Multinationality, CEO Compensation, and Corporate Governance: Some Empirical Evidence

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Abstract

The design of management compensation contracts provides an important corporate governance tool for reducing agency conflicts and improving firm performance. We examine the chief executive officer (CEO) compensation contracts of multinational (MNC) and domestic (DC) corporations. Prior research on MNCs document significant structural differences between MNCs and DCs. We find that several aspects of multinationality alter the desirability of management bonding of MNCs vis-à-vis DCs, and test our contracting hypothesis on a sample of U.S. MNCs and DCs. Consistent with our hypothesis, we find that CEO compensation of MNCs is less aligned to equity performance than that of DCs. Furthermore, there appears to be additional differences in the use of governance constructs between MNCs and DCs.

1. Introduction

Empirical studies document significant differences between multinational corporations (MNC) and domestic corporations (DC). For example, MNC stock returns are less correlated to the domestic market return than DC stock returns;[1] cross-sectional studies show that multinationality is significantly positively related to higher market value;[2] and event study results of foreign acquisitions document significant shareholder gains for the acquiring U.S. multinationals.[3] The internalization theory of foreign direct investment (FDI) provides an explanation for some of the observed differences between MNCs and DCs.[4] For an MNC to succeed in a foreign environment, it must possess certain valuable assets—often termed firm-specific advantages or monopolistic advantages—that are sufficient to compensate for the costs of setting up foreign operations and competing against potential indigenous producers (Dunning 1988). The internalization theory posits that FDI occurs due to a market failure which prevents firms from transferring their monopolistic advantages in the international market place. The firms that are able to internalize the markets for their assets can generate monopoly rents.

Research on optimal wage contracts suggests that firm-specific factors play an important role in determining the nature of the chief executive officer's (CEO) compensation package (Lippert and Moore 1994). Compensation contracts can be used to bond managers' interests with equity holders' interests. The degree of alignment of manager-shareholder interests will be limited to the point where the marginal benefits of bonding just exceed the marginal costs (Jensen and Meckling 1976). However, the desirability of bonding devices as mechanisms to control managerial incentive problems will vary across firms of differing characteristics. For example, firms with greater uncertainty in their operating environment, which causes steep monitoring costs (Demsetz and Lehn 1985), are more likely to pursue greater bonding, while firms with higher-valued future growth options, which result in high agency costs of debt (Myers 1977), should exhibit less bonding.

If MNCs differ structurally from DCs as suggested in previous literature, then the compensation packages of MNC management should reflect these differences. In this study, we examine the degree of alignment of CEO compensation with equity value of U.S.-based MNCs and DCs. Specifically, we use Murphy's (1993) pay-performance alignment measure to test whether the CEO compensation packages of MNCs differ from that of DCs, and if so, whether the differences are consistent with the existing explanations of MNCs. The empirical model controls for additional attributes such as the complexity of the firm's production process, internal and external monitoring, and other aspects of corporate governance structure that have been identified as influential variables on the pay-performance alignment measure. We find that CEO compensation of MNCs is less aligned with equity performance than that of DCs, and that the difference is related to the MNCs' investment opportunities. Furthermore, we find additional differences between MNCs and DCs in the likelihood of use of other governance constructs.

In the next section, we review the relevant literature on MNCs and optimal wage contracts, and thus motivate the empirical model to test for the expected differences in pay-performance alignment between MNCs and DCs. The data and methodology are described in the following section. The final two sections contain a discussion of our results and a brief summary, respectively.

2. Theoretical Background

2.1 Theory of MNCs

Internalization theory suggests that in the presence of transactional market failure, the firm must transfer its firm-specific advantages across national boundaries within the organization rather than in the international market place (Dunning 1988). Those firms that can internalize the markets for their assets can earn monopoly rents (Hymer 1976). These assets or firm-specific monopolistic advantages of the MNC must be significant enough to offset the additional costs involved in operating over longer distances and in different legal, cultural, and political environments.

