A social comparison perspective of executive remuneration committees in

Australian companies

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Refereed Paper
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A social comparison perspective was used to examine executive remuneration committee processes in Australian companies. Remuneration committee data from 1995 to 1999 from Australia’s largest publicly-listed companies were examined and remuneration committee members were interviewed. The findings of this paper suggest that social comparison effects are present in remuneration committees. Two factors drive these effects. First, legal requirements for salary disclosure have contributed to an environment of uncertainty. Where objective measures may have been used before, less objective market comparisons may be more common. Second, the prevalence of ‘best practice’ recommendations as to the composition of a remuneration committee has resulted in committees being primarily comprised of non-executive directors. The concentration of committee members with like experiences and/or attributes increases the likelihood of social comparisons.

Key words: Social comparison, Remuneration committee, Governance, Australia

INTRODUCTION

Executive remuneration is a contentious issue and a number of attempts have been made to explain management rewards through the use of, among others, economic models such as Fama’s (1980) and Jensen and Meckling’s (1976) agency theory. Researchers are currently seeking alternative theories – many having a varied pedigree of social-psychological research – which may provide deeper insights into the processes involved in the formulation, appraisal and re-formulation of executive pay. One such theory is social comparison theory. Barkema and Gomez-Mejia (1998), Daily, Johnson, Ellstrand, and Dalton (1998), Miller (1995) and O’Reilly, Main, and Crystal (1988) have examined this theory in their respective studies into executive pay.

Social comparison theory can assist in our understanding of remuneration committee processes. This paper explores social comparison theory as it relates to executive remuneration and the basis of its relevance and utility. As Barkema and Gomez-Mejia (1998:142) noted, a challenge for researchers lies in exploring how the definition, measurement and relative importance of criteria such as market rates, peer rewards and behaviour depend on a firm’s governance structure and on contingency variables.

SOCIAL COMPARISON THEORY

Social comparison processes (Festinger, 1954) involve social actors and decision makers constantly relying on a wide range of social comparisons to secure equity in the setting of their expected rewards. People have a need to evaluate their opinions and abilities. In the absence of objective criteria, social
criteria are used. They will prefer to make comparisons with others who are perceived as similar: opinions might be evaluated in closed social circles and abilities might be measured against those who are thought to possess similar attributes. Further, people are motivated to make the comparisons when they believe the opinion or the ability is important and when the referent group is important to the individual. While there is a general tendency for people to compare themselves with others who are perceived to possess similar opinions and attributes (or abilities) (Goodman, 1974), there is also a tendency to select referents with slightly higher abilities for comparison. The comparisons may be motivated by self-improvement motives (upward comparisons) or self-enhancement motives (downward comparisons). Individuals also engage in comparisons in ‘an attempt to reduce personal uncertainty and conserve or improve self-esteem’ (Conner, 2003:134).

In the context of remuneration committees – the board sub-committee charged with devising and recommending executive reward packages – Ezzamel and Watson (1998:223) argued that non-executive directors selected to serve on remuneration committees were chosen because of their similarity to those involved in the selection process. Similarities between executive and non-executive directors in terms of earnings levels meant that committee members may base their judgements regarding appropriate executive reward packages on their own earnings (Tversky & Kahneman, 1974).

**Social Comparison Theory and Executive Remuneration Committees**

In this paper, remuneration committee processes are viewed primarily through the lens of social comparison theory. Mumford (1983) believed that social comparison had important applications in novel environments and Kilduff (1990) thought that the theory had applications when individuals faced important and ambiguous decisions, while Finkelstein and Boyd (1998) found that managerial discretion had a positive relationship on CEO pay. Task uncertainty and complexity, such as that experienced by a remuneration committee, will prompt members of a group to seek others to assist in finding solutions to problems presented to the group. In the context of making a decision after the processing of complex and voluminous data, social comparison theory may help explain the size and composition of CEO reward packages in Australian companies.
Social Comparison Theory Applied in Governance and Remuneration Research

