

Executive compensation in The Netherlands and its relation to firm performance.

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May 2009

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1 Introduction

In this thesis I will look at the compensation of CEO's in Dutch listed companies. I have chosen this subject with a view to the fact that CEO-compensation has been much in the news lately both in Europe and The United States. Economically as well as politically the continuous rise in CEO-compensation has created a lot of unrest and negative feeling in Western society. A typical example of this is the promulgation of the "graaitax"; the very name of which suggests money-grubbing and greediness. It was recently introduced by the Dutch Minister of Finance in response to the growing opposition to the "graaicultuur" as represented by the excessive bonuses and salaries paid out to CEO's.

Almost everyone has an opinion of his own about the subject and a great many interest groups are involved in the ongoing discussion concerning CEO-compensation policy. Within the companies there are the members of the supervisory board, the employees, the shareholders and, of course, the executives themselves. But not only within the companies is it a topical subject. Among participants in the discussion are also politicians, external auditors, researchers, the media and, of course, the general public. They all have their own point of view about the compensation levels of CEO's and one of the main problems is that most of them do not understand why a specific CEO should get a particular amount of compensation.

At first CEO compensation was an issue of only the company and its shareholders, but it is seen much broader now. Two years ago the the Dutch consumers organisation (Consumentenbond, February 2007) made an appeal to its members not to buy products of Nutricia as a protest to the total of 14 million euro's that Nutricia's CEO, Jan Bennink, was expected to get that year as a compensation. In a petition "Abzockerei(swindel)-Initiative" Thomas Minder, owner of the Swiss company Trybol, offered 150.000 signatures to the Swiss government in support of a legal ban of golden handshakes and advance payments to CEO's of listed companies. His action was instigated by the bankruptcy of Swissair, which also led to financial problems in his own company and many other supply companies of Swissair. However, the bankruptcy did not have any consequences for Swissair CEO, Mario Corti, who got 5 years of salary in advance. The majority of people taking part in the public debate are critical of the levels of the compensation that CEO's of listed companies receive. They can't see any justification for

what they consider to be excessively high salaries that are paid out and there is a general feeling that in this respect things have got out of hand. Therefore it will be interesting to try and find out how the levels of CEO-compensation are actually determined and executive pay and performance are linked. I will focus on the Dutch situation in particular. Although a lot of research has been done into the relation between executive pay and firm performance, only very little attention has been paid to the situation in The Netherlands. Duffhues and Kabir (2007) investigated the pay-performance relation of executives of firms listed on the Euronext Amsterdam over the years 1998-2001. They put the result of their research into perspective, because in their opinion the available data were primitive. They assumed that changes in corporate governance would provide more adequate data and thus lead to more transparency. They expected a stronger pay-performance relation as the outcome of a similar research over a later period.

In the second chapter of this thesis I will describe the theory of Corporate Governance in The Netherlands including the law involving the specific two-tier “structuurregime”, with a management board made up of executive board members and a separate supervisory board of non-executive members. I will pay attention to the Dutch Corporate Governance Code “Tabaksblat” and the recommendations of the Frijns-committee. The Dutch Corporate Governance Code is based on the agency-theory. In the agency theory the shareholder is referred to as principal and the executive as the agent. According to this theory, if a company has an effective remuneration policy, the interest of the agent is equal to the interest of the principal, and consequently the agent will be acting in the interest of the principal.

The law involving “structuurregime” was changed in 2004 in order to enlarge the role of holders of shares and holders of certificates of shares. Both this law and the “Tabaksblat” code were introduced on the assumption that the enlargement of the power of the shareholders, combined with an increased transparency of the remuneration policy, would contribute to a more universal acceptance of the compensations. I will also describe the “Wet Harrewijn”, which is supposed to give the works council more insight into the remuneration of the executives. In this first part of my thesis I will try and find an answer to the question whether the laws and regulations involving corporate governance have enlarged the transparency of compensation-policy in The Netherlands.

In the third part I will give an overview of relevant research into CEO-compensation levels that has recently been done. It is important to know what hypotheses have been investigated and what the findings of the researchers were. This in order to be able to analyse and interpret the data correctly and to establish what relations were found by them. Most research on the issue has been done in the United States, but the situation there differs from the situation in Europe. In the United States executives are much more in control of company policy and this plays a significant role. Furthermore, in the United States, unsuccessful executives run far more risks than their European colleagues.

Contrary to the majority of studies concerning remuneration of executives, in my review, I will also include treatises which emphasise the managerial power theory. Until the current credit crunch most economists fully supported the agency theory. Social scientists, however, welcomed and accepted the managerial power theory with open arms as it added underlying psychological / biological motives as a plausible explanation of human behaviour in a particular environment.

My research is based on the figures from the annual reports of 50 Dutch listed companies, 25 companies listed in the Amsterdam Exchange Index and 25 relatively smaller companies listed in the Small cap Index. My starting point is the year 2004, because from then the corporate governance code “Tabaksblat” did apply. I will examine the relation between the level of CEO-compensation and the performance of their firms, using both accounting figures as well as total share holder return as proxies for firm performance. Contrary to the assumption of Duffhues and Kabir (2007), I do not expect a significant positive relation between CEO compensation and firm performance.

In addition, I will also assess the hypothesis that the appointment of a new CEO leads to an increase of CEO income.

Most of the research is done for large companies and their top managers. Of course, these are the people that get the highest salaries and bonuses. The commotion in the press, both national and international, focuses, in particular, on this category of executives. However, in my opinion, too little attention is being paid to the compensation of CEO's of smaller companies, in spite of the fact that they outnumber the big shots by far and are, as such, of great interest to the overall economic development. An interesting question is whether the situation with regard to transparency and comparison is the same in the smaller listed companies, with relatively lower paid CEO's. To assess that I will also include a group of CEO's of smaller listed companies in my research.

In my thesis I will try to find the answer to a number of questions by reviewing existing research and examining relevant data. These questions are:

- Do the practices of remuneration of small corporations in The Netherlands deviate from the practices of the companies listed in the AEX?
- Will the publication of the remunerations as required by law and code result in understanding and acceptance of the current practices?
- What further research would be interesting in relation to this subject?

2 Developments in the field of Corporate Governance

In this chapter I will explain, what is meant by the term “corporate governance” and will clarify the agency theory on which the concept of corporate governance elaborates.

Duffhues and Kabir (2007) presumed that changes in corporate governance would self-evidently lead to different outcomes of studies comparable to theirs. As my research centres its attention on the period 2004-2007, when most of the changes in corporate governance were implemented, it is obvious of interest to know the substance of these changes.

2.1 The Agency Theory

Already in the seventeenth century large companies emerged which were organised in essence as public limited companies. They were only a small number however, as the majority of the companies until the twentieth century were family owned and members of that same family also formed the direction. So the interests of the directors matched the interests of the owners of the company since they were united in the same family or even in the same persons. In the nineteenth and twentieth century the public limited company became the usual legal form of the large companies. It allowed the firms to acquire money from investors on the stock exchange market to realise growth and take-overs. Large companies came into existence, many of them developed into multinational corporations. The directors of these companies no longer owned (a substantial part of the) company. They managed the firm on behalf of the shareholders (Dijk van, K. and others, 1991). A manager was appointed to direct the firm because of his skills, no longer on the grounds of his origin. These developments also implied that the interests of the directors of the company did no longer automatically match the interests of the owners of the company. After all the shareholders want to maximise the return of their investments and to create long term value of their shares. The managers, in their turn, strive to enlarge their own wealth and try to further their careers. And which interest will prevail as far as the executive is concerned?

The executive directors hold a powerful position: they have control of more information about the company, of the decisions to be taken and of the activities to display. The shareholders can hardly judge whether the executives put in maximum effort to optimise the value of the firm. And it is difficult for the principal to verify what the agent is actually doing.

Then there is the problem of risk sharing: overall shareholders tend to participate in more than one company and are risk neutral towards a specific company. The executives are bound, at least in career terms, to the firm they direct and therefore are risk averse.

By avoiding risks, the directors do not always promote the interests of the shareholders, who what's more can not adequately monitor the direction of the company. This diversion of interests leads to loss of value: the agency costs.

Table 1: Source: Eisenhardt (1989), p.59

Agency Theory Overview

Key idea	Principal-agent relationships should reflect efficient organization of information and risk-bearing costs
Unit of analysis	Contract between principal and agent
Human assumptions	Self-interest Bounded rationality Risk aversion
Organizational assumptions	Partial goal conflict among participants Efficiency as the effectiveness criterion Information asymmetry between principal and agent
Information assumption	Information as a purchasable commodity
Contracting problems	Agency (moral hazard and adverse selection) Risk sharing
Problem domain	Relationships in which the principal and agent have partly differing goals and risk preferences (e.g., compensation, regulation, leadership, impression management, whistle-blowing, vertical integration, transfer pricing)

The agency theory attempts to describe the relationship between the shareholders (the principal) who delegate work to the executive (the agent), who performs that work (Eisenhardt, 1989). It is concerned with resolving the three problems that may emerge in agency relationships, as mentioned above. Eisenhardt (1989) states the crucial question: “Is a behaviour-oriented contract (e.g., salaries, hierarchical governance) more efficient than an outcome-oriented contract (e.g., commissions, stock options, transfer of property rights, market governance)?” She summarises the dilemma’s dealt with by the agency theory in the table 1.

The agency theory has developed along two lines: the positivist and principal-agent approach (Eisenhardt, 1989). Positivist researchers focus on situations in which it is likely that the principal and agent have conflicting goals. They conduct studies on the principal-agent relationship between owners and managers of large, public companies describing the governance mechanisms that limit the agent’s self-serving behaviour. For example, managerial opportunism can be decreased by increasing the firm ownership of the manager. Besides, the board of directors can play a significant role to remove the information deficit as to remuneration contracts in order to control managerial behaviour. In comparison with the positivist stream, the principal-agent stream (theory) is abstract and mathematical. It focuses on determining the optimal contract between the principal and the agent, behaviour versus outcome. The nature of the remuneration of the executive forms an important component of this contract. If the principal has full information of what the agent has done, then a contract that is based on behaviour is most efficient. The executive, in the same manner as all the other employees, offers his labour in return for money and/or other benefits. This kind of contract would be unproblematic if this trade mechanism worked properly. In reality, however, it does not necessarily prevent the executive from pursuing his own interests.

What we see, however, is that the principal is not fully informed. One way is to use the remuneration to try and influence the behaviour of a person. To do so, (part of) the remuneration-package will be made dependable on the financial results of the company and/or other performance of the executive. According to the agency theory it is possible to design a remuneration package that matches the interests of both agent and principal, so the agent is stimulated to act (also) on behalf of the principal.

In order to be able to design an effective package it is very important to find the right balance between performance on the one hand and reward on the other. Rewards should be related to goals that are in the interests of shareholders and must be realisable, not easy to manipulate and objectively measurable. Much used elements of a performance-based remuneration package are (Van Praag, 2005):

- The assignment of shares. The more shares a CEO owns, the more his remuneration depends on the returns on this stock. In this way the conflict between interests of the shareholder and the CEO can be limited.
- The assignment of options. If executives get options to exercise later on, their reward will depend on the return on shares in the future. If the firm performs well, the exercise price will be higher. Bad performance will annihilate the value of the options.
- The Long Term Incentive Plans link the assignment of options and shares to performance measures. The executive gets his shares or can exercise his options only if the settled targets for a certain period are met.
- The assignment of bonuses. Bonuses are given based on measures and linked to targets. They belong to the 'cash' part of the remuneration scheme. Firms often use the possibility to readjust the amount of the bonus to the circumstances under which the executive has performed. This discretionary judgment allows a reward without performance.

In fact the two streams of the agency theory described above are complementary: the positivist theory identifies various contract alternatives, whereas the principal-agent theory indicates which contract is the most efficient under varying levels of outcome uncertainty, risk aversion, information and other variables (Eisenhardt, 1989). In this thesis I will discuss the works of scholars of the positivist stream as well as those of the principal-agency theory. Moreover I will use both approaches to check my hypotheses.

2.2 Corporate governance

In 2003 the Committee Tabaksblat published a report on corporate governance (see par. 2.6) in which they formulated principles and best practices for the behaviour of listed companies. In their reaction to the proposals of the Committee Tabaksblat, the Dutch government described good corporate governance as follows: efficient supervision on the directors of listed companies, a balanced distribution of influence over the board of directors, the supervisory board and the general shareholders' meeting, and an adequate account by the board of directors and the supervisory board of the efforts to further the

continuity of the firm and a careful appraisal of the various interests, among them those of employees and other stakeholders of the company (Kabinetsreactie op Tabaksblat code, 2004). Eyck van Heslinga and Schoenmakers (2006) gathered several definitions of the concept of corporate governance from various countries. Although the emphasis in these definitions differs, they share the notion that it concerns the system, structure or process on which the company is managed. The Code Tabaksblat follows the subscription of the Peter's Commission: "management and power, responsibility and influence and accountability and supervision. In this respect integrity and transparency play an important part. These aspects are a subject for discussion in many parts of society, in both the private and the public sector" (Peters, 1997). It involves company processes, laws and regulations made by government or other institutions, and it affects the way the company is directed. Corporate governance does also include the relationships between the company and its stakeholders and the relationships among those stakeholders themselves. The most important stakeholders in this respect are the shareholders, the management, and the board of directors. Other stakeholders involved are employees, customers, suppliers, banks, regulating institutions and, of course, the society as a whole. The board of directors mostly plays a key role in corporate governance. They are responsible for the organisation's strategy, the development of directional policy and the ensurance of accountability of the organisation to its shareholders and other authorities. Already in 1776 Adam Smith indicated the dilemma's following the separation of ownership and management in public limited companies: "The directors of such companies, however, being the managers rather of other peoples money than of their own, it cannot well be expected, that they should watch over it with the same vigilance which partners in private copartnery frequently watch over their own...negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company" (cited by Eyck van Heslinga and Schoenmakers, 2006). As one of the aims of corporate government is to safeguard the interests of the shareholders, the agency theory, considered before, plays an important role in its conceptualization (Eyck van Heslinga and Schoenmakers, 2006). It explains how to align the interests of executives and shareholders and to increase the accountability of the executive towards the shareholders. Unequal access to information about the ins and outs of the company and the different interests of the various stakeholders has led to the drawing up of corporate codes in most western capitalistic societies.

