman test of endogeneity shows that there is no endogeneity problem in our models and hence our models are more appropriate than the 2SLS models. We also run several models, such as the first lagged models, to double check the robustness of our results, the results are not significantly different than what is reported in this study.

As additional robustness check we add to our models the square values of CEO tenure and CEO age and report the results in Table 5. The results are consistent with the previous findings as we detect a negative relationship between CEO pay and board size while a positive relationship is found between CEO pay and board independence. We also report a positive association between firm size and profitability. As regards CEO tenure, the results are positive and significant, which is consistent with our hypothesis, the results of the squared

value of CEO tenure is found to be negative and significant, indicating a non-linear positive relationship between the period served the CEO and his/her compensation.

<<Insert Table 5 about here>>

Summary and overall conclusion

This study aims to investigate the relationship between corporate governance features and CEO compensation using UK Travel and Leisure listed firms. The study employs panel data analysis for our models and provides evidence that corporate governance have an impact on CEO pay. In particular, we find that board size is negatively related to CEO pay and board independence is positively associated to CEO pay (in line with the rent extraction theory). In addition, regarding the CEO characteristics, we detect that CEO age is positively associated with CEO compensation and thus older CEOs are paid more than younger CEOs. Finally, we detect a non- linear positive relationship between CEO tenure and CEO pay. These results reflect the unique setting of tourism related firms in the UK. Accordingly, we provide further evidence, using tourism related firms, about the effect of corporate governance on CEO compensation policy.

These findings are important for UK policy makers and the management of UK listed firms as we find that large board size is associated with lower CEO compensation. Also, we detect a weak impact of board independence as a monitoring tool. Thus, the role of independent directors in UK listed firms need to be identified and clarified in a clear way. In addition, we detect that CEO age can reflect experienced CEOs and hence they are paid higher than young CEOs. Finally, we report that there is a positive but non-linear link between CEO tenure and CEO compensation, indicating the importance of CEO tenure in negotiating his/her compensation package.

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Table 1 Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
Ceop	0.387	0.136	0.000	0.820
Board_size	8.960	2.331	4.000	17.000
Board_Independence	0.642	0.124	0.380	1.000
Board_meetings	9.400	3.306	4.000	27.000
CEO_tenure	4.568	4.585	0.000	21.600
CEO_age	51.624	6.886	32.000	64.000
Leverage	0.041	0.072	0.000	0.860
Size	6.170	0.671	4.020	7.500
ROE	0.256	0.338	-0.960	0.999

CEOpay is CEO pay slice defined as the percentage of the total cash compensation of top executives captured by the CEO; Board-size is the number of directors on board; Board-Independence is the ratio of non-executive directors to total number of directors on board; Board-meetings measured as number of board meetings per year,; CEO tenure is the number of years for the CEO in his position; CEO age is the age of the CEO;; Leverage is ratio of total debt to total equity; Size is the natural logarithm of total assets; ROE is net income to total equity.

Table 2 Correlation Matrix

	Board_size	Board_Independence	Board_meetings	CEO_tenure	CEO_age	leverage	size	ROE
Board_size	1.000							
Board_Independence	0.153***	1.000						
Board_meetings	-0.142*	-0.029	1.000					
CEO_tenure	0.078	-0.077	-0.163**	1.000				
CEO_age	0.195***	0.263***	0.041***	0.310	1.000			
leverage	0.154*	0.026	0.008	-0.115	0.102	1.000		
size	0.525**	0.080**	0.001*	0.306	0.419*	0.099	1.000	
ROE	0.149*	0.060	0.019	0.116	-0.041	-0.053	0.128	1.000

Note: Variables are defined in Table 1, ***, **, * significant at 1%, 5%, and 10% levels respectively.

Table 3 Determinants of CEO compensation –Fixed effects models

	Model 1		Model 2		Model 3		Model 4	
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
Board_size	-0.023***	0.007	-0.023***	0.007	-0.020***	0.006	-0.020***	0.007
Board_Independence	0.446***	0.096	0.384***	0.114	0.412***	0.100	0.371***	0.118
Board_meetings	-0.002	0.003	-0.003	0.004	-0.003	0.003	-0.003	0.004
CEO_tenure	0.003	0.004	0.004	0.004	0.002	0.004	0.002	0.004
CEO_age	-0.001	0.002	-0.001	0.002	-0.001	0.002	-0.001	0.003
leverage					-0.087	0.083	-0.082	0.088
size					0.085*	0.049	0.063	0.053
profitability					0.0001***	0.000	0.0001***	0.000
constant	0.360**	0.152	0.376**	0.164	-0.153	0.325	-0.008	0.371
Years	No		Yes		No		Yes	
R^2	0.207		0.300		0.260		0.29	

Note: Variables are defined in Table 1; ***, **, * significant at 1%, 5%, and 10% levels respectively

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Table 4 Determinants of CEO compensation –Clustered errors models

	Model 1		Model 2		Model 3		Model 4	
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
Board_size	-0.026***	0.002	-0.026***	0.002	-0.027***	0.003	-0.027***	0.003
Board_Independence	0.469***	0.104	0.457***	0.119	0.481***	0.119	0.459***	0.148
Board_meetings	0.001	0.003	0.001	0.003	0.001	0.003	0.001	0.003
CEO_tenure	-0.002	0.002	-0.001	0.002	-0.002	0.003	-0.002	0.003
CEO_age	0.002*	0.001	0.002*	0.001	0.001*	0.001	0.002	0.001
Leverage					0.026	0.188	0.031	0.205
size					0.011	0.016	0.012	0.017
profitability					-0.024	0.025	-0.025	0.031
Constant	0.208***	0.060	0.240***	0.064	0.183**	0.090	0.207**	0.121
Years	No		Yes		No		Yes	
R2	0.330		0.350		0.330		0.360	

Note: Variables are defined in Table 1; ***, **, * significant at 1%, 5%, and 10% levels respectively; standard errors are robust to serial correlation within each group and time.

Table 5 Further analysis

	Model 1		Model 2		Model 3		Model 4	
	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.	Coef.	Std. Err.
Board_size	-0.022***	0.007	-0.022***	0.007	-0.018***	0.007	-0.018***	0.006
Board_independence	0.461***	0.096	0.355***	0.113	0.367***	0.118	0.435***	0.100
Board_meetings	-0.002	0.003	-0.002	0.003	-0.003	0.003	-0.002	0.003
CEO_tenure	0.014**	0.006	0.019***	0.007	0.014**	0.007	0.009	0.006
CEO_tenure^2	-0.001**	0.000	-0.001***	0.000	-0.001**	0.000	-0.001	0.000
CEO_age	-0.002	0.025	-0.019	0.026	0.008	0.028	0.020	0.026
CEO_age^2	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Leverage					-0.071	0.090	-0.084	0.084
size					0.049	0.053	0.080*	0.048
profitability					0.0001*	0.000	0.0001***	0.000
Constant	0.348	0.643	0.829	0.682	-0.188	0.794	-0.693	0.713
Years	No		Yes		Yes		No	
R^2	0.220		0.270		0.320		0.280	

Note: Variables are defined in Table 1; ***, **, * significant at 1%, 5%, and 10% levels respectively.