Charles O’Reilly (Stanford University, 2002), a critic of the indiscreet use of economic models in executive pay research, described reasons for why social dynamics within the remuneration committee (not labour market forces) had significant influences on CEO pay. In the committee, there is a strong element of peer-group comparison when determining CEO reward packages. A director on the remuneration committee of one company may be a CEO in another company.ii

Latent and conscious feelings of reciprocity may be present on boards. Molm’s (2003:3,4) examination of exchange theories described a reciprocal exchange as one where ‘actors’ contributions to the exchange ‘are separately performed and nonnegotiated [. . .] that is, A’s behaviour individually produces rewards for B, and vice versa’. Directors, particularly in U.S. companies, often owe their appointment to the CEO and may feel indebted to the CEO despite their apparent independence. As the CEO often recommends potential directors who share similar experiences and other personal characteristics, positive social comparisons may be more likely.iii

Boards (and, by extension, board committees) have often been criticised as rubber stamps for executive initiatives (see, for example, Oliver, 2000; and Ward, 1997).iv It may follow, then, that ‘rubber stamp behaviour’ is to be expected when boards are viewed through social comparison lenses. More broadly, this may be what Belliveau, O’Reilly, & Wade (1996) describe as the ‘number of psychological and political processes that shape individual and group decisions everywhere’.

On the basis of methodologically inconsistent studies which tended to focus on the economic determinants of pay, O'Reilly et al.’s (1988) application of social comparison theory may provide a better model for explaining executive pay. As CEO performance is sometimes difficult to quantify and is often ambiguous, committee members engage in social comparison. The CEO’s salary package, therefore, is likely to reflect the salary levels of remuneration committee members more so than market forces (see, also, Daily et al., 1998; Westphal & Zajac, 1997).
The composition of the committee is thought to affect the size and composition of the CEO’s pay package. One would expect that if the committee is comprised of members beholden to or dependent on the CEO, the salary package would be larger. This hypothesis was not supported by Daily et al.’s (1998) study of the relationship between the composition of remuneration committees and CEO pay levels, as shown earlier. Subsequently, studies such as Daily et al.’s (1998) indicate some support for agency theory and a need to further test the validity of social comparison theory.

FOCAL SOCIAL COMPARISON STUDIES

Attention is directed towards three studies which have paid particular attention to the relationship between CEO pay, the remuneration committee and social comparison theory and serve as primary theoretical drivers for the present study.

O’Reilly, Main, and Crystal (1988): Compensation as tournament

Three perspectives for understanding CEO pay were examined in O’Reilly, Main, and Crystal’s (1988) article: neoclassical explanations that have used common economic determinants; CEO pay levels being the results of tournaments (Lazear & Rosen, 1981); and social comparison as a fitting social psychological explanation for CEO pay. While mixed or no support was found for the respective hypotheses of the first two perspectives, the social comparison argument is of most interest to this paper. O’Reilly et al. (1988) reasoned that since most of the outside directors were likely to be or to have been CEOs in other companies, then a social comparisons may be taking place. The CEO’s pay could be at least partially attributed to the pay earned by the remuneration committee's members.

Studying a sample of 105 firms (drawn from Business Week's 1985 survey of executive compensation) representing nine industries, the researchers found that approximately 65 per cent of remuneration committee members were current or retired CEOs. O’Reilly et al. (1988:269) also found that the presence of highly remunerated outside board members is related to high CEO salaries in a statistically significant manner. And these results hold even when there are controls for the fundamental economic characteristics of the corporation such as size, profitability and industry.

However, it was also conceded that these results did not prove that the appointment of a highly-paid
executive as an outside board member would lead to a rise in the pay for that firm's CEO.

**Main, O'Reilly, and Wade (1995): Economic and psychological perspectives**

Main, O'Reilly, and Wade (1995) viewed the board of directors as a social group subject to the norms of reciprocity, authority and similarity and liking and discussed economic, institutional and psychological factors that affect how the board of directors determine executive rewards. In discussing modern corporate governance, Main et al. (1995:304) presented an argument against ‘the theoretical ideal of [the board as] a group of vigilant, informed and impartial principals objectively monitoring the performance of top management so as to serve the shareholders' interests’. Two explanations were suggested for this contention: first, the legal roles and responsibilities ascribed to boards are not as clear as the theory suggests; and second, board members are often selected by CEOs.