Especially in times of economic turmoil and losses of stock value, the behaviour and pay of the executives led to calls for corporate governance reforms. In the aftermath of the crash of 1929 the American scholars Berle and Means researched the consequences of ownership and control being separate. They argued that the separation of ownership and management allowed the pillaging of the corporations by the executives. (Eyck van Heslinga and Schoenmakers, 2006). The implications of their work was clear. Berle and Means advocated embedded voting rights for all shareholders, greater transparency, and accountability.

In the years 2000 till 2004 a wave of accounting scandals revealed fraudulent activities by trusted executives of large companies. Such misdeeds involved complex methods for misusing funds, overstating revenues, understating expenses, overstating the value of corporate assets or underreporting the existence of liabilities. Among the fraudulent companies were well-known, and by then respected, firms like Xerox (United States), AOL (United States), Ahold (The Netherlands), Parmalat (Italy), Worldcom (United States) and Enron (United States). The last two scandals gained worldwide attention by their dimensions.

Enron was hailed, until its exposure in corporate fraud, by many, including the workforce, as an overall great company, praised for its large long-term pensions, benefits for its workers and extremely effective management. As was later discovered, many of Enron's recorded assets and profits were inflated, or even wholly fraudulent and nonexistent. In the case of Worldcom a \$ 11 billion fraud was involved (Romar and Calkins, 2006), the largest fraud disclosed till the Madoff-scandal occurred in 2008 (The Guardian, 2008). As a result of the scandals and bankruptcies in the early 2000's, the international society showed a growing interest in corporate governance reform. Companies, shareholders, politicians and even the man in the street were involved in the discussion on this topic and in many countries this resulted in updating the laws and regulations involving corporate governance (Gerard, 2006).

In the United States these regulations were set down in the Sarbanes-Oxley Act which explicitly focuses on the reliability of the accounting. The directors have to endorse the truthfulness of the annual report and have to state that the company is 'in control'. Based on the Sarbanes-Oxley Act, directors who deliberately publish incorrect financial information can now, by law, be held personally responsible for misgovernment and can consequently be sent to prison.

In Europe, The European Commission published the Action Plan 'Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward' in 2003. This Action Plan sets out the reasons why it is necessary that the European regulations involving Corporate Governance should be modernised referring to the effect of recent scandals, the internationalization of companies, the continuing integration of European capital markets, the constant progress in information and communication technologies and the expansion of the European Union.

The main objectives of the Action Plan are to extend the rights of shareholders, to protect third parties and to foster efficiency and competitiveness of business. The Action Plan is based on a comprehensive set of proposals, grouped under six chapters: corporate governance, capital maintenance and alteration, groups and pyramids, corporate restructuring and mobility, the European Private Company, cooperatives and other forms of enterprises.

The European Commission did not come up with one single European corporate code, because of the diverging corporate law constellations in the various European countries. According to the Action plan, every member state of the European Union develops a code, which companies have to follow. If a company does not follow the code or even a part of the code, they will have to explain why they decided not to do so in their annual report.

In The Netherlands in 1997 the Peters Committee issued forty commandments on corporate governance ahead of the European guidelines as incorporated in the Action Plan of 2003. Because the commandments were not embedded in the Dutch legal corporate law structure, companies were insufficiently motivated to comply to them. The Action Plan, on the other hand, provided the necessary legal basis for corporate regulations, so in the Netherlands the Code Tabaksblat was formulated. In Belgium separate codes for public (Code Lippens) and non public companies (Code Buysse) are used.

Key elements of good corporate governance principles include, according to the Committee Tabaksblat (Tabaksblat, II.3, 2003), honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organisation.

2.3 The International Financial Reporting Standards (IFRS)

Transparency was not just furthered by good corporate governance, international accounting standards also contribute to a clear insight of the policies and performance of the companies. Therefore, in the year 2000 the European Council adopted the Financial Services Action Plan (FSAP), as the legislative framework for developing the single European market in financial services. It contained 42 legislative measures which aimed to fulfil the objective of creating an effective, integrated financial services market. The Commission also stated its intention to make it mandatory for all listed enterprises (including banks and insurers) in the European Union to prepare consolidated financial statements in accordance with International Accounting Standards (IAS): “The application of the standard will ensure that the financial impacts of the use of financial instruments are reflected in company financial statements appropriately and with full transparency. This standard has been prepared by a private accounting standard setter (<the International Accounting Standards Board (IASB) J.J.>) and will become operative in 2001. The Community endeavours by this directive to facilitate the use of the standard by companies right from the beginning, since otherwise serious problems would be created.”

Indeed, the FSAP came into effect, when, in 2002 all member states of the European Union agreed that publicly traded companies in the European Union must prepare their consolidated accounts on the basis of IFRS, as adopted for use in the European Union, in the year 2005 at the latest. The requirement to apply the IFRS affected more than 7 000 European companies that had earlier used their own national Generally Accepted Accounting Practices (GAAP). The International Accounting Standards (IAS), which are issued by the International Accounting Standards Committee (IASC) and if necessary adapted by the International Accounting Standards Board (IASB) , are included in the IFRS.

Before the year 2005 the annual reports of Dutch listed companies were composed in accordance with the Richtlijnen voor de Jaarverslaggeving (Dutch Generally Accepted Accounting Practices). Starting on 1 January 2005, however, these companies, as all other listed companies in the European Union, had to use IFRS. Non-listed enterprises and foundations, to which book 9 of the Civil Law also applies, are free to choose IFRS or the Richtlijnen voor de jaarverslaggeving.

It is self-evident that uniform standards for accounting and reporting lead to more transparency and comparability. An important difference between Dutch GAAP and IFRS is that under IFRS assets are appraised at fair value, whereas Dutch GAAP uses the purchase price, in the case of permanent assets minus the statutory write-downs. Therefore, an annual report based on IFRS is a more correct reflection of the actual position of the company.

In 2005 the IFRS was adopted in The Netherlands. For reasons of comparability IFRS requires that at the first application, the comparative figures in the annual reports are based on IFRS as well (IFRS 1). Thus, IFRS figures of 2004 are also available for the companies. Apart from the introduction of the Tabaksblat Code as of January 1 2004, the availability of comparable data under the same rules for reporting influenced my decision to choose the period 2004-2007 for my research.

2.4 The Civil Law (“Burgerlijk Wetboek”)

Of course, (international) understandings about accounting standards and good corporate governance need to be grounded on the national law systems. In The Netherlands corporate governance is embedded in the book 2 of the civil law, which is only applicable on public limited companies and ltd's. In 1971 it was laid down that the public limited companies should apply the so-called ‘structuurregeling’. Among other things they were obliged to install a supervisory board separated from the board of directors (FEM Business, 2003).

The exhaustive discussion about corporate governance in 2004 led to modification of this section of the law. The amendments aimed to strengthen the position of shareholders and certificate holders in relation to the supervisory board. In the past the supervisory board appointed new members themselves. Under the 2004 regulations the supervisory board still nominates new members of the board but the general meeting of shareholders is the body that actually decides. The general meeting of shareholders, under certain conditions, is also entitled to dismiss the complete supervisory board. In matters of remuneration the general meeting of shareholders have the final say. They determine the remuneration policy and have to approve the allowance of bonuses, options and shares to the executives. The general meeting of shareholders also has to approve important changes in the general policy of the company, and the mergers, take-overs etc. of the company cannot take place

without their consent. Finally the general meeting of shareholders decides on the annual account.

As for the remuneration of executives and supervisors the company is obliged to account for all payments, irrespective of the kind of remuneration. Also payments to former executives and supervisors must be accounted for and the same goes for payments by a subsidiary company.

The law allows the Dutch government to implement supplementary regulations concerning the content of the annual report and that is what they did by designating the Code Tabaksblat as corporate governance code for companies to comply to.

2.5 Board Structure in the Netherlands

In corporate governance an important issue concerns the ultimate responsibility for the direction of the company and the control over the management. In Western society the dilemma of “checks and balances” between the interests of the executives and the shareholders are solved in different ways.

In the United States, as in a lot of other countries, a corporation is governed by a board of directors which has the power to choose a chief executive officer, the CEO. The CEO is one of the members of the board, but has the wide power of managing the corporation on a daily basis. The CEO, however, needs to get the approval of the other members of the board for certain major actions, such as hiring his/her immediate subordinates, raising money, acquiring another companies and carrying out major capital expansions or other expensive projects. The other members of the board can either be executives or non-executives. This type of organization of the direction of a company is known as a one-tier structure (Peij, 2008).

In the Netherlands a lot of companies, especially the ones listed on the stock exchange market, are forced by law to use the “structuurregime” and have a two-tier structure. In this structure there is a management board, composed of executive board members and a separate supervisory board with non-executive members (Peij, 2008).

The ‘structuurregime’ takes effect on public limited companies (NV’s) and Ltd’s (BV’s), cooperation’s and mutual insurance companies that meet the following criteria:

- over 100 employees in The Netherlands
- a compulsory (by law) employees council
- a capital of over € 16.000.000.

The use of the structuurregime is optional, even if the firm does not meet all three of the above mentioned criteria, as long as the company has an employees council.

Main features of the structuurregime concern the shift of influence and authority within the company. A company under the structuurregime has a two-tier structure and, therefore, an obligatory supervisory board. This supervisory board was given three rights that in a one-tier company normally rest with the general meeting of shareholders. These rights are:

- appointment of members of the management board;
- nomination of new supervisory board members; and
- dismissal of individual supervisory board members.

The general meeting of shareholders actually appoints the nominated supervisory board members. With notification of the employees council, the general meeting of shareholders can also dismiss the whole supervisory board.

Before 2004, the supervisory board had three competences that in a one-tier company normally rest with the general meeting of shareholders:

1. the appointment of executives;
2. the appointment of members of the non-executive board;
3. the statement of the annual report.

In October 2004, the law involving “structuurregime” was changed in order to enlarge the role of holders of (certificates of) shares and of the employees council as well.

The rights of holders of certificates of shares were significantly strengthened. They did not have voting rights but since October 2004 they can ask for a mandate to use the voting rights belonging to the underlying shares. Refusal, limitation or revocation is only possible in a limited number of circumstances.

The general meeting of shareholders, which in the past could only approve of the report stated by the supervisory board, are now themselves also responsible for the annual report.

2.6 The Dutch Corporate Governance Code

The Dutch civil law compelled the Dutch listed companies to have a two-tier structure, but in many corporate policy matters, the Dutch government let the initiative to the stakeholders themselves to regulate the relations in and between companies, management, supervisors and shareholders.

2.6.1 The Dutch Corporate Governance Code by the Tabaksblat Committee

In 2003 the first Corporate Governance Committee was installed, under chairmanship of M. Tabaksblat. This Tabaksblat Committee was an initiative of a number of private parties: Euronext Amsterdam, The Netherlands Centre of Executive and Supervisory Directors (NCD), the Foundation of Corporate Governance Research for Pension Funds (SCGOP) and the Association of Securities Issuing Companies (Eyck van Heslinga and Schoenmakers, 2006). The Committee was invited to write a new code of best practice involving corporate governance. As it was felt that the accounting scandals and frauds of recent years had undermined the trust in the management and supervision of the companies, the initiators aimed and the government hoped, to restore faith in the management of the listed companies. A sound and transparent system of checks and balances in companies should help to achieve these objectives. The characteristic feature of the code is that it is based on self-regulation.

The subject of social-responsible entrepreneurship is not reflected on in the code, because of its all-embracing nature that is not specifically tied to a national corporate structure.

The Dutch Corporate Governance Code was published December 2003 and was declared applicable to all Dutch companies listed on the Amsterdam Stock Exchange Market.

The code is not a law in itself, but a legislative code of conduct. Its guidelines are based on existing legislation (including ‘structuurregime’ and jurisprudence) concerning the internal and external relations of listed Dutch companies. The code is principle-based and not rule-based: it is the spirit and not the letter of the code which is important; application of the code should improve the access of companies to the capital markets; the effectiveness of companies can be enhanced in this way (Code Tabaksblat, Parameters for a new code).

The Dutch Corporate Governance Code is effective from the financial year starting on or after 2004, January 1st. The stipulated code contains both principles and concrete provisions which persons involved in a company (including members of the management board and the supervisory board) and stakeholders (including institutional investors) should take into consideration in their relation towards each other. The appliance of the principles has to be stated in the annual report of a listed Dutch company.

In the Dutch Corporate Governance Code these principles are the basis for developing specific best practice provisions. The provisions create a set of standards for the behaviour of management board members and supervisory board members, also in relation to the external auditors, and shareholders. They reflect national and international best practice

and can be regarded as an interpretation of general principles of good corporate governance. Deviation from the best practice provisions is allowed, but reasons must be given. This means that the 'apply or explain principle' has to be used and listed companies have to explain in their annual report why and to what extent they do not apply the best practice provisions of the Dutch Corporate Governance Code.

The position of the shareholders of the company is strengthened by the Code. In their general meeting the shareholders can discuss the corporate governance structure and the adjustment of the Code. They can call for application of the code and also may authorise non-application of some code-provisions. If the general meeting of shareholders gives their approval, the company has to comply to the approved.

The general meeting of shareholders have also acquired the right to state the annual account and to refrain from discharging management board an/or supervisory board for liability for their conduct.

Furthermore shareholders representing a qualified amount of capital were given the right to put subjects they wanted to discuss on the agenda of the general meeting of shareholders.

For practical reasons holders of certificates of shares are put on one level with holders of actual shares.

The code is based on the two-tier system in The Netherlands, with a management board and separate supervisory board. Provisions regarding the supervisory board are also applicable to non-executive directors in a one-tier structured company and provisions regarding the management board are in these companies also applicable to executive directors.

Before the introduction of the Corporate Governance Code the members of the supervisory board co-opted themselves but now the general meeting of shareholders have the decisive voice where the appointment of new supervisors nominated by the supervisory board is concerned. And a majority of the general meeting of shareholders, if they represent more than one third of the outstanding shares of the company, can even dismiss the complete supervisory board.

The Corporate Governance Code expects the supervisors to be intensely involved with the company, therefore it recommends that one person should not to be engaged as a supervisor in more than five companies. Besides, the supervisors have to be independent of the company and its management so that they are able to exercise their duties properly.