The internalization-based explanation of MNCs is consistent with much of the empirical evidence. Errunza and Senbet (1981, 1984) show that multinationality is positively related to higher market valuation. Doukas and Travlos (1988) find that cross-border acquisitions lead to higher shareholder gains for the acquirer. Horst (1972), Caves (1974), and Lee and Kwok (1988) show that MNCs have larger investments in such intangible assets as research and development (R&D) and advertising. Morck and Yeung (1991) show a positive relationship between intangible assets and the higher market valuation of MNCs, while Morck and Yeung (1992) show that MNCs with high intangible assets observe higher shareholder gains following foreign acquisitions.

2.2 Determinants of Optimal Wage Contracts

Lippert and Moore (1994) find that attributes related to the firm's operating characteristics and internal and external monitoring devices are relevant to the determination of compensation packages. Firms that face greater uncertainty in their operating environment tend to rely more heavily on alignment since monitoring is costly and inefficient. Firms with greater growth opportunities are found to have less alignment; Lippert and Moore (1994) find this to be consistent with Bizjak, Brickley, and Coles' (1993) finding that firms with long investment horizons are less inclined to tie the CEO's compensation to short-term

stock price movements. However, if the variables used to proxy growth opportunities, R&D expenditures and market-to-book value of assets ratio, also proxy for the value of the growth options, Myers (1977) would suggest that these firms would want to lower the CEO-shareholder bonding to reduce the agency cost of debt. In addition, while regulated firms are found to have lower pay-performance alignment, firms with higher proportion of insider representation in the board have greater bonding because the board is less independent. This suggests that monitoring is a substitute for bonding, which is consistent with Beatty and Zajac (1994), Mehran (1992), and Lippert and Moore (1994).

2.3 Multinationality and Alignment

The MNCs' ability to internalize the markets for their assets across national borders allows them to generate monopoly rents from their investment options. Rahman (1997) finds that MNCs with investment options have a higher cost associated with debt-financing, which is consistent with Myers' (1977) agency cost of debt theory.[5] According to Myers (1977), managers acting in the interest of shareholders forego positive net present value (NPV) investment options because the benefits from the project must be shared with bondholders. The foregone investment options represent one agency cost associated with debt. Since the MNCs have higher agency cost of debt due to their higher-valued investment options, they would prefer to structure management compensation contracts that are less aligned with shareholder interests.

The MNC's greater flexibility in taking advantage of marketing and production capacities that are diversified across different national markets, thus different business cycles, can reduce the uncertainties surrounding its operating environment (Demsetz and Lehn 1985). In fact, Agmon and Lessard (1977) and Fatemi (1984) suggest that shareholders value the indirect international diversification afforded by the MNCs' direct investments abroad.[6] Shapiro (1992) states that MNCs have lower operating exposure to exchange rate risks than exporting firms, and that "international diversification may allow firms to reduce the total risk they face" (Shapiro 1992, p. 19). If higher risk is associated with greater alignment, the possible lowering of risk with increasing degree of multinationality may lead to lower levels of alignment.

On the other hand, due to the complex nature of its operations, it may be more difficult for shareholders to monitor management decisions in the case of an MNC than of a DC (Morck and Yeung (1991)). Since bonding and monitoring are often substitutes, it is possible that MNCs could have greater alignment than DCs. To summarize, the degree of multinationality may lead to either lower or greater alignment depending upon whether multinationality lowers risk or increases monitoring costs, respectively, while the MNCs' greater agency costs of debt suggests a lowering of alignment conditioned on their investment options.