Drawing from the same population as O'Reilly et al. (1988), Main et al.’s (1995) studies suggested that social influence had a significant influence on the pay setting process. That is, efficient corporate governance models driven by theories such as agency theory and transaction cost economics would be difficult to obtain as long as the CEO exercised social influence over directors.

**Ezzamel and Watson (2002): Pay comparability and UK boards**

Pay comparisons in large, publicly-listed U.K. companies were examined through social comparison and equity theory lenses by Ezzamel and Watson (2002). Factors such as corporate governance, the maintenance of executive pay comparability, team cohesion, competitive employment opportunities and signalling to external stakeholders the high quality of the firm’s executives were thought to be important in the pay setting process (Ezzamel & Watson, 2002:209). As well as alignment with the external executive market, the remuneration committee was thought to also attempt to maintain a level of comparability with the pay of other board members (see, also, Ezzamel & Watson, 1998).

Ezzamel and Watson’s (2002) study of 199 *Times 1000* companies suggested that external labour market and board pay comparisons were important in explaining both CEO and directors' pay rewards. Two reasons are offered as to why the complex executive pay-setting process is unlikely to mirror the
incentive alignment concerns integral to models such as those in agency theory. First, remuneration committees appear to seek a balance between maintaining equity between directors and ensuring that external market considerations (particularly for the CEO) were not ignored. Second, equity was found to be multidimensional in the context of CEO and director pay. Lateral equity meant that pay had to conform to the ‘going rate’ of the market. Vertical equity related to the magnitude of the pay and its changes over time that reflected hierarchical, symbolic and political differences between executives (Ezzamel & Watson, 2002:228).

Comment on Focal Social Comparison Studies

In studies discussed above social comparison offered at the very least novel, if not promising or conclusive, explanations for executive pay. Despite the potential offered by social comparison theory, it should be noted that it is untested in the context of executive pay and governance in publicly-listed Australian companies. Where there is a separation of ownership and control (a fundamental assumption in some economic theories) relatively lacking, social comparison processes are likely to play a more prominent role.

Given recent heightened public interest in corporate activity, increased levels of share ownership and shareholder activism, increased and tightened regulation and increased global activity which necessitates sound and transparent governance structures, it is of interest to know whether social comparisons can play an appreciable role in Australian boardrooms.

METHODOLOGY

To develop an insight into remuneration committees and the application of social comparison theory, quantitative and qualitative modes of data collection and analysis were employed. A database was developed from corporate governance data provided in annual reports from Australian companies. Demographic and activity data for remuneration committees was obtained from companies which appeared at least four times in the Business Review Weekly’s listing of the top 500 public companies for the years 1995 to 1999. For the purposes of analysis, the companies were divided into either five
equal size categories (measured by 1999 profit results) or seven broad industry groupings (the collapsing of 24 Australian Stock Exchange industry classifications).

Twenty-one interviews were conducted with remuneration committee members in a variety of industry classifications. Participants were asked to describe the main issues and challenges for remuneration committees. The key findings from the data collection and analysis process are outlined below.

DISCUSSION OF RESULTS

It appears that the combination of legislative changes and the promulgation of ‘best practice’ codes resulted in a fertile environment for social comparisons to take place. On one hand, the demands from regulatory bodies and the (sometimes conflicting) prescriptive nature of the contemporary corporate governance literature created uncertainty. One of the potential consequences of this uncertainty is the triggering of social comparisons. On the other hand, legal and regulatory requirements as well as prevailing governance attitudes affected the composition of the committee. That is, where there was first a potential for social comparisons, the compliance with these ‘best practices’ promoted and reinforced social comparisons.

In the statistical analyses, some of the results suggested social comparison effects between the years 1995-1999. In the two one-way between groups analyses of variance for company size (i.e. Profit 1999 category) and remuneration committee size (i.e. Total members) and in the profile analyses for company size and remuneration committee demographics over time, two distinct groups were identified: committees in the highest profit category and committees in the remaining lower profit categories, suggesting social comparison effects. This distinction will be illustrated in Table 1.