One of the important subjects of the Corporate Governance Code is the remuneration of the executives and supervisors. The general meeting of shareholders got control over the remuneration policy, even though the final say over compensation for individuals within the framework of this policy stayed with the supervisory board. The Tabaksblat Committee states the following principles regarding this subject:

“The amount and structure of remuneration which the management board members receive from the company for their work shall be such that qualified and expert managers can be recruited and retained. If the remuneration consists of a fixed and a variable part, the variable part shall be linked to previously determined, measurable and influenceable targets, which must be achieved partly in a short and partly in a long term. The variable part of the remuneration is designed to strengthen the board members’ commitment to the company and its objectives”. (Code Tabaksblat, II.2 Amount and composition of the remuneration)

“The report of the supervisory board shall include the principle points of the remuneration report of the supervisory board concerning the remuneration policy of the company. The notes to the annual accounts shall, in any event, contain the information prescribed by law on the level and structure of the remuneration of the individual members of the management board.” (II.2: Determination and disclosure of remuneration)

“The supervisory board shall determine the remuneration of the individual members of the management board on a proposal by the remuneration committee and within the scope of the remuneration policy adopted by the general meeting of shareholders” (II.2: Determination and disclosure of remuneration).

Best practice provisions regarding the principles above, involve conditions for receiving and retaining shares and options, exercising options, determination of option-value, remuneration on dismissal, content of the report of remuneration, explanation of special remuneration and the way of disclosure of remuneration contract.

To evaluate the operation of the Corporate Governance Code Tabaksblat and its implementation by listed companies and shareholders, the Dutch government installed a Monitoring Committee at the end of the year 2004. This committee was not entitled to adapt the provisions of the code. In the long run a separate committee will be put together to evaluate the code and adapt it (see below).

In its first report (2005) the Monitoring Committee was positive with respect to the compliance of the listed companies to the Code Tabaksblat. After all the percentages of appliance of and compliance to the code were high even after one year. The committee,

however, observed a lack of uniformity and thus transparency in the field of remuneration policy. The companies that were examined did, on the one hand, indeed allow their remuneration policy to be looked into, but, on the other hand, decided not to motivate and account for the actual management and remuneration policy (Monitoring Commissie Corporate Governance Code, 2005). One of the most neglected provisions in the code relate to the advisability to restrain the amount of the “golden handshake” to a maximum of one year salary.

The Dutch Association of Owners of Securities (VEB) established over 2008, that no more than 63 percent fully complied to the code. They still found a lack of a lack of uniformity and thus transparency regarding the strategies of the company and the compensation of top executives.

The monitoring committee was more positive: they found that the rate of compliance with the Code by listed companies rose from 92% in 2005 (for the 2004 financial year) to 95% in 2007 (for the 2006 financial year), while the rate of application rose from 87% to 90%.

2.6.2 The Corporate Governance Code by the Frijns Committee

Every year, since 2005, the Monitoring Committee, presided over by the former CEO of the Dutch pension fund ABP, has published a report on the extent listed companies complied with the Code in the preceding year. In these reports the Committee made good practice recommendations concerning internal risk management, remuneration and diversity in the composition of the supervisory board. In December 2008, the Committee published a document, *De Nederlandse corporate governance code, beginselen van deugdelijk ondernemingsbestuur en best practice bepalingen* (Frijns, 2008), in which they recommended the revision of dozens of provisions of the Dutch Corporate Governance Code to adapt to recent developments in the national and international business community.

The most significant modifications concerned:

- the rights of the general meeting of shareholders;
- the integral risk management of the company;
- the internal rules of auditing;
- the duties of the management and supervisory boards in regard of corporate social responsibility;
- the role of the supervisory board whose powers should be strengthened;
- the remuneration of the executives.

Within the framework of my thesis I will restrict myself to the alterations connected with the remuneration policy. That is the provisions directly related to the remuneration of executives as well as the provisions indirectly influencing the pay of the management by strengthening the powers of the supervisors to control management board remuneration. The Frijns Committee had to bear in mind the social indignation over the, what was seen as excessive remuneration of the CEO of Numico, Bennink, who was rewarded 85 million euro's for selling his company to Danone. In the same period Rijkman Groenink received 30 million euro's after his bank ABN Amro had been dismantled and sold in parts to Fortis, the Royal Bank of Scotland and the Bank of Santander. Public outrage in The Netherlands over excessive pay was fed further by comments and veiled threats of leading CEO's of big Dutch listed companies. They went so far as to threaten to transfer the headquarters of their enterprises away from The Netherlands, if the protesting and nagging about their earnings did not stop (FEM Business, 2007).

The Frijns Committee took a middle of the road position in this. They mentioned that the level of management board remuneration in Dutch listed companies had, indeed, risen considerably in recent years, but, as they remarked, this was only in keeping with the situation in Europe generally. Notwithstanding this qualification they aimed to channel and prevent the remuneration policies of companies from getting out of hand with the statement of the following provisions:

- The remuneration structure must be simple and transparent (Principle II.2);
- To avoid a "leapfrog" effect within the organisation the impact of the total remuneration on the pay differentials has to be considered (Principle II.2);
- The right balance must be struck between remuneration in the short-term and remuneration in the long term, the same goes for the relation between the fixed and variable component (Preamble);
- Non-financial indicators must be taken in account to determine the structure and level of remuneration (Best practice II.2.3);
- The remuneration structure must not encourage the taking of risks that are not in keeping with the adopted strategy (Best practice II.2.3);
- In the case of dismissal, whether involuntary or not, the remuneration is maximised on the pay of salary of one year (Best practice II.2.8);
- The remuneration report must contain information about and set criteria for the composition and the cost of the management board remuneration (Best practice II.2);

The powers of the supervisory board were strengthened. The chairman of the committee, Jean Frijns, disclosed a couple of months after the publishing of the report, his personal motive to increase the power of the supervisory board. In the *Volkskrant* (03-12-09) he declared: "It is disappointing to see that the elite in The Netherlands was not competent to guide the discussion over remuneration in the business community. Time after time persons were individually put on the spot by claims for higher pays". The Frijns Committee, therefore, gave the supervisory boards more responsibility and say over the remuneration of the management. This is substantiated by the following provisions:

- The supervisory board shall analyse the possible outcomes of the variable remuneration components and how they may affect the remuneration of the management board members before they decide over it (Principle II.2.1). Contrary to suggestions in earlier reports (2006,2007), however, the Frijns Committee did not propose a remuneration ceiling;
- The supervisory board can adjust a variable component of the remuneration awarded in a previous year if it is, in their opinion, an unfair result due to extraordinary circumstances. More important, in the light of the public outrage over excessive pays, is the power of the supervisory board to recover from the management board members any variable remuneration awarded on the basis of incorrect or other data (Best practice II.2.10-11).

The publishing of the Code Frijns did not reconcile the opposing opinions over the remuneration of managers in The Netherlands: the listed companies agreed, the trade union disapproved, the association of stock owners saw lost opportunities for enhancing the interests of the shareholders and the Minister of Finance maintained the announcement of tax laws to curb excessive bonuses.

2.7 The Harrewijn Act

Not only the various corporate codes aim to stimulate the business community to communicate transparently over the remuneration policy. Already in 1990 the *Stichting voor de Arbeid* advised the companies and their works councils to include information about the distribution of pay within the company in their information over the social policy and personnel policy. Companies, however, hardly acted upon this advice. Therefore the Member of Parliament Ab Harrewijn initiated in 2001 a bill to compel the companies to inform the works councils over the salaries that the various categories of

employees, managers and supervisors received. It was not until 2006 before the Act was put into operation, however.

The Harrewijn Act set the following objectives:

- to facilitate the works council in their duties by providing explicit financial data, including those in relation to the pay of the managers and the supervisors;
- to give the works council insight in the developments of costs within the company;
- to make the costs of special benefits for employees, managers and supervisors transparent.
- to prevent differences in pay that are ill-founded;
- to further the discussion on the remuneration policy.

In fact all these objectives were aimed at preventing the management to receive a compensation that would be out of proportion in comparison to the pay of all those employees involved in the company.

The Dutch government wished to strengthen the powers of the works council further by giving it the right of speech with regard to the remuneration of the executives and this led to the introduction of a bill in December 2007.

The obligations deriving from the Act Harrewijn overlap the provisions of the civil code on annual accounts, the Code Tabaksblat and Frijns (Burgers, 2008). Especially for listed companies the Act Harrewijn, in fact, does not add substantial obligations.

The effectiveness of the Act Harrewijn seems to be limited: the obligations to inform lead to a considerable amount of bureaucracy and the works councils does not seem to consider the obligation to give full information on benefits as their highest priority (Burgers, 2008).

2.8 The tax law

As I have mentioned above, the government tried to stimulate the transparency of the remuneration policy of listed companies and to redirect the discussion on the justification of the compensations of executives both by imposing the corporate government codes and by introducing the Act Harrewijn.

The authorities have, however, also other means to influence the behaviour of the public and the companies. In particular tax laws and regulations have been used to encourage the kind of behaviour as politicians would like to see it. Incentives have been included in tax laws, but these have also been used to discourage or even to punish behaviour disapproved of by the authorities.

In 2006, for instance, tax regulations were introduced to discourage the award of options whose strike price is below the then current quotation of the underlying shares by considering the difference between the exercise price and the share price as taxable income.

2.9 Evaluation

In this chapter I demonstrated changes in regulation, as well in law as in codes of corporate governance. Reasons for these changes were diverse. An important factor was the globalisation of the economy, which required standards for accounting and rules for remuneration policy, making them both more transparent. Other factors were the financial scandals and the lack of understanding of the excessive variable pay of executives, which urged politicians to initiate corporate laws as well as tax laws.

3 Review of literature on executive pay and firm performance

In existing research, mostly performed in the Anglo-Saxon countries, the theory mainly used is the agency theory. In this theory, as we saw in the former chapter, two parties are involved: the principal and the agent. The agent represents the principal in his actions and is expected to act like the principal should do himself. In the studies I discuss, the shareholders are referred to as principals and the CEO is the agent. The CEO therefore should make decisions and take actions for the benefit of the shareholders, to maximize their wealth. To promote this kind of conduct, remuneration rules should be based on what is also called the ‘at arms length principe’. The remuneration contracts should aim at the creation of shareholders value, therefore the remuneration committee should remain free from meddling by the CEO or even other members of the board.

In this chapter I will discuss the works of leading authors on the subject of compensation policy in order to be able to interpret the findings of my research on Dutch companies. I selected studies from several countries, among them research results from the United States, the United Kingdom, France and The Netherlands. In this way I established a summary of the prevailing opinions on the relationship between performance of CEO’s and the remuneration they get in the Western capitalist society. I have put together my survey in such a way that the chronological order also roughly reflects a shift in results of the studies from well-founded arguments fully supporting the plausibility of the agency theory to those showing the inadequacies of the remuneration practices and even rejecting them and putting forward evidence that the remuneration policies are dominated by managerial power.

Table 2, *After the example of Mertens, Knop and Strootman, 2006, p. 16, table 1*

Author	Country	Year	Findings
Jensen and Murphy	US	1990	<ul style="list-style-type: none"> - A positive and significant but limited empirical relation between the pay of CEO's and firm performance. - Compensation contracts are implicitly constrained by political forces. - Optimal compensation contracts reflect the goals of providing efficient risk sharing. - Measure the relation between performance of the CEO and the growth of shareholders value.
Hall and Liebman	US	1998	<ul style="list-style-type: none"> - CEO compensation is highly responsive to firm performance. - The design of executive compensation is a very important issue. - The level of CEO compensation and its sensitivity have grown fast over 15 years. - Depending on the measures used the outcomes of the pay-performance differ substantially.
Bebchuk and Fried	US	2004	<ul style="list-style-type: none"> - CEO's have a deciding voice in the process of framing the compensation contract: the managerial power theory. - Negative reactions of relative outsiders ('outrage') constrains all too exuberant compensations. - Managers profit from results they did not achieve: 'windfall profits'. - Many executive compensation practices are hidden.
Pukthuang Talmor and Wallace	US	2004	<ul style="list-style-type: none"> - The leading determinants of pay variation are: <ul style="list-style-type: none"> . Managerial strategic discretion and task complexity; . Corporate governance. - Firm performance and CEO-specific characteristics are the least determinant factors.
Missionier-Piera Cavazan-Jeny and Margaine	F	2008	<ul style="list-style-type: none"> - Complexity of firm operations has a great impact on executive compensation. - There exist a negative relation between risk and the compensation package of the CEO. - Performance measured with accounting data is not a relevant determinant for CEO's compensation. - Corporate governance variables correlate with CEO's fixed and total compensation, this correlation doesn't appear with bonuses.
Gerard	UK	2006	<ul style="list-style-type: none"> - Incentives are seldom focused on long term shareholder value. - Short term individualistic incentives seem to have been constructed by the desire to pay more rather than to further alignment with shareholder interests. - A competitive market of executives which compels to pay huge compensations doesn't exist. - Remunerations consultants tend to recommend increases in executive pay. - Remuneration committees, which try to pay compensations just above median, stimulate a leap-frog of compensations.

Duffhues and Kabir	NL	2007	<ul style="list-style-type: none"> - Dutch firms were reluctant to disclose specific remuneration data during the period 1998-2001. - Dutch listed firms were famous for their ingenious use of anti-take defences. - Ordinary shareholders had no say over compensation of executives. - The pay-performance relationship is not positive during the period 1998-2001. - Leverage has a significant positive influence on executive pay. - Managers frequently proclaim working towards many goals other than shareholder value.
Mertens Knop and Strootman	NL	2007	<ul style="list-style-type: none"> - The CEO's take an ever more prominent position in the board. - Salaries rose a relative modest 20% during the period 2002-2006, bonuses mounted a 70% higher. - The percentage of incentive directed pay as part of the compensation package increased considerably during the period 2002-2007. - Differences in size are clearly reflected in the remuneration of the CEO's. - The average salary of an AEX-CEO is 100 to 60 for a Mid Cap-CEO is 40 to a Small Cap-CEO. - There is no evidence that Dutch listed firms correct the pay-performance relation for trends in the industry or general market.
Fennema and Heemskerk	NL	2008	<ul style="list-style-type: none"> - In the last quarter of the 20th century the aristocracy was replaced by meritocracy in the top of the Dutch listed firms. - 'Exhibitionistic self-enrichment' is linked to the rise of new professionals who adopted 'Anglo-Saxon' mores. - The compensation of a CEO is not so much related to performance as well as to representation of prestige. - The media and eventually the European Union should constrain the self enrichment of the CEO's.