3. Data and Methodology

3.1 Sample Description

The initial sample consists of the 1000 firms for which Murphy (1993) calculated a measure of the alignment of CEO compensation to equity performance for the United Shareholders Association. The CEO data is based on proxies filed with the Securities and Exchange Commission by the largest 1000 firms (ranked by December 31, 1992 market capitalization) that disclosed CEO compensation information for 1992. The median and mean values

for total compensation in 1992 were $1.3 million and $2.2 million, respectively. Base salary and bonuses accounted for 44% and 19% of the total compensation, respectively, while stock options and restricted stock accounted for 23% and 4%, respectively. This sample is reduced to 724 firms for which various firm-specific data could be found in the Compustat files.

The sample of 724 firms with CEO compensation and other financial data is dichotomized into samples of MNC and DC firms. The original sample of firms is filtered so as to only keep clearly identifiable MNCs and DCs in the sample. Since the current study's emphasis is on the MNC's ability to exploit market imperfections across national borders, only firms that have operations in at least five foreign countries are classified as MNCs. Firms that do not have any foreign operations are defined as DCs. *The Directory of American Firms Operating in Foreign Countries* is used to apply the definitions. A total of 607 firms are left in the sample of which 430 are DCs and 177 are MNCs.

3.2 Methodology

The primary objective of the paper is to examine if there is a difference in the degree of alignment of pay-performance measures between MNC and DC CEO compensation packages. Murphy's (1993) pay-performance sensitivity measure provides the dollar change in total compensation of the CEO per $1000 change in equity value for each firm in the sample. This measure, ALIGN, includes salary and bonuess, equity holdings, and executive stock options. ALIGN is regressed on the firm-specific explanatory variables according to equation (1) below.

$$ALIGN_i = \beta_0 + \beta_1 \ RISK_i + \beta_2 \ GROWTH_i + \beta_3 \ REG_i + \beta_4 \ INSIDE_i$$
$$+ \beta_5 \ FTAX_i + \beta_6 \ MNC \cdot GROWTH_i + \beta_7 \ SIZE_i + \varepsilon_i \qquad (1)$$

The firm's total risk, RISK, is measured using the standard deviation of returns on equity. [7] The firm's investment options, GROWTH, is estimated using the average capital expenditures over the 1992-1993 period.[8] REG is an indicator variable used to show if the firms is regulated. It is defined as one if the firm is a utility or a financial firm (SIC codes 4911-4932 and 6312-6332), and zero otherwise. INSIDE is the proportion of the board that is employed by the firm as CEO, president, vice-president, treasurer, or secretary. We include a size variable for two reasons: (1) The larger the firm size, the greater the likelihood of more information asymmetries associated with its operating environment, and (2) the possible difference in firm size between MNCs and DCs. SIZE is estimated as the logarithm of total assets.

The critical variables in our test of the impact of multinationality are the ratio of foreign to total taxes, FTAX, and the interactive variable, MNC·GROWTH.[9] While internalization and corporate international diversification explanations of MNCs suggest that there would be less alignment as the degree of multinationality increases, the potentially higher monitoring costs related to MNCs would suggest that there could be greater alignment. Therefore the sign on FTAX is not predicted a priori. However, the interactive variable, MNC·GROWTH, should capture any differential effects related to the higher-valued investment options of MNCs. Since MNCs with investment options should want lower alignment (Lippert and Moore 1994; Rahman 1997), we expect the coefficient on MNC·GROWTH to be negative.

In summary, the expected signs of all the coefficients are:

$$+ \quad\quad - \quad\quad - \quad\quad + \quad\quad ? \quad\quad - \quad\quad\quad ?$$

$$\text{ALIGN} = f \ (\text{RISK, GROWTH, REG, INSIDE, FTAX, MNC·GROWTH, SIZE})$$

4. Results

4.1 Alignment of Shareholder-Manager Interests

Table 1 contains the information on several characteristics of the sample MNCs and DCs. There is a striking difference in the pay-performance alignment of CEO compensation between MNCs and DCs: For every $1000 dollar change in equity value, there is a $33 dollar change in the value of DC CEO's compensation, while there is only a $12 change in the MNC CEO's compensation. We have hypothesized that there could be lower alignment of MNC CEO's compensation with equity performance due to either their higher-valued investment options or their greater diversification. The cross-sectional analysis attempts to test between the two explanations.