In similar analyses for Broad Industry Groups, industry type did not have a significant effect on the nature of the remuneration committee over time, suggesting either similarities in committee membership across industries, or that directors had a tendency to sit on multiple remuneration committees across industry demarcations. However, there were no significant effects for time (i.e.
1995 to 1999) when the committee was viewed from a company size perspective. In this case, the results suggest that committee membership is not particularly dynamic and remains constant.

The implications of no significant time effects for company size indicate that moves into new referent groups require time before commonalities among the cohort become re-established. For example, a lowly-ranked company (by profit) may be more likely to have a committee that is comprised of directors who sit on boards and/or committees in other lowly-ranked companies. If this company is highly successful for a number of years, it will be sent to a new and different group of referents – i.e. highly-ranked companies (by profit). The process of selection and assimilation may be slower if the referent groups do not meet each other’s expectations. Committee members in lowly-ranked companies may aspire to interact with contemporaries in the more profitable companies. This aspiration is not likely to be reciprocated if social comparison theory sees directors as seeking like others or others that they would like to be like. By way of example, this kind of clustering can be seen when the board memberships of prominent directors are matched against directors who occupy board seats in smaller companies. Table 1 illustrates this point.

**TABLE 1**

<table>
<thead>
<tr>
<th>Directorship of board members in selected companies</th>
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<table>
<thead>
<tr>
<th>Director</th>
<th>Number of other BRW500 directorships</th>
<th>Other BRW500 directorship rankings</th>
<th>Director</th>
<th>Number of other BRW500 directorships</th>
<th>Other BRW500 directorship rankings</th>
</tr>
</thead>
<tbody>
<tr>
<td>10th-ranked BRW500 company</td>
<td>490th-ranked BRW500 company</td>
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</tr>
<tr>
<td>1</td>
<td>1</td>
<td>12</td>
<td>1</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>1</td>
<td>3</td>
<td>2</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>3</td>
<td>1</td>
<td>43</td>
<td>3</td>
<td>1</td>
<td>72</td>
</tr>
<tr>
<td>25th-ranked BRW500 company</td>
<td>475th-ranked BRW500 company</td>
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<td></td>
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<td>1</td>
<td>1</td>
<td>13</td>
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<td>3</td>
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<tr>
<td>50th-ranked BRW500 company</td>
<td>450th-ranked BRW500 company</td>
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<td>1</td>
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<td>35</td>
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<tr>
<td>3</td>
<td>1</td>
<td>75</td>
<td>3</td>
<td>1</td>
<td>491</td>
</tr>
<tr>
<td>75th-ranked BRW500 company</td>
<td>425th-ranked BRW500 company</td>
<td></td>
<td></td>
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<tr>
<td>1</td>
<td>2</td>
<td>84,169</td>
<td>1</td>
<td>2</td>
<td>371,403</td>
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<tr>
<td>2</td>
<td>1</td>
<td>50</td>
<td>2</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>3</td>
<td>2</td>
<td>101,500</td>
<td>3</td>
<td>0</td>
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</tr>
</tbody>
</table>

As shown in Table 1, a cursory analysis of the directorships of board members in selected companies
in the Business Review Weekly’s top 500 publicly-listed companies in 2004 lends some support to a social comparison argument. Directors in the top 100 companies may be more likely to occupy board seats in other companies. In addition, these directors will tend to occupy seats in companies with higher rankings. Stapledon and Fickling’s (2001) study identified sixteen non-executive directors of top 100 listed companies who had three directorships in the top 100. Seven directors held four directorships in the same 100 companies.