3.1 Jensen and Murphy

The first influential researchers whose work on remuneration policy I will discuss are Jensen and Murphy. In their paper (1990) they refer to the conflict of interests between the shareholders of a listed company and the CEO as a classic example of a principal-agent problem. Shareholders do not have complete information about the managerial actions of a CEO and the investment opportunities he decides on. Like most people, the CEO is more interested in his private wealth than in the maximization of the shareholders wealth. To ensure that the CEO will act on behalf of the shareholders, his personal interest must become congruent with the interest of the shareholders.

Compensation policy is one of the most important factors in an organization's success. As Jensen and Murphy argue(1990): the basic problem with existing compensation surveys is

that they focus exclusively on *how much* CEOs are paid instead of *how* they are paid. And not only does the apportioned compensation determine how top executives behave but it also helps to determine what kinds of executives an organization attracts. Jensen and Murphy (1990) compare the pay of top lawyers and financial advisers with the compensations top executives receive. They conclude that the high salaries for, for instance, lawyers and financial experts attract the brightest talents from among the young people who graduate. This talent drain could lead to a negative selection of corporate executives. This is what makes the vocal protests over CEO pay so damaging in the opinion of Jensen and Murphy because they put off even more the brightest talents. Therefore Jensen and Murphy (1990) state that it would be appropriate for the pay CEO's receive to be based on the main objective of the shareholders, which is the shareholders' wealth. In their opinion a compensation policy that links the CEO's utility to the shareholders wealth, helps aligning the private and social costs and benefits of alternative actions and thus provides incentives for CEO's to take appropriate actions.

The study of Jensen and Murphy (1990) shows a positive and significant empirical relation between the pay of CEO's and firm performance. They find that the part of CEO compensation based on firm value rises with \$ 3,25, on average, for each \$ 1.000 increase in the value of the company.

In their opinion this reward is very small for an position in which incentive pay is expected to play an important role. They, therefore, believe that their results are inconsistent with implications of formal agency models of optimal contracting.

Jensen and Murphy (1990) also state that the role of political forces in the process of contracting implicitly regulates executive compensation by constraining the type of contracts that can be drawn up by managers and shareholders. These forces, also within organisations, appear to be important but they are difficult to document, because of their informal and indirect way of operation. Jensen and Murphy (1990) also have a statement about risk. When a CEO is assumed to be risk neutral, the optimal contract should be that the CEO receives the entire output as compensation and pays the shareholders an up-front fee so that the CEO's expected utility exactly equals his reservation utility, i.e. the minimal compensation he is prepared to work for. But CEO's are not risk neutral and the main reason for the existence of public corporations is the ability to achieve efficiencies in risk bearing. Thus transfer of risk from executives to shareholders generates costs from poor compensation. So Jensen and Murphy (1990) state that optimal compensation contracts must reflect the goals of providing efficient risk sharing and provide the CEO

with incentives to take appropriate actions. But how should the performance of the CEO be measured? Jensen and Murphy measured the performance of the CEO in growth of shareholders value, which became the standard and is since known as the Pay Performance Sensitivity.

They also showed (Jensen and Murphy, 2004) that cash compensation, i.e., salary and bonus, forms only a small proportion of the total remuneration. When the added value of shares and options are included, the Pay-Performance Sensitivity appears to increase drastically. The figure below, copied from their Working Paper, indicates a growing share of options and stock in the compensation packages in the United States, a trend which is followed by European companies. Jensen and Murphy (1990) were the first to include in the definition 'total remuneration' not only the salary, bonuses, options, shares and pension contributions the CEO received, but also the added value, in the period concerned, to all options and shares the executive owns. For their empirical research, however, they used the more restricted definition of cash to assess the development of the remuneration over the years.

Jensen and Murphy published their outstanding study in 1990, which was based on data from the period 1974 till 1986.

3.2 Hall and Liebman

Hall and Liebman (1998) elaborated on the findings of Jensen and Murphy using data from the 1980-1994 period. They held the opinion that the construction of performance incentives for managers in large companies is an enormously important issue because they found, unlike Jensen and Murphy (1990), that CEO compensation is highly responsive to firm performance. If there was no meaningful connection between CEO pay and company performance, they doubt that the trillions of dollars market value of publicly traded companies would be managed efficiently. Whereas Jensen and Murphy (1990) based their analyses on cash pay, Hall and Liebman (1998) focused on a broader measure of compensation, including changes in the value of stock and stock options. They found that the wealth of a CEO rises with \$ 25,11 for every \$ 1.000 increase of shareholders wealth. Although the rising of CEO wealth per \$ 1.000 of increasing firm value does not seem to be high, in a big company it can be a very high amount of money. As Hall and Liebman (1998) say: "Typical changes in CEO compensation are small relative to firm value, but not small relative to typical CEO wealth".

In their opinion, studies that only focus on changes in bonus and salary underestimate the sensitivity of the relation between pay and performance. Hall and Liebman (1998) also found that the level of CEO compensation and the sensitivity of CEO compensation have grown fast over the 15 years in the period between 1980 and 1994.

To measure the pay performance sensitivity of a CEO, Hall and Liebman applied several measures such as:

- How many dollars does a median CEO earn when his firm moves from a median stock price performance to a 70th percentile firm performance?
- What percentage does a median CEO earn when his firm moves from a median stock price performance to a 70th percentile performance?
- What extra percentage does a median CEO earn when the Total Shareholder Return of his firm increases with 1 %?
- The Jensen Murphy sensitivity: how many dollars does a median CEO earn when the value of his firm grows \$ 1000?

Hall and Liebman (1998) used two different definitions of ‘total compensation’. They distinguish ‘flow’ or ‘direct’ compensation, that is all rewards received during the year, including salary, bonus, options, shares and others on the one hand and on the other hand ‘stock’ or ‘total’ compensation, that is ‘flow’ compensation increased by the added value of options and shares the executive owns. They used both definitions and pointed out that, depending on the definition applied, the sensitivity of pay and performance varied substantially. “Indeed for a given change in firm value, we find that changes in CEO wealth due to stock and stock options, evaluations are more than 50 times larger than wealth increases due to salary and bonus increases” (Hall and Liebman, 1998). They also pointed out that as far as changes in the value of stock and stock options holdings are concerned, they don’t have a relative component, i.e. the increase of value of options or shares is not corrected for the overall development of the market or the performances of other companies which operate in the same sector of industry. That probably is one of the reasons why since the nineties CEO’s are increasingly awarded with stock and stock options, as well in the US as in Europe.

Most of the difference between the results of Jensen and Murphy (1990) and Hall and Liebman (1998) can be explained by the difference in measures used. In my opinion this conclusion is self-evident because the extra part of the compensation equalises the increase of value of his own shares and options. And thus follows the percentage of the increase of shareholders value.

Using the same measure as Jensen and Murphy (1990), the results of Hall and Liebman (1998), however, give a 60 percent higher estimate of an increase of CEO compensation with \$ 5,25 per \$ 1.000 increase of firm value.

So the conclusion of their paper is that CEO's are not paid like bureaucrats and they found evidence that CEO compensation is highly related to firm performance.

3.3 Bebchuk and Fried

Bebchuk and Fried (2004) argue that the dominant view among economist is that the principal-agent problems are adequately solved by the common practices of executive compensation. By a well chosen package of incentives the interests of the executive are supposed to be aligned with the interests of the shareholders. They call this theory "the official story". In fact however, the shareholders do not contract directly with the executives but the board of directors acts as an intermediary instead. And this board of directors, although it is supposed to act solely in the interest of the shareholders, is likely to consider the CEO's interests as more important than those of the shareholders. After all, directors are well paid and want to keep their jobs and valuable perks that often go with it. A member of the Board of Directors who opposes the CEO takes the risk not to be reappointed to the board and to lose the accompanying benefits. CEO's can also use their powerful position in the firm by benefiting individual directors directly or indirectly. Directly for instance, by allowing directors to take advantage of business dealings with the company they manage themselves. For example, Verizon's 2001 board included an executive director of Boston Consulting Group, which received \$ 3.5 million from Verizon for services in 2000 (Bebchuk and Fried, 2004, p. 27). Indirectly by contributing to the societal prestige of an individual director. Oracle, for example, had on its board three Stanford University professors and made large contributions to the university (Bebchuk and Fried, 2004). Thus, it is unrealistic to expect the board to negotiate the best possible executive compensation contract from the shareholders' perspective. Bebchuk and Fried (2004) therefore developed an alternative view concerning executive compensation. They observed that in practice the compensation contracts represent something more like what is often described in the business press as 'putting one's hand in the till', in which managers extract enormous sums of money through their control of their own pay-setting process. They did an extensive review of empirical data and concluded that there is substantial evidence in support of the theorem that CEO's are the deciding factor in the process of framing the compensation contract. But managers' potential rents

are not unlimited. Market forces and the need for board approval place some constraints on compensation arrangements. More important in the view of Bebchuk and Fried are, however, the negative reactions of relevant outsiders, to which they refer as “outrage”. The more widespread and strong these negative reactions are the larger the costs, i.e. loss of prestige and standing, to directors and managers. When the potential outrage costs are large enough, they will deter the adoption of arrangements that managers would otherwise favour. A striking example of the working of this “outrage constraint” is the indignation by the Dutch people over the compensation to the new CEO of Ahold, Moberg, who took office in September 2003 after a serious accounting scandal. After a consumer strike at the Dutch supermarket leader Albert Heijn, subsidiary of the Ahold concern, Moberg gave up a part of the compensation agreed on by the board of directors (Volkskrant, 2003).

The main premise of Bebchuk and Fried’s managerial power based analysis is that executive compensation is controlled primarily by the executives themselves. Executive pay practices show for instance that executive options are almost always written as a function of raw returns, never filtering out factors unrelated to executive effort. So, even when the data of a particular firm seem to show a positive relationship between pay and performance, there is no proof that the results are generated by the endeavours of the CEO. “To determine managers performed well, however, we must assess the manager’s performance against that of their peers. There is no incentive value in rewarding managers for increases in stock price or accounting earnings that have nothing to do with their efforts or decision making, but rather reflect general market or sector changes, or other forms of pure luck.” Bebchuk and Fried (2004) call this ‘windfall profits’. When in the nineties the stock market went up, all executives did well, even those whose firms performed badly. But when in the early 2000’s the market declined, firms lowered the exercise price of the options to adjust for all market wide movements. So executives reap benefits when the market rises but insulate themselves from market declines by repricing. And often executives are allowed to sell their options and restricted shares before the end of the period in which they are supposed to function as incentives. Finally, many executive compensation practices are hidden and camouflaged. Retirement plans with all kind of benefits and sometimes even lifetime “consulting” contracts take forms that are typically not discussed in the press.

Bebchuk and Fried (2004) do not give a cohesive alternative for the executive compensation system. But they make some suggestions for improvement: for instance, they encourage investors to pay executives options that filter out general market

movements and to make it harder for executives to unwind incentives. They also plead for transparency in the structure of executive compensation. And, of course, they want to increase the power of shareholders relative to the managers, for example, by improving the rights of shareholder-nominated candidates in corporate elections.

During the ‘credit-crunch’ of 2008 Bebchuk and Fried ‘s (2004) observations were proven to be accurate in practice: in spite a total loss for the commercial banks of 38 billion dollars and near bankruptcies the financial sector in the USA still set apart 18,4 billion dollar to compensate the bankers. The literal title of their study “Pay without Performance” became the reality (Volkskrant, 30 January 2009).

3.4 Pukthuanthong, Talmor and Wallace

Pukthuanthong, Talmor and Wallace (2004) find in their research about the United States financial sector that corporate governance is the third leading determinant of pay variation, after managerial strategic discretion and task complexity. In their research corporate governance includes ownership structure and board characteristics. Firm performance and CEO-specific characteristics are the least explanatory factors in this research. Since a lot of studies have been carried out on the relationship between performance and compensation, the outcome of this part of the study is surprising.

3.5 Cavazan-Jeny, Margaine and Missionier-Pierra

Cavazan-Jeny, Margaine and Missionier-Pierra (2008) did their study about determinants of CEO compensation using a sample of 99 listed French companies over a period of three years (2002-2004). In France companies with a legal status comparable with the plc (United Kingdom) or Inc.(United States), the *Société Anonymes*, are either an incorporated company with a single board (*Conseil d’Administration*, CA, one- tier) or have the dual structure (two-tier) with a single board of directors (*directoire*) and supervisory board (*conseil de surveillance*). Cavazan-Jeny, Margaine and Missionier-Pierra, (2008) investigate the compensation of top executives in France with four dimensions: the performance of the firm, its risk, its size and its governance attributes.

Overall the size and the complexity of the firm seem to have a major impact on executive compensation in France. The relation between pay and performance is less straightforward as it depends in their research on the variable used to measure performance and also their results surprisingly suggest that performance measured with accounting data is not a relevant determinant for CEO’s compensation.

Contrary to their expectations, in their study risk has a negative relationship with the compensation package of a CEO. Yet they show a correlation between corporate governance variables and CEO's remuneration: the audit committee has a significant and positive relation with fixed and total compensation as does the percentage of independent directors on the board. The compensation committee shows also a significant but negative association with fixed and total compensation. Cavazan-Jeny, Margaine and Missionier-Pierra (2008) did not find a relationship between any of the corporate variables and bonuses.

3.6 Gerard

Obviously inspired by Bebchuk and Fried (2004) the British author Patrick Gerard reviewed executive pay practices in the United Kingdom (Gerard, 2006). His book gives a detailed examination of the incentives arising from a typical executive reward package. Gerard found that the incentives are seldom properly focused on the creation of long term shareholder value. Short term, individualistic incentives are far more common. They seem to have been constructed by the desire to pay more rather than to further alignment with shareholder interests.

Gerard (2006), like Bebchuck and Fried (2004), thinks that the non-executive directors not always act in the interests of the shareholders as they do not sufficiently limit the influence of the CEO on the determination of his compensation. They strongly disagree on this point with Jensen and Murphy (1990) who have the opinion that the non-executive directors are reluctant to reward CEO's with substantial (and therefore highly visible) financial gains for superior performance. Jensen and Murphy even observed that "uninvited but influential guests at the managerial bargaining table (the business press, labour unions, political figures) intimidate board members and constrain the types of contracts that are written between managers and shareholders".