As can be expected, MNCs are much larger than the sample DCs. The average value of MNCs' assets, $19.7 billion, is over 2.5 times the value of DC assets. MNCs' annual sales of $8.3 billion is over three times the value of DC sales. The capital expenditures to total asset ratio for MNCs and DCs are similar averaging between 4-5%. Finally, the foreign tax to total tax ratio for the MNCs at 35% is significantly greater than the DC figure of 12%.[10]

Table 1
Characteristics of the sample of domestic and multinational firms from the United Shareholders 1992 CEO compensation data.

Characteristic[a]	Domestic (DC)	Multinational (MNC)	Combined (DC+MNC)
1. Pay-performance alignment	32.89	11.90[b]	26.77
2. Total assets ($ millions)	7474.40	19714.78[b]	11024.11
3. Market value of equity ($ millions)	2408.49	6401.79[b]	3566.54
4. Sales ($ millions)	2396.30	8313.52[b]	4103.03
5. Capital expenditure/Total assets (%)	4.87	4.34	4.70
6. Foreign tax ratio (%)	11.95	34.93[b]	20.63

[a]Characteristic 1 is the mean value of the dollar change in total compensation of the CEO per $1000 change in equity value for 1992. Characteristics 2-4 are the mean values for the fiscal year-end 1991. Capital expenditure/Total assets is based on the two-year sum of capital expenditures and total assets beginning fiscal year 1992. Foreign tax ratio is the five-year average of the ratio of foreign taxes paid to the total taxes for the period 1987-1991.
[b]Significantly different from the domestic corporations' sample mean at the one percent level.

Table 2 contains our cross-sectional regression results. Model 1 includes all the variables shown in equation (1) except FTAX. GROWTH is negative but insignificant; the DC investment options apparently do not have a big impact on ALIGN. The coefficient of the interactive variable, MNC·GROWTH, is, however, significantly negative. As investment opportunities increase, there is significantly less alignment in the CEO compensation packages of MNCs relative to DCs. This is consistent with Myers (1977): The higher-valued investment opportunities of MNCs would result in greater agency costs of debt. Therefore, the MNCs would want to reduce shareholder-manager alignment of interests. The coefficient of RISK is not significant; we do not find evidence suggesting greater bonding for

Table 2		
Parameter estimates (t-statistics in parentheses) from Ordinary Least Squares regression of pay-performance alignment on various characteristics of domestic and multinational firms.		
Variables[a]	Model 1	Model 2
INTERCEPT	88.30 (4.10)	88.80 (3.58)
GROWTH	-80.99 (-1.00)	-92.72 (-0.99)
MNC·GROWTH	-263.81 (-2.17)	-245.20 (-1.77)
FTAX		-4.88 (-0.87)
RISK	-0.01 (-0.31)	-1.96 (-1.58)
REG	-22.76 (-2.64)	-2.84 (-0.11)
SIZE	-8.11 (-3.31)	-8.34 (-2.96)
INSIDE	55.30 (2.85)	70.69 (3.12)
Sample Size	478	386
R2 (%)	8.75	8.53
F-Value	7.53	5.04

[a]GROWTH is the average capital expenditures relative to total assets. MNC·GROWTH is interactive with GROWTH and the binary variable MNC, where MNC = 1 if multinational corporation; MNC = 0 otherwise. FTAX is the ratio of foreign taxes to total tax. Risk is the standard deviation of the return on equity. REG is a binary variable, where REG = 1 if an utility or financial; REG = 0 otherwise. SIZE is the log of market value of assets. INSIDE is the proportion of insiders on the board.

firms with greater risk. As expected, REG, has a negative and significant coefficient. Regulated firms are expected to need less bonding due to monitoring by regulatory agencies, and this is supported in Model 1. The coefficient for INSIDE has the expected positive sign and is significant. Firms with more insiders on the board feel the necessity to tie the CEO's compensation closer to the firm's equity performance. Finally, firm size, SIZE, has a negative and significant coefficient; the larger the firm, the less alignment there is between the CEO's compensation and equity performance.