The remuneration committee, as a social construct, is a form of organisation that is capable of acquiring and processing large quantities of data in a variety of ways (Hillman, Cannella, & Paetzold, 2000). The data may come in the forms of consultants’ reports, newspaper articles, internal memos, anecdotes from colleagues and acquaintances, rumours, non-verbal cues in communication or daydreams – among many other forms. Also, individually and collectively, the members of the committee are thought to have limits in what they can do and how they perform tasks. Rational decisions (and, therefore recommendations) are not always possible. In other words, as committee members are capable of devising rewards that may ultimately play a part in driving up the company’s share prices and may save that company millions of dollars in executive fees, they may be just as capable of recommending packages which do not have any obvious relationship with performance.

The conditions thought to be conducive for social comparisons are similar to those experienced by a remuneration committee, as shown in Table 2. Generic social comparison conditions are listed in this table along with examples of those conditions in an executive remuneration committee context.
TABLE 2
Social comparison in the remuneration committee

<table>
<thead>
<tr>
<th>Conditions leading to social comparisons</th>
<th>Examples in the remuneration committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental uncertainty</td>
<td>- Compliance ‘mine field’</td>
</tr>
<tr>
<td>A need to evaluate opinions</td>
<td>- Committees are likely to seek a decision by consensus</td>
</tr>
<tr>
<td>Absence of objective criteria</td>
<td>- Judgement is used and economic values are placed on performance that cannot always be measured quantitatively</td>
</tr>
<tr>
<td>Comparisons made with similar individuals or groups</td>
<td>- Committee members who have experience in companies of similar size or industry are preferred</td>
</tr>
<tr>
<td></td>
<td>- ‘Best practice’ pressures committees to be comprised primarily of one type of company officer: the non-executive director</td>
</tr>
<tr>
<td>Comparisons made with important individuals</td>
<td>- The board’s chair often chairs the remuneration committee</td>
</tr>
<tr>
<td></td>
<td>- Committee members who have developed a positive reputation in the business community are valued</td>
</tr>
<tr>
<td>Latent and conscious feelings of reciprocity present</td>
<td>- More likely to occur in cases of board interlock</td>
</tr>
</tbody>
</table>

Recent studies on board (and committee) behaviour and performance suggests that this facet of corporate governance still appears to be mired in mystery. A 2004 issue of the *Academy of Management Executive* identified contemporary issues in board performance. Cascio’s (2004) article questioned board selection processes and Letendre’s (2004) contribution dealt with the characteristics of good boards. This present study has aimed to clarify some of the questions about board behaviour by paying specific attention to one of its committees, but many other facets of executive remuneration phenomena remain unexplored. More work in this field is required in order to develop a better understanding and insight.

CONCLUSION
This exploratory study into Australian remuneration committees has provided another entrée to research on the remuneration committee and is a framework for subsequent studies which may lead to the development of typologies and policy for committees. The study has also extended the application of social comparison in the study of corporate phenomena. The present study identified social comparison effects in remuneration committees in Australian companies. Consistent with what has been described as social comparison theory’s ‘renaissance period’, this paper took a step toward considering ‘basic comparison motives other than self-evaluation . . . [and considered] the social construction of comparison targets’ (Buunk & Mussweiler, 2001:469).
REFERENCES


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\(^1\) CEOs may be particularly instrumental in the appointment of new executives and directors (Barkema & Pennings, 1998:984; Finkelstein & Hambrick, 1996; and Hambrick & Finkelstein, 1995).


\(^3\) Mumford (1983:878-879) describes the utility of social comparison theory in peer evaluations.

\(^4\) In his interviews with executives, Mace (1971:26-27) was told that, The board rarely, if ever, rejects out of hand a proposal by the president, but their existence in the management scheme of things influences the president and helps his decisions within the bounds of conscionable conduct.

\(^5\) It should be noted that studies such as Bitler, Moskowitz, and Vissing-Jørgensen (2001), Bitler, Moskowitz, & Vissing-Jørgensen (2004), and Shaw, Gupta, & Delery (2000) do not dismiss the explanatory power of agency theory. They are more likely to question its narrow conceptualisation of board-CEO relationships, and often advocate the interpretation of agency theory alongside ‘... the more psychological approaches [which] begin with the premise that the compensation-setting process relies on the deliberations of a small group of people of a firm's compensation committee’ (Belliveau et al., 1996:1570).