Gerard (2006) argues that a competitive market of executives does not exist, and consequently it is not the market which compels to pay huge compensations. The existing CEO's control the influx of future executive talents, which is not affected by how much they earn. For the market for executive talent does not behave like a normal market that is to say, in terms of supply and demand, where, if the price of a commodity goes up, the economics of supply are improved and the supply is increased. However, the market for executive talent does not train up more potential CEO's because they are paid more. In

fact the higher reward packages have the effect of reducing the number of potential candidates. The higher the compensation the more important it is that the person appointed is well known to the wider industry and the financial press. This restricts the pool of candidates. (Gerard, 2006). The scarcity of executives is artificial and the high level of executive pay is better explained by the power of the incumbent chief rather than by any market considerations.

Gerard is also critical about the role of remuneration consultants, which have become extremely influential after the Greenbury Code (1995) came out. This corporate code recommended that “<remuneration committees> should judge where to position their company relative to other companies. They should be aware what other comparable companies are paying and should take account of relative performance” (cited in Gerard, 2006, p. 147) Remuneration committees, therefore, started to make much greater use of remuneration consultancies, which were able to gather all data needed and to advise them on what compensation should be plausible. However, to keep executive remuneration practice moving along, it is firmly in the interest of remuneration consultancies to recommend increases in executive pay. And also the proposals of the remuneration committees themselves force the levels of payment up. Almost all companies aspire to pay their executives at (slightly) above median rates. Of course, by the mathematical definition of median, it is only possible for half of all companies to achieve this. So the effect was a leap-frog of compensations.

3.7 Duffhues and Kabir

In the Netherlands, Duffhues and Kabir (2007) performed the first comprehensive study that investigates the pay-performance relationship in Dutch companies. They collected data of a large sample of Dutch firms during the period 1998-2001 and analyzed them. Until 2002 Dutch firms were not legally obliged to make public the amount of compensation paid to CEO and other directors, so the annual reports of the companies had to be searched for information on executive pay. About two-third of listed firms are found to reveal the amount of compensation paid to executive directors. Typically most of these firms were reluctant to disclose specific compensation data: they simply reported the aggregate compensation of all executive directors. Smaller companies with only one executive director did not disclose any information all claiming privacy rights. This lack of transparency was caused by the fact that the pressure from many corporate governance mechanisms was very limited in the Netherlands. Duffhues and Kabir (2007) stated that

Dutch listed firms are famous for their ingenious use of several anti-take defences that resulted in bad international reputation with respect to corporate governance quality. Managers frequently proclaim working towards many goals other than shareholder value maximization.

Another remarkable feature is that ordinary shareholders have no authority in establishing the height of the remuneration of executive directors. This power rests with the Supervisory Board and they ought to use this power within the boundaries of the remuneration policy adopted by the general meeting of shareholders, but objections are rarely made in shareholders meetings against the proposed remuneration of a CEO. There are, on the other hand, instances in which dominant shareholders of a firm have allegedly colluded with the management, thus influencing decisions for their own benefits.

Duffhues and Kabir (2007) consider the most important result of their finding, that the pay-performance relationship is not positive for Dutch firms in the concerning period. In their opinion managers seem to influence their own compensation, since higher pay is awarded even when there is no increase of firm performance.

This finding is robust to alternative model specifications. It also holds after making important controls for several factors like firm size, leverage, industry and time.

In contrast with pay-performance relationship, the firm size is found to be a positive and statistically significant determinant of compensation indeed. Leverage has a significant positive influence on executive pay. The finding is consistent with the propositions that managers are able to influence their own compensation. So Duffhues and Kabir (2007) question whether linking pay to performance is an effective tool in the sense of “optimal contracting” device to realize the stated goals of the corporations.

Apparently shareholders with large ownership stakes accept a policy of “pay-for-no-performance”. Duffhues and Kabir (2007) believe that there is some degree of collusion between block holders and management. Many block holders are concerned with the existing business interests, so that there is an increased risk of losing more by being critical towards management compensation policy.

3.8 Mertens, Knop and Strootman

Mertens, Knop and Strootman (2007) delivered a study describing and analyzing trends and developments in compensation and incentive policies of 90 Dutch companies in a mixture of AEX-listed companies, Mid Cap firms and Small Cap enterprises in the period

2002-2006. Apart from this, they also focus on transparency, a prerequisite for an accurate evaluation of the performance of companies.

In the realm of compensation Mertens, Knop and Strootman found striking data.

For instance, as to the levels of compensation offered to members of the board, the CEO is rewarded a 30% higher salary, whereas his bonus was almost 70% up on that of his fellow executives. This finding marks the trend that CEO's take an increasing prominent position in the board.

A second trend can be distinguished, viz. a relative modest rise of 20% in salary pay in five years, whereas, on the other hand, on average, the bonus has been doubled in the same five years. But this figure was influenced by the fact that in 2002-2003 one quarter of the CEO's did not get any bonuses at all and in 2005 and 2006 all CEO's were awarded bonuses as a form of incentive. In 2005 the average CEO had a mixed compensation of 1/3 fixed salary, 1/3 short term bonus and 1/3 long term bonus. In a 2008 update Hewitt observed that the relations had shifted even to a larger share of incentive based compensation: the basic salary takes 25%, the short term incentive 35% and the long term incentive 40%.

The differences in size are clearly reflected in the remuneration of the CEO's. The average salary of the CEO of a Mid Cap firm is no more than 60% of the average salary of a CEO of an AEX-listed company. The average salary of a Small Cap firm at the most only 40%. The average bonus of an AEX-fund turns out to be even four times higher than the bonus of a Mid Cap fund and five times higher than the bonus of a Small Cap fund.

As for the remuneration policy, it is predominantly unclear what targets should be met to get a bonus, let alone on what criteria firms pay their CEO's even more than the maximum bonus agreed on or extra bonus percentages above target. This lack of transparency is often competitively motivated. The trend is to use more measures to award a bonus, which increases the complexity of the remuneration policy and is not instrumental to the transparency. But in practice a combination of measurement of accounting and shareholders value is accomplished. Mertens, Knop and Strootman (2007) could not substantiate in the empirical part of their study that Dutch listed companies correct the pay-performance relation for trends in the industry or general market. So there may occur 'windfall profits'.

The appointment of a new CEO, especially with AEX-listed firms, is often accompanied by a substantial rise of compensation. Two causes emerge: on the one hand more CEO's from outside The Netherlands are appointed, who are accustomed to higher pay and on the

other hand often firms in a crisis situation want new chiefs who then are in a position to make higher demands (Mertens, Knop and Strootman, 2007).

3.9 Fennema and Heemskerk

Fennema and Heemskerk (2008) put in their popular-scientific book, *Nieuwe netwerken* (2008), the relationship between pay and performance in The Netherlands in a much broader perspective. They are political scientists who emphasize the social environment in which the actions of top executives are embedded. They convincingly describe the development in the 20th century of the Dutch national economic elite in which two features are dominant: the scaling-up and mergers of companies resulting in internationalising these firms and the replacement of the 'Old Boys Network' by management professionals resulting in a meritocracy.

Till the sixties of the 20th century trade and industry in The Netherlands were still regionally oriented. Directors on the supervisory boards were recruited from well-known reliable families who were accustomed to deal with each other. Economic circles in the regions Amsterdam, Rotterdam and Twente each had their own characteristics.

The history of ABN Amro perfectly illustrates the process of regional banks merging into a national bank, and finally even into an international banking stronghold. In 1964 the Rotterdam Bank and the Amsterdam Bank merged into Amro Bank and the Dutch Trade Company and the Twentsche Bank into ABN. In 1991 these banks, in their turn, merged into ABN Amro that aimed to play a prominent role in the international banking system (Fennema and Heemskerk, 2008).

In the seventies the transformation of the economic elite became apparent. As the regional orientation faded away, also the predominance of the families of aristocratic and patrician descent disappeared. In 1962 half of the executive elite was comprised of members of these families, in 1969 they held one third and in 1976 this had already been reduced to only a quarter of the seats on the relevant boards. It turned out to be an irreversible process and in 2001 there were only a few of them were left in prominent positions. The professionalizing of the management led to the rise of a new meritocracy of academics, predominantly financial experts.

During the nineties the two lines of development came together. A wave of mergers and international acquisitions was accompanied by a new pattern of conduct of the professionals. In 2001 foreign investors owned 57 percent of the shares of the largest Dutch companies. This percentage grew from 64 percent in 2003 to 69 percent in 2005.

And 22 out of the 36 directors appointed in 2006 were foreigners (Fennema and Heemskerk, 2008).

Table 3, Source: *Fennema and Heemskerk (2008), p. 90*

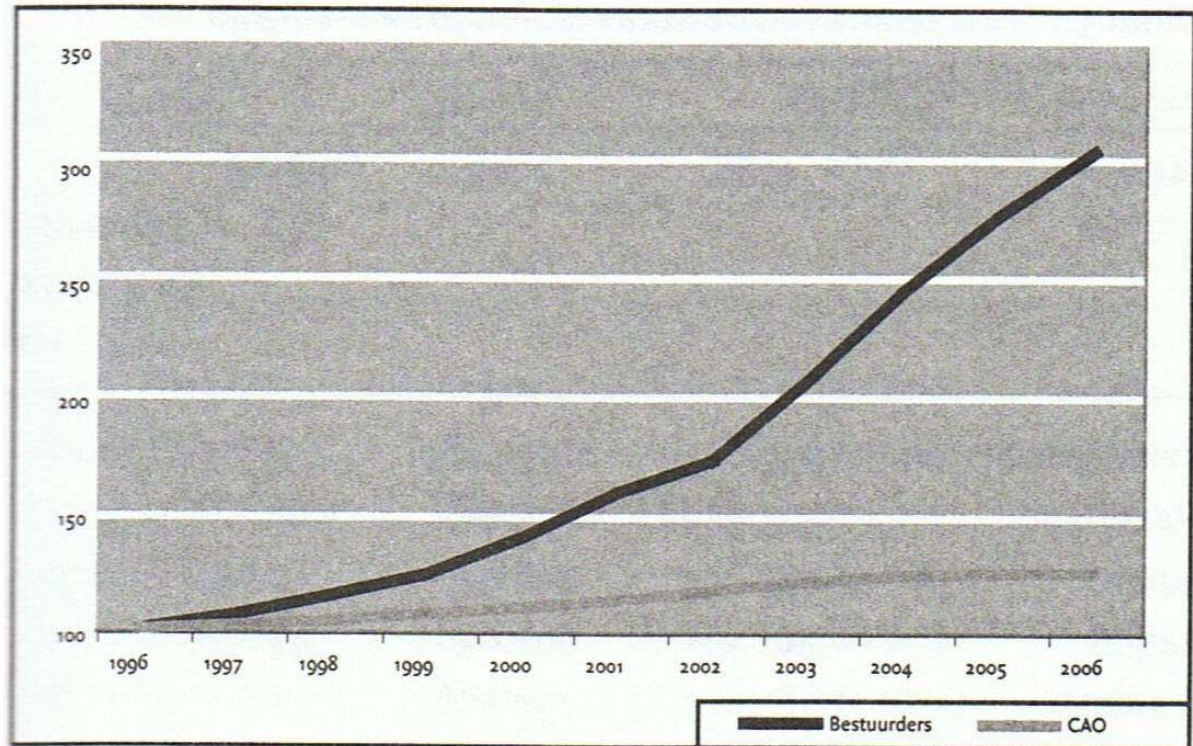
Herkomst	1996	2001	2005	2006
Nederlands	78%	63%	58%	55%
Brits	5,9%	10,3%	11,4%	12,6%
Amerikaans (vs)	4,3%	10,3%	7,6%	9,7%
Frans	1,5%	3,0%	6,1%	6,5%
Belgisch	2,2%	5,3%	4,5%	5,4%
Duits	3,7%	3,7%	4,9%	3,6%
Zwitsers	0,3%	0,3%	1,9%	1,1%
Braziliaans	–	0,3%	0,8%	0,7
Fins	–	0,0%	0,4%	0,7
Italiaans	0,3%	1,0%	0,8%	0,7%
Zweeds	1,2%	1,0%	1,1%	0,7%
Overig	2,2%	1,7%	2,7%	3,2%
Totaal aantal posities	323	300	264	278
Waarvan bezet door buitenlanders	70 22%	111 37%	111 42%	125 45%

The growing number of foreigners taking positions in the executive boards as well as the supervisory boards subsequently led to the inevitable adoption of a more Anglo-Saxon style of business management thus what we see is an increase in the predominance of the shareholders value and along with it a sharp rise in the incomes of the CEO's. When the American Don Shepard in 2002 succeeded Kees Storm as CEO of Aegon, he changed the management style of the concern scrupulously. He replaced Storms' dictum "Respect people, have fun, make money" by his own motto: "I don't respect people who don't make money" (Fennema and Heemskerk, 2008).

The Dutch executives were all too eager to adopt these Anglo-Saxon mores.

Fennema and Heemskerk (2008) linked the process of ‘exhibitionistic self enrichment’ (an expression of the former Dutch prime minister Kok) to the decay of the ‘Old Boys Network’. The class-consciousness and shared values of the old elite limited their thirst for money. But the process of individualization eroded the common values and loosened the moral standards. The self constraint weakened and the individual status consciousness was consolidated.

Table 4, Source: *Fennema and Heemskerk (2008), p. 101*



Fennema and Heemskerk (2008) argue that the image of the CEO is no longer defined by the class he belongs to but rather by the wealth he represents. The compensation of the CEO is thus not so much related to performance, but rather to a representation of prestige. In this sense, therefore, the top executive is not so much driven by greed for money, but rather they suffer from ‘mimetic greed’, nurtured by the longing for what is also desired by other people. This greed can be satisfied by their ranking as bulk earner in the newspapers or by their wealth as showed in the lists of Quote magazine. On the other hand the media can play a role in the constraint of this self-enriching tendency of executives: in that, by exposing their greed, the press and other media, may effectively damage not only the reputation of a particular executive and of course consequently his firm, and even the reputation of the executive in general.

Also the European Union could create a political and judicial environment for a social variant of capitalism that combines the focus on long-term development, protection of employees, equilibrium of the interests of all stakeholders and more social-economic equality and less huge differences in incomes.