Model 2 in Table 2 adds the firm's foreign tax to total tax ratio, FTAX, as a measure of the firm's degree of multinationality. We hypothesized that a higher degree of multinationality could lead to (1) lower alignment since the greater corporate diversification afforded by foreign operations reduces the uncertainty surrounding operations, or (2) greater alignment since monitoring costs would be higher. The coefficient on FTAX is negative but insignificant. All the other coefficients have similar signs to Model 1. The coefficient on MNC·GROWTH is still negative and significant; it appears that the lower alignment of MNC CEOs compensation is due to their higher-valued investment options, and not the degree of multinationality per se.

4.2 Corporate Governance Constructs

While the significantly lower alignment with shareholder interests observed in the MNC CEO's compensation contract may be explained by the MNCs' higher-valued investment opportunities, the reduced reliance on bonding as a corporate governance tool suggests the possibility of structural differences in corporate governance costructs between MNCs and DCs. To further explore the inherent differences in governance constructs between MNCs and DCs, we employed a sequential response logit model. We included governance factors, which have been found to be of significant influence in prior studies (e.g., Lippert and Moore 1995). These factors include: ALIGN and INSIDE, which were defined earlier; CONFVOT, which is equal to one if shareholders have confidential voting rights and zero if they do not; and NOPILL, which is equal to one if the firm does not have a poison pill technique at their disposal and zero otherwise.

Table 3 provides the results of a sequential response logit model which uses the zero-one indicator variable, MNC = 1 and DC = 0, as the dependent variable. This technique provides elasticities, in addition to parameter estimates and their t-values, for assessing the relative importance of each independent variable in the model. The log-likelihood ratio statistic is employed to test the null hypothesis that all of the estimated coefficients for the independent variables are equal to zero. The pseudo-R^2 measures the overall fitness of the model.[11]

As illustrated in Table 3, ALIGN, CONFVOT, and NOPILL are important explanatory variables in distinguishing between MNCs and DCs, while INSIDE is not. As expected, the ALIGN coefficient is negative and statistically significant. This is consistent with our previous finding that MNCs have lower pay-performance sensitivities relative to DCs. CONFVOT is positive and significant, suggesting that MNCs are more likely to provide shareholders with confidential voting rights. NOPILL is negative and significant, suggesting that firms that have no poison pill techniques are less likely to be MNCs. The INSIDE variable is insignificant, suggesting that there are no significant differences between MNC and DC board structures.

Table 3
Parameter estimates from Sequential Response Logit Model of the binary variable, MNC (where MNC = 1 if multinational corporation; MNC = 0 otherwise), on various corporate governance characteristics.

Variables[a]	Coefficient	T-Values	Elasticities
INTERCEPT	-0.864	-4.45	n/a
ALIGN	-0.008	-2.37	0.412
CONFVOT	1.764	6.08	0.391
NOPILL	-0.936	-4.22	0.323
INSIDE	0.721	1.16	0.082
Summary Statistics:	Log-Likelihood Ratio: 0.1102		Pseudo-R2: 0.1388

[a]ALIGN is the CEO pay-performance sensitivity. CONFVOT and NOPILL are binary variables that are set to one if the firm allows confidential voting or does not have poison pills, respectively; zero otherwise. INSIDE is the proportion of insiders on the board. n/a: not applicable.

The elasticity measures provided in Table 3 provide a means by which to rank the independent variables in terms of their explanatory power. Thus the ALIGN variable has the highest elasticity (0.412) and as such is the most important explanatory variable in the model. The second most important variable is CONFVOT (