3.10 Evaluation

The first studies I reviewed, Jensen and Murphy (1990) and Hall and Liebman (2004), which were conducted in the nineties of the twentieth century, departed from the idea that the agency theory had been proven to be valid. Their authors advocated to stimulate the executives of listed companies not to be risk-averse. Therefore, they applauded the granting of substantial variable pay for CEO's who succeeded to increase the shareholders value. Maybe influenced by the financial scandals that occurred in the early years of the third millennium in the United States and elsewhere, some economists, like Bebchuk and Fried (2004) and Gerard (2006), in contrast stressed the managerial power theory in explaining CEO compensation. They argued that the executives used their near monopoly over firm information and their position of power in connection with the non-executive directors to increase their income, sometimes in excessive ways. Surprisingly, Pukthuanthong, Talmor and Wallace (2004), however, found CEO-characteristics as well as firm performance to be the least explanatory factors for the settlement of executive pay. Cavazan-Jeny, Margaine and Missionier-Pierra (2008), as well as Duffhues and Kabir (2007) and Mertens, Knop and Strootman (2007), still based their research on the premise of the agency theory, but they did not demonstrate a significant positive relation between executive pay and firm performance. Fennema and Heemskerk (2008) in fact support the managerial power theory, but they stress the psychological factors that determine the behaviour of the CEO's. The hypotheses I will formulate in the next chapter, which I will test in chapter 6, are for the most part inspired by the assumption of the correctness of the managerial power theory.

4 Hypotheses

In chapter 3, I discussed several studies on the pay-performance relationship in Western countries. In this chapter I will link the described movement from agency theory to managerial power theory to a pair of hypothesis, which I will make operational and test in the next chapters.

The studies I discussed in the former chapter shifted from full support of the agency theory to rejection of it and holding the managerial power theory. Janssen and Murphy (1990) as well as Hall and Liebmann (1998) are known as the leading authors on the subject. The findings of their studies were used as a basis for the corporate governance codes and the majority of economists followed their track. The Frijns Committee still bases its code on the agency theory, although they propose to constrain the managerial power by enlarging the powers of the Supervisory Board.

Although the results of their study do not show a significant positive relation between pay and performance in Dutch companies over the years 1998-2001, Duffhues and Kabir (2007) also adhered the agency theory. After all, they assumed that due to poor corporate governance their data were not adequate and that adequate data would indeed have led to a positive relation.

Bebchuck and Fried (2004), on the other hand, rejected the agency theory and made a reasonable case for the managerial power theory. In their opinion not shareholders but managers have the final say in the process of framing the compensation contract. Besides, managers profit from so called “windfall profits”, results they did not achieve themselves. In their view neither the shareholders nor the non-executive directors were in the position to hold back the managers from excessive payment. Only public outrage could constrain these practises. Indeed in 2008 and 2009, in the context of the credit crunch, the outrage constraint became manifest both in the United States Congress and in the European Parliaments. Until then, Bebchuck and Fried (2004) found little support among the majority of economists, who still adhered the adage of Jensen and Murphy (1990) “It’s not how much you pay, but how”.

I share Bebchuck and Fried’s view that managerial power dominates the power of shareholders as stated in the agency theory. In my opinion it is surprising that this view was not embraced in economic circles.

After all, Bebchuck and Fried (2004) convincingly pointed to the often neglected phenomenon of “windfall profits”. In my judgement shareholders are not tied up with the remuneration of executives as long as the value of the stocks they own increases. This standing aloof from the debate on executive remuneration alters if the value of their stocks is decreasing, as turned out during this credit crisis.

Last year, shareholders of the Dutch listed companies Corporate Express and Philips rejected remuneration plans of executives for the first time. This year the remuneration plans of DSM and Randstad were deferred (Elsevier, March 28, 2009).

Given the foregoing, I will test the following hypothesis:

There is no relation between remuneration of CEO's and firm performance of Dutch listed companies in the period 2004-2007.

My study, like the research done by Duffhues and Kabir (2007) over the period 1998-2001, will also reveal that there is not any positive relation between firm performance and remuneration. They mainly used accounting variables as a measure for performance, unlike many other studies which centred on market values. The market value, in my opinion, is much more vulnerable to factors from outside the sphere of influence of the CEO and his company than accounting measures. Therefore I will also mainly focus on accounting measures, on which the so called “windfalls” do not apply.

As stated before, I assume that, also in the years before the credit crisis, the managerial power prevailed against the power of the shareholders in matters of remuneration. One of the instances that the balance of powers is expressed, is when a newly appointed CEO steps forward. Therefore my second hypothesis runs as follows:

Replacement of a companies CEO in the period between 2004 and 2007 leads to a rise in compensation.

5 Research Design

In this chapter I will explain how I intend to examine the hypotheses I that I have put forward and why the data I use are relevant in this context. In order to carry out my research in a proper way, I shall use Libby's predictive validity framework (Libby et al, 2002) as it enables me to increase the validity and reliability of my findings. Before that, however, I will make some remarks on the extent to which some firms comply to the principle of transparency in matters of remuneration, as expressed in the Dutch Corporate Government Code (2003) and I will also account for the sources from which I selected the data I used for my research.

5.1 Transparency

From 2002 on Dutch companies are obliged by law ('Wet openbaarmaking bezoldiging en aandelenbezit van bestuurders en commissarissen') to publish the remuneration of individual executives. Not only do basic salaries, bonuses, pension fees and contingent golden handshakes have to be recorded separately but the total remuneration of the CEO including options and shares has to be published as well. The Dutch Corporate Governance Code Tabaksblat, which has been effective since 2004, contains both principles and concrete provisions, which both persons involved in a company (including members of the management board and the supervisory board) and stakeholders (including institutional investors) should take into consideration in their relation towards each other. One of the main principles of the Tabaksblat Code is the transparency principle in matters of compensation.

5.2 Hypotheses

The first hypothesis I will test runs as follows:

There is no relation between remuneration of CEO's and firm performance of Dutch listed companies in the period 2004-2007.

In accordance with the agency theory (see chapter 2) and the corporate government codes which rely on it (see chapter 2), the basic economic principle is that the remuneration of the CEO depends on the performance of his firm and thus that firm performance is an independent variable. So, basically what I want to test is whether firm performance influences the remuneration of the CEO.

The second hypothesis I will test runs as follows:

Replacement of a company's CEO in the period between 2004 and 2007 leads to a rise in compensation.

As I have already argued earlier in this thesis, I am convinced, just like Bebchuk and Fried (2004) and Gerard (2006), that managerial power is a dominating factor in the process of establishing the remuneration of CEO's. The nomination of a new CEO is, in my opinion, one of the occasions that this managerial power can be operative. After all, supervisors, and also the shareholders, want to appoint the best qualified person to do the job. And it is for the manager to show that he is the competent executive they are looking for.

As compensations of CEO's are made public, the nominee is in the position to judge his market value in relation to the remuneration of comparable CEO's. Furthermore, a remuneration consultancy, if called in during the recruitment procedure, will probably put the nominee higher in order of rank if he presents himself and his competences well. Besides, it is very unlikely that the remuneration committee will judge the competences of the nominee to be of a lower quality than those of a CEO of a competing company.

5.3 Sample

My research is focused on companies listed at the Amsterdam stock exchange. There are three classifications at the Amsterdam stock exchange, namely :

- the AEX-index, which contains the 25 companies whose shares are most traded and generally also are the largest enterprises,
- the AMX or Midcap-index, which contains the companies that take position 26 to 50 and
- the ASCI or Smallcap-index, which contains the companies ranking from the positions 51 to 75.

The criteria to compose the Midcap-index and the Smallcap-index are the same criteria as with respect to the AEX-index.

Every year in March, and recently in September too, the revised composition of these indexes are published. In order to establish whether my findings hold for both the larger and the smaller listed companies, I decided to include in my research the companies listed on the AEX as well as the ASCI listed companies .

For my sample I chose to base my selection of companies on the classification of 1 March 2008 when I started my research. Besides, this choice also reflects the situation nearest to the closing of my research period (2004-2007).

5.4 Sources of data supply

To collect the most correct data on the remuneration of CEO's of Dutch listed companies I initially consulted two databases, namely www.topsalaris.nl, a database initiated and edited by the Volkskrant, and www.bestuursvoorzitter.nl, which is conducted by the Vereniging van Effectenbezitters (VEB), the Dutch association of shareholders. These sites publish the compensation of the CEO's, divided over different components such as basic salary, bonus, shares and options, pensions and, should that be the case, golden parachutes plus any other component of income as well. With the exception of shares and options, I compared the data of both these sites with regard to components of remuneration and, where they were in line with each other, I copied them in my database. However, I could not use the data of about half of the selected firms, because it turned out that their data were mutual divergent. Therefore, I took a closer look at the remuneration paragraphs of the annual reports of the concerning companies I downloaded, and reproduced the failing correct data. The observed differences were often due to the fact that the annual accounts used other currencies than the euro, but that the Volkskrant or VEB went on to handle these data as if they were represented as euros or they applied different exchange rates. An other source of misunderstandings and incorrect data is the habit of some firms to report the bonuses in the year they are paid out instead of accounting them to the year the bonuses are earned (see appendix 3). Companies which follow that procedure, also frequently fail to mention the amount of bonus they are willing to pay for performance in the then current year.

In contrast to the remuneration figures, as referred to above, the data of financial performances of the companies were relatively easy to collect on the Thomson One Banker Database, which is more reliable than the remuneration databases I used.

5.5 Missing data

Unfortunately I did not have all the relevant data within the sample at my disposal. As to the Hunter Douglas company, I could not find any data concerning remuneration of their executives, neither in the divers databases I referred to nor in the annual reports. The same goes for the compensation paid in 2007 to the executives of the Antonov company.

As for the annual accounts, the data of the enterprises Teleatlas and Corporate Express are missing in the Thomson One Banker database. I tried to retrieve the annual accounts of these companies myself, but unfortunately I did not succeed. For that reason, I had to

settle for the fact that I could not dispose of the data of those companies nor of those of Antonov over the year 2007.

Therefore, being unable to get hold of the necessary details, I do not have the data of Hunter Douglas, Teleatlas, Corporate Express and Antonov over the year 2007.

5.6 Variables

As mentioned before, my first hypotheses runs:

There is no relation between remuneration of CEO's and firm performance of Dutch listed companies in the period 2004-2007.

In accordance with the agency theory (see chapter 2) and the corporate government codes which rely on it (see chapter 2), the basic economic principle is that the remuneration of the CEO depends on the performance of his firm and thus that firm performance is an independent variable. So, basically what I want to test is whether firm performance influences the remuneration of the CEO. In order to establish that, it is necessary to make both concepts operational.

In the case of firm performance there are two ways to operate: one way is based on accounting measures, the second relates to market measures.

For accounting measures I chose Return on Equity (ROE), Return on Assets (ROA), and Operating Profit Margin (OPM). I will use the Total Shareholder Return (TSR) as a market measure of performance.

To make the variable CEO compensation operational it is necessary to decide which components are part of it. I decided to measure this reward in two ways, using on the one hand the (short term) bonus and on the other hand the Total Cash Compensation (TCC).

In theory the bonus is often linked to specific achievements to be delivered by the CEO or to a performance aimed at by the firm in the same year. The other measure I will use is the Total Cash Compensation that is (basic) salary, short term bonus, pension fee, and other cash components.

For several reasons I decided to exclude shares and options from this measure of compensation; after all, these stocks often are also granted for reasons not related to performance as is the case with premiums with appointment and retention premiums.

These kinds of reward, therefore, are not easy to relate to a particular year or to a particular kind of compensation. Moreover, the valuation of shares and options, especially in the year they are granted, is usually a controversial point of discussion. Granted shares and options mostly are vested in another year than the year in which the performance has

been accomplished. In my opinion, therefore, the increase of value in other years should be labelled as income out of capital instead of as income out of labour. After all, this income depends on the possession of shares and options respectively.

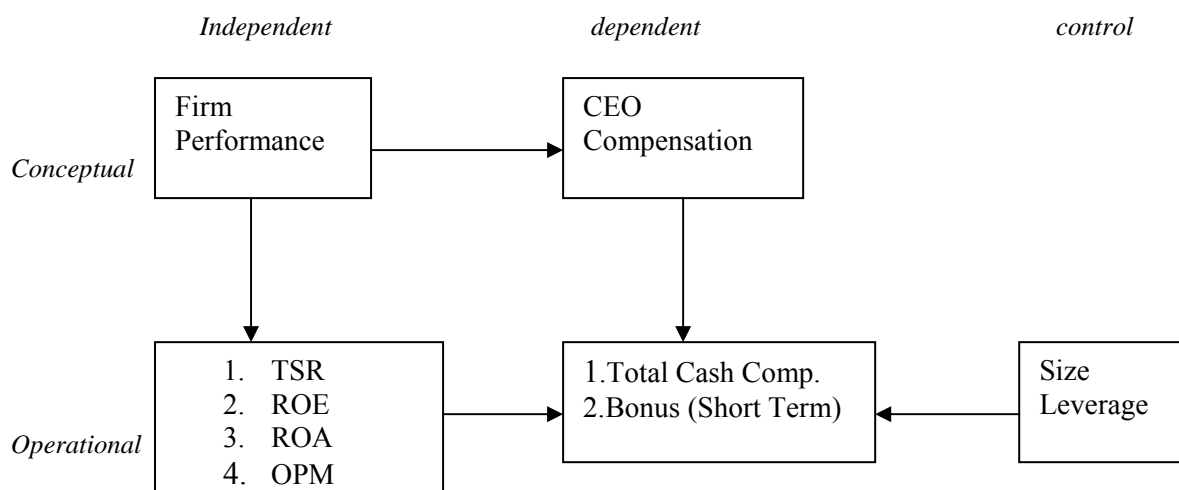
Of course, several schemes exist to determine the actual value of promised shares and options, but they all are debatable. The files of the Volkskrant and VEB on this matter have processed the data using different methods and therefore are not compatible.

To prevent my research erroneously misrepresenting a relationship between the chosen variables, I will add a few control variables. In recent decades many studies, for example Hall and Liebmann (1998) and Mertens, Knop and Strootman (2007), have shown a strong relationship between the size of the company and the compensation of the CEO.

Therefore, I will apply a control variable for size. If the variable for firm performance is a market measure, I will use as a control variable for size likewise a market related measure, namely total market capital. If the variable used for firm performance on the other hand is an accounting measure, I will also use an accounting measure for size, namely total assets. The second control variable I will use is leverage, defined as total debt as a percentage of common equity. The influence of relatively high debts on the compensation of the executive can be positive as well as negative. On the one hand, the money provider will monitor the activities of the firm, so the rises of compensation must be better argued. On the other hand, a high debt of the company leads to a higher risk, which could justify a higher pay for the CEO.

The third control variable I will use is time, that is to say the remuneration and other variables are linked to a certain period.

Table 5, *Libby's predictive validity framework (2002), p.795*



My the second hypotheses is:

Replacement of a company's CEO in the period between 2004 and 2007 leads to a rise in compensation.

Just as with the first hypothesis, one of the variables in this hypothesis is CEO compensation. Again it will be measured in more than one way: the Total Cash Compensation, and the components it consists of which are (basic) salary, short term bonus, pension fees and other cash components. Costs of company car, social security fees and health insurances are in some reports named as other cash components and in others they are assimilated in the salary. Therefore, and for the fact that in the years 2004 till 2007 regulations in Health insurance, social security and fiscal interpretation of company cars in The Netherlands changed, the variable I will use for salary also contains "other cash components". The other, independent, variable in this hypothesis is whether the companies CEO has been changed between 2004 and 2007.

5.7 Methodology

As, among others, Jensen and Murphy (1990), Hall and Liebman (1998) and Mertens, Knop and Strootman (2007) I will examine the changes in the variables in a certain year, compared with the preceding year to test the first hypothesis.

First of all I checked by way of a Q-Q-test whether the dependent variables "Change in Total Cash Compensation" and "Change in Short Term Bonus" were divided in a normal way (De Vocht, 2008). Unfortunately, that did not happen. The departure from the normal segmentation was, even after deleting three outliers, such that a regression-analysis, based on these data, could not be carried out in a reliable way. That is why I chose to transform the variables for total compensation and for bonus into logarithms. An additional advantage of using the logarithms is that the influence of the outliers is limited, so there is need to remove them out of the sample.

I will use the logarithmic variables for changes in pay over the different years, in a regression-analysis.

This regression-analysis shows as follows:

$$\Delta \text{LN (Pay)}_{it} = \beta_0 + \beta_1 \Delta (\text{Perf})_{it} + \beta_2 \Delta (\text{Size})_{it} + \beta_3 \Delta (\text{LEV})_{it} + \beta_4 \Delta (\text{Time})_{it} + e_{it}$$

Apart from the dependent variables, as mentioned above, independent variables will also be used. With regard to performance there are four measures.

First of all the market measure delta TSR: Total Shareholder Return at time, t , subtracted with the TSR of one year earlier, $t-1$. The other measures are accounting measures, namely delta ROA (Return On Assets), delta ROE (Return On Equity) and delta OPM (Operating Profit Margin). Also the ROA, ROE and OPM at time t are subtracted with the same ones at time $t-1$, and with regard to the added control variables for size, leverage and time a delta is calculated. At the end an error is left, which is called e_{it} .

As I already argued in this thesis, I am convinced, just like Bebchuk and Fried (2004) and Gerard (2006), that managerial power is a dominating factor in the process of establishing the remuneration of CEO's. The nomination of a new CEO is, in my opinion, one of the occasions that this managerial power can be operative. After all, supervisors, and also the shareholders, want to appoint the best qualified person to do the job. And it is for the manager to show that he is the competent executive they are looking for.

As compensations of CEO's are made public, the nominee is in the position to judge his market value in relation to the remuneration of comparable CEO's. Furthermore, a remuneration consultancy, if called in during the recruitment procedure, will probably put the nominee higher in order of rank if he presents himself and his competences well.

Besides, it is very unlikely that the remuneration committee will judge the competences of the nominee to be of a lower quality than those of a CEO of a competing company.

Because of the relatively small number of changes of CEO's within my sample in a particular year, I decided to measure the effect of the appointment of a new CEO on the compensation levels over the total period 2004-2007. Therefore, I will calculate the shifts in CEO remuneration with regard to the companies of the sample of which the data of remuneration are known. The composition of the total remuneration, as mentioned before, contains, once again, basic salaries, annual bonuses, pension fees and other cash components of compensation. For the same reasons as mentioned with regard to hypothesis 1, I will not include rewards in the shape of shares and options.

To test the second hypothesis, I will divide the total sample of companies in two groups, one group consisting of companies which have experienced a change of CEO between 2004 and 2007, the second group of firms retaining their CEO during the indicated period. Subsequently I will compare the results of the calculations with regard to the development

of compensation between each group of companies. To do so, at first I will determine the mean as well as the median of both of the groups. Subsequently, I will perform the Mann-Whitney test. This test is a non-parametric test, that shows whether the findings are significant and the null hypothesis, that there is no dissimilarity between the two groups, accordingly can be rejected (De Vocht, 2008).

As I mentioned before, I expect the mean rise of compensation in the group where a change of CEO occurred, to be substantially higher than the mean rise of compensation in the group of companies which retained their CEO.

6 Research Results

In chapter 5, I indicated how I would test the hypotheses I formulated. In this chapter I will describe the testing itself and the results it delivered.

6.1 First hypothesis

The first hypothesis I tested runs as follows:

There is no relation between remuneration of CEO's and firm performance of Dutch listed companies in the period 2004-2007

As explained in the previous chapter, I calculated the relation between the changes of reward and the change of firm performance through a regression analysis.

This regression analysis shows as follows:

$$\Delta \text{LN (Pay)}_{it} = \beta_0 + \beta_1 \Delta (\text{Perf})_{it} + \beta_2 \Delta (\text{Size})_{it} + \beta_3 \Delta (\text{LEV})_{it} + \beta_4 \Delta (\text{Time})_{it} + e_{it}$$

First of all I studied the change of the Total Cash Compensation, made up of basic salary, annual bonus, pension fee and other cash components. I expected not to find any relation between this dependable variable and the independent variables for firm performance: the change in ROA, the change in ROE, the change in Operating Profit Margin and the change in TSR. I founded my expectation on my view concerning the dominance of the managerial power.

The results of the regression analysis, as shown in table 6, did not entirely meet my expectations. As for the change in ROE and OPM, I could not find a significant relation (significance level 5%) with the change in Total Cash Compensation. With the change of ROA and TSR, however, the regression analysis did actually show a significant relation. But the explaining value of this result of the regression analysis is a minor matter, in spite of an apparently positive relation between the change in ROA respectively TSR and the change in Total Cash Compensation and in spite of the positive testing of the model. The determination coefficient (R Squared) measures at most 0,056, and the adjusted R-squared 0,048, which counts for an explanation of the variance in the dependent variable change in the Total Cash Compensation. In other words: about 95 % of the change in total cash compensation is caused by other factors. Given that a determination coefficient of at least 64% is needed to classify the relation as strong (De Vocht, 2008), I characterize this relation as extremely weak.

Table 6 *Regression results for Total Cash Compensation*

	1	2	3	4
Constant	-39,312 (0,528)	-72,32 (0,254)	-32,805 (0,600)	-23,072 (0,712)
ROE	0,174* (0,052)			
ROA		0,255*** (0,005)		
OPM			-0,130 (0,151)	
TSR				0,191** (0,027)
Size	0,087 (0,314)	0,100 (0,238)	0,086 (0,319)	0,078 (0,358)
LEV	-0,73 (0,417)	-0,062 (0,476)	-0,084 (0,357)	-0,133 (0,119)
Time	0,054 (0,527)	0,099 (0,253)	0,045 (0,599)	0,032 (0,710)
Adj. R ²	0,019	0,048	0,006	0,028
F-statistic	1,671 (0,160)	2,782** (0,029)	1,226 (0,303)	1,982 (0,101)
No. of obs.	140	140	140	137

***, **, * indicate significance at the 1%, 5% and 10% level, respectively
the p-values are between brackets

The results of the regression analyses concerning the changes in the annual bonuses, as shown in table 7, are different. Theoretically a bonus is based mainly on firm performance, but my conviction is that a lot of others factors matter.

For the change in three out of the four performance measures, I actually found significant positive relations as far as the change in bonus is concerned. With regard to the change in ROA the regression analysis showed an adjusted R-squared of 0,161, in the change of ROE and TSR the adjusted R-squared was respectively 0,139 and 0,028. All three analyses again show a statistically extremely weak relation. The major part of the variance has not been explained by the model.

In the regression concerning the changes in annual bonus, I also found a significant relation with the change in Operating Profit Margin. However, this was a negative relation, which means that an increase of the percentage of OPM leads to a decrease of change in annual bonus paid. With an adjusted R-squared of 0,095, this relation can also be referred to as very weak.

None of the control variables, added to the model, showed significance (5% level) and, therefore, have no impact on any of the relations found.

Tabel 7 *Regression results for Bonuses*

	1	2	3	4
Constant	792,215 (0,288)	224,217 (0,254)	933,168 (0,222)	1260,231 (0,109)
ROE	0,397*** (0,000)			
ROA		0,434*** (0,000)		
OPM			-0,332*** (0,000)	
TSR				0,223*** (0,009)
Size	-0,010 (0,901)	0,014 (0,857)	-0,012 (0,888)	0,102 (0,226)
LEV	0,160* (0,059)	0,147* (0,073)	0,146* (0,093)	0,009 (0,916)
Time	-0,085 (0,289)	-0,024 (0,768)	-0,100 (0,222)	-0,134 (0,110)
Adj. R ²	0,139	0,161	0,095	0,028
F-statistic	6,654*** (0,000)	7,722*** (0,000)	4,668*** (0,001)	3,219** (0,015)
No. of obs.	140	140	140	137

***, **, * indicate significance at the 1%, 5% and 10% level, respectively
the p-values are between brackets

6.2 Second hypothesis

The second hypothesis I tested runs as follows:

Replacement of a company's CEO in the period between 2004 and 2007 leads to a rise in compensation.

To get a first indication about the plausibility in figures, I tested this hypothesis by calculating the difference between the total cash compensation between the years 2004 and 2007.

With that I took an extra variable in for “change” and I noted the number 1, meaning a change of CEO within the indicated period, and the number 0 if there occurred no change of CEO. After that I calculated the mean and the median for both groups.

The results of these calculations are represented in the next table.

Table 8 *Difference in total remuneration between 2004 and 2007*

Change	Mean	Number	Median
0	484.898	29	167.592
1	595.678	17	357.245
Total	525.838	46	211.000

The figures from the table corroborate my expectation that the rise of compensation would be higher with companies where a change of CEO's occurred. The mean rise of compensation amounted to € 111.000 higher, whereas the median even shows a difference of nearly € 190.000. The large difference between the mean and median in the group seems to indicate influence of one or a few cases on the mean, is extraordinary big. And indeed, one of the cases from the sample strongly deviates from the mean: the rise of compensation of the Aegon CEO Shepard between 2004 and 2007 with € 3.886.000. Aegon excepted, the mean of the group without CEO change falls from € 484.898 to € 362.358. For that reason I regard the rise in compensation of the Aegon CEO an outlier and thus I did not include this figure in my further calculations.

I tested my second hypothesis by calculating the difference between the total cash compensation and its components (salary and other cash components, annual bonus, pension fee) between the years 2004 and 2007.

I calculated the mean and the median for both groups for all components. Both the mean and the median of the group whose CEO changed, turned out to be higher than the mean and median of the other group for the bonuses as well as for the total cash components. To verify whether this effect is significant, I did a Mann-Whitney test, that has no requirements for the segmentation of the sample.

Table 9, Difference in remuneration between 2004 and 2007

	Change	Number	Mean	Median	Mean Rank	Asymp.Sig.(2-tailed)
Salary	0	28	185.838	70.909	23,14	0,925
	1	17	29.440	79.522	22,76	
Bonus	0	28	102.033	53.036	19,14	0,011
	1	17	560.407	278.000	29,35	
Pension fee	0	28	74.488	10.654	24,75	0,251
	1	17	5.831	0	20,12	
Total Cash Components	0	28	362.358	142.296	20,43	0,092
	1	17	595.678	357.245	27,24	

The results of the Mann-Whitney test show that CEO change has a significant effect on the bonuses, as for the total cash components the effect is not significant at the usual 5% level. For the salaries and the pension fees, CEO change seems to have a negative affect, but the Mann-Whitney test teaches us that those effects are far from significant.

From the previous it appears that the importance of the bonuses rises whenever a new CEO is appointed.

The comparisons show that a change of CEO does, indeed, lead to a rise of compensation. I see this result as an indication of support for the managerial theory. If the agency theory would be dominant, then I would expect the mean compensation to drop in the group of companies with a change of CEO. After all, if the supervisors and shareholders should wish to reward their CEO on the basis of performance, they would be anxious for evidence, which only could be provided by evaluation of the functioning of the newly appointed CEO.

7 Conclusions

I wrote this thesis in a period in which the news was dominated by the credit-crunch.

Already in the first half of the year 2008 house prices in the United States plummeted. It was rumoured, that banks and investors owned loans based on mortgages issued to people who were not even able to pay the interest, let alone the redemption. Low-income Americans had got mortgages far above their potential financial capability to repay, on the assumption that house prices would continue to go up.

In the summer of 2008 the facts turned out to be even worse than the rumours. Salesmen, urged on by alluring bonuses, had sold mortgages even to ninja's (no income, no job, no assets), people living on benefits. The banks had packaged mixtures of bad and more solid loans and resold them as securities. What seemed to be valuable assets, however, might as well be papers without value. All over the world mistrust started to dominate the connections between the banks, which became very anxious to loan to each other. The banking system nearly collapsed after the failure of the commercial bank Lehman Brothers in September 2008. Governments had to intervene by issuing huge loans, giving extensive guarantees and even by buying banks. The banking system, however, sustained the crisis, but even injections of thousands of billions euro's in the economies of Western societies could not prevent the credit-crunch to affect the wider global economy.

The outrage Bebchuk and Fried (2004) had warned for, had occurred in full vehemence. The general public as well as many economists looked for the wrongdoers and asked themselves what was the reason that a seemingly booming economy could collapse in a fortnight. They pointed at the excessive pay of the executives, who were accused to be focused on the growth of shareholder's value as a means to increase their own income out of the bonuses they were due to receive in pursuit of their compensation contract.

A general consensus in media and among politicians was formed which blamed the system of variable pay for being the cause of the wanton carelessness with which the executives had directed their banks and companies. Apart from this, social scientist and a few economists forwarded other explanations. Instead of the analyses based on the agency theory, which upheld for an adequate relationship between pay and performance, those critics forwarded theories that emphasized the psychological factors in the behaviour of the managers. Verdegaaal (2008) explains: "Like a shark gets wild when he smells blood, a human is completely infatuated by money". But it is not only the greed for money which inspires the executives to maximize their incomes. As Fennema and Heemskerk (2008)

argue, they suffer from ‘mimetic greed’, nurtured by the longing for what is also desired by other people. And Conniff (2002) attracted once more a lot of attention with his sociobiological approach of the rich.

In the studies I reviewed in chapter 3, I already observed that there had been a gradual shift in focus by economists towards social and psychological factors influencing the behaviour of the top executives, instead of only taking the agency theory as a basis. And although the latest revision of the Dutch Corporate Government Code (Frijns, 2008) is still based on the validity of the agency theory, it also contains recommendations for strengthening the powers of the Supervisory Board. In this way the Code aims to channel and prevent the remuneration policies of companies from getting out of hand.

Of course the recommendation that the remuneration structure must be simple and transparent (Principle II.2) is still fundamental for the effectiveness of the Code. In my research, however, I noticed that some enterprises did not really strive for transparency. The Hunter Douglas company, for instance, failed to publish the remuneration data of the Executive Board, as recommended by the Dutch Corporate Government Code or even as it is mandatory by Dutch law. When Randstad, the company specialised in temporarily staffing, took over its former competitor Vedior, it failed, whether or not willingly, to mention in its annual report the compensation paid to Gunning, the former CEO of Vedior. Other companies apply an obscure system of defining the variable pay and / or report the rewards in such a way, that the possibilities to compare those figures in a proper way are nearly impossible. For instance, by scrutinizing annual reports and media, I discovered that a few bonuses and / or golden handshakes turned out to have been disguised as pension fees or salaries (see appendix 3).

It is common practice to publish the remuneration of the executives in the annual report of the accounting year, but it happens time and again that companies state the given bonuses in the annual report of the year following the year in which the bonus was earned.

Sometimes this departure from the usual code of behaviour is explained, but only too frequently an explanation is lacking. Of course, it can be argued that it is correct to mention the variable rewards in the annual report of the year they are paid out. It is, however, misleading to do so, because, if there is a relationship between pay and performance, one tends to relate this connection to the outcomes of a wrong year.

Moreover, as the IFRS demands a true and fair view of the net worth, awarded compensations, that can be looked upon as a debt, have to be stated on the balance in my view.

Mertens, Knop and Strootman (2007) already observed that one of the trends in remuneration policies is to use more measures to award a bonus, which increases its complexity and is not instrumental to the transparency (see page). Of course, it is unclear whether a certain remuneration contract has to be complex to do justice to the stated goals or that the complexity is used as a device to throw dust into the shareholders' and the general public's eyes.

Another factor that diminishes the comparability of the compensation awarded is the use of different currencies in some annual reports. Of course it is possible to reproduce the current exchange rates of US-dollar and pound sterling, but I should recommend companies listed on the stock exchange of Amsterdam (also) to report in euro's.

In my opinion the principles and best practices of the Dutch Corporate Governance Code are too lax. In many aspects the transparency of corporate governance would benefit from a more rule-based approach.

Following Duffhues and Kabir (2007) in their opinion that managers frequently proclaim to work towards many goals other than shareholder value maximization, I did not expect that in The Netherlands, performance is a leading determinant of CEO compensation. According to Mertens, Knop and Strootman (2007), the performance sensitivity has increased between 2002 and 2006. This is, however, no proof for more alignment with shareholders interests. It could be, and it is even probable, that because of generally rising share prices and accompanying "windfalls" the bonuses have been paid. Therefore executives consider the bonuses more and more as a secure part of their income.

The confirmation of the second hypothesis, *Replacement of a company's CEO in the period between 2004 and 2007 leads to rise in compensation*, shows that, at least where it concerns the appointment of a CEO, the managerial power is preponderant. K. Wawoe, who prepares a dissertation on the use of bonuses as incentives by banks, concludes that the amount of the bonus is determined not just by the achievements, but to a large degree by characteristics of the personality. "A person who is enterprising, assertive and dominant, and who puts his own interests before those of others, succeeds in obtaining a higher reward" (Volkskrant 10-23-2008).

The revised Dutch Corporate Government Code (Frijns, 2008) is still based on the principles of the agency theory, but it also allows for the managerial power theory. For

the Frijns Committee gave the supervisory boards more responsibility and say over the remuneration of the management, obviously in an attempt to curb managerial power. Paces (2007) phrases this notion as follows: “The crucial difference (highlighted by the present study) is that the institutions of corporate governance do not support incentive-compatibility by allocating powers to shareholders, but by constraining abuse of the same powers by corporate controllers. In this perspective, managers and controlling shareholders can no longer be considered as agents, as if they were sort of employees of investors. Surely, they do not consider themselves as being in such a position.”

Jensen and Murphy ‘s axiom (1990) that it does not matter how much a CEO is paid, but essentially *how* a CEO is paid, is preponderant. The Dutch Corporate Government Code and also the Act Harrewijn are in line with this principle, although the social consequences of the excessive pay, however, are ignored. Jensen and Murphy (1990) argue that supervisors, caused by public pressure, become even reluctant to reward CEO’s. In my opinion Bebchuck and Fried (2004) and Gerard (2006) convincingly demonstrated the dominating power of the managers over the supervisors and the recommendations by Frijns (2008), to allot more power to the supervisors as a counterweight, can also be seen as a confirmation in this respect. In chapter 5 I explained the driving force of the public nature of compensations of CEO’s. The use of benchmarks stimulates the ‘mimetic greed’ (Fennema and Heemskerk, 2008). In their column Winter and Cools (2008) quote a foreign CEO who said: “I know I am being overpaid, but the benchmark shows I am not being overpaid enough”.

But also from the perspective of the agency theory itself, the adage of Jensen and Murphy (1990), that it is more essential *how* a CEO is paid than how much he is paid, is open to question. Eisenhardt (1989) argues: “the heart of the agency theory is the trade-off between a. the cost of measuring behaviour and b. the cost of measuring outcomes and transferring risk to the agent”. As it appears from the developments during the credit-crunch, these latter costs can be extremely high. Over 8 years Lehman Brothers, for instance, paid its CEO \$ 60.000.000 cash and \$ 250.000.000 in shares (Winter and Cools, 2008). This handsomely rewarded CEO was the one who led Lehman Brothers to bankruptcy. One can argue that the excessive pay of the CEO stimulated him to take the risks that led to the downfall of Lehman Brothers.

7.1 The myth of the firm performance reward

During the debate over the causes of the credit-crunch, media and politicians paid, almost exclusively, attention to the pernicious role that the system of variable rewards plays. The general public, as well as many economists, seem to believe in what I call the myth of the firm performance reward. They are convinced that the amount of the bonuses fully depends on the performance of the firm. So the executives are accused of being focused on short term results only in order to maximize their bonuses.

The outcome of my research does not support this one-sided opinion. After all, even when the credit-crunch is partly caused by the bonuses, this does not mean that the self-enrichment of the managers relates to firm performance.

My research conducted on my first hypothesis: *There is no relation between remuneration of CEO's and firm performance of Dutch listed companies in the period 2004-2007*, revealed striking findings. To a large extent this hypothesis was confirmed: I did not find positive relations between, on the one hand, changes in respectively ROE and OPM, on the other hand, the change in Total Cash Compensation. As for the relation between change in ROA, respectively TSR and change in Total Cash Compensation: the analysis shows a significant positive relation, which is, however, extremely weak.

Between the change in bonus and the changes in all three performance measures ROE, ROA and TSR, I actually found a significant positive relation. But these three analyses too show a statistically weak relation. For the analysis of the change in OPM I even found a weak significant negative relation with the changing bonus.

My findings inspired me to have a closer look at several studies on the pay-performance relationship. Most of them, including Jensen and Murphy (1990), Hall and Liebman (1998) and Mertens, Knop and Strootman (2007), reported the finding of positive relations between pay of executives and firm performance. However, their statistical foundations are as weak as the outcome of my analyses. None of them shows a R-Squared higher than 0,17, which is statistically weak (Vocht de, 2008) and means that at least 83% of the relation between pay and performance has to be explained by other factors than firm performance. Although the economists, mentioned before, published these findings in their calculations and tables, they do not elaborate on them.

This leads me to the bold conclusion that prominent economists and their adherents attributed to the myth that the excessive pay of CEO's is justified by their proven

contributions to the performance of the firm. This myth detracts the attention from other explanations of the excessive pay such as the shortage of capable CEO's, the "mimetic greed" and the drive to rise in the pecking order of CEO's. All of these causes are, of course, related to managerial power, which, in my opinion, is an important cause of compensation rising to excessive levels.

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Appendix 1

This table shows summary statistics of compensation paid to the Chief Executive Officers of Dutch firms of registered on both the AEX and ASCI.

		Report			
Year		basis etc.	bonus	pension	Total
2004	Mean	607.952	432.960	138.112	1.179.023
	N	48	48	48	48
	Median	430.050	159.000	92.344	691.000
	Minimum	102.000	0	0	119.070
	Maximum	1.645.000	3.390.469	567.000	4.629.067
	Std. Deviation	440.107	646.071	148.358	1.045.752
2005	Mean	640.551	464.224	221.418	1.326.195
	N	49	49	49	49
	Median	459.063	196000	77.718	768.000
	Minimum	118.000	0	0	200.000
	Maximum	1.853.930	2.998.000	4.000.000	6.421.000
	Std. Deviation	478.552	596.893	578.648	1.282.883
2006	Mean	657.503	598.252	170.661	1.426.416
	N	49	49	49	49
	Median	500.000	303.270	88.802	851.000
	Minimum	122.083	0	0	136.000
	Maximum	2.015.000	4.059.000	1.458.000	6.351.000
	Std. Deviation	478.525	781.995	258.927	1.361.253
2007	Mean	759.438	739.748	182.982	1.682.168
	N	48	48	48	48
	Median	507.014	335.158	90.922	996.500
	Minimum	125.080	0	0	172.869
	Maximum	3.505.277	4.292.000	1.421.000	6.824.000
	Std. Deviation	629.212	918.791	277.556	1.555.910
Total	Mean	666.182	558.512	178.476	1.403.171
	N	194	194	194	194
	Median	483.213	225.667	85.000	832093
	Minimum	102.000	0	0	119.070
	Maximum	3.505.277	4.292.000	4.000.000	6.824.000
	Std. Deviation	510.568	750.112	353.501	1.326.467

Appendix 2

Summary of Financial performances of the sample

Year		Net Revenues (millions)	Net income (millions)	Total Assets (millions)	Yearend market capital (millions)
2004	Mean	13.329	856	4.3357	9.725
	N	47	47	47	46
	Std. Deviation	35.053	2.452	152.651	24.067
2005	Mean	15.229	1.136	55.704	11.289
	N	47	47	47	47
	Std. Deviation	41.677	3.272	200.794	27.683
2006	Mean	16.555	1.224	59.383	13.217
	N	47	47	47	47
	Std. Deviation	43.687	3.285	211.469	29.376
2007	Mean	18.919	1.500	65.503	14.390
	N	46	46	46	46
	Std. Deviation	49.151	3.928	231.073	31.548
Total	Mean	15.993	1.177	55.936	12.156
	N	187	187	187	186
	Std. Deviation	42356	3.254	199.443	28.130

Year		ROE	ROA	Operating Profit Margin	Leverage	TSR
2004	Mean	8,54%	3,20%	-33,95%	137,87%	35,17%
	N	47	46	44	47	45
	Std. Deviation	65,63%	27,14%	310,66%	262,40%	53,79%
2005	Mean	20,81%	5,97%	-196,67%	137,91%	39,46%
	N	46	46	45	47	45
	Std. Deviation	22,54%	24,65%	1.007,57%	300,67%	42,49%
2006	Mean	20,47%	7,25%	-1.072,57%	132,58%	32,70%
	N	46	46	45	47	47
	Std. Deviation	22,98%	21,27%	5.781,37%	266,59%	28,66%
2007	Mean	25,24%	11,90%	-67,15%	121,93%	2,56%
	N	46	46	45	46	45
	Std. Deviation	30,61%	13,74%	527,39%	209,11%	27,95%
Total	Mean	18,71%	7,08%	-344,06%	132,63%	27,53%
	N	185	184	179	187	182
	Std. Deviation	39,98%	22,32%	2.964,47%	259,97%	41,87%

Appendix 3

This appendix gives some examples of some strikingly observations in the reports of the companies involved in my research.

Until 2006, the remuneration figures in the report of Kardan were only in US Dollars.

Vedior reports their bonuses in the year they are paid out. Since Randstad took over Vedior in 2007, the yearly bonus of Gunning over 2006 is not reported in Vediors report. Although Randstad should enclose Vediors figures in their 2007-report, I could not find Gunnings 2006 bonus.

Exact:

CEO Hagens leaves on sabbatical in 2003 and never came back. Officially he stepped down in 2005. According to the reports he got his salary paid during those years. He was also allowed to use the company's airplane during that time, according to the report "at his own expense". After the period he buys the plane at market value. So, in my opinion, the plane he mostly uses is depreciated at the costs of the company.

Heineken 2005:

"An extra payment over past service was made in anticipation of the new pension policy for the current Executive Board members in effect as of 2006. The retirement age is 65, but individual Executive Board members may retire earlier with a reduced level of benefit. Contribution rates are designed to enable an Executive Board member to retire from the company at the age of 62 with a benefit that represents about 62 percent of the pre-retirement base salary". For Mr. Ruys a payment of €4.000.000 was done!

"Stepped down from the Executive Board on 1 October 2005. Mr. Ruys will be entitled to a monthly salary until 1 July 2007 and a pro rata bonus over 2006. The deferred benefits have been recognised in 2005".

Aegon 2006:

"The bonuses for the 2006 Plan, as well as Mr. Shepard's additional STI bonus related to AEGON's net income over the financial year 2006, will be calculated and paid in 2007, after adoption of the 2006 annual accounts by shareholders, and be reported in the 2007 Annual Report."

Eriks groep 2005:

"Met de oud-voorzitter is bij zijn aantreden in 2001 als voorzitter een regeling voor de variabele vergoeding overeengekomen die doorloopt tot twee jaar na zijn aftreden. De inschatting voor de als oudbestuurdervergoeding aan te merken uitkering bedraagt EUR 0,6 miljoen, waarvan EUR 0,2 miljoen betrekking heeft op het verslagjaar 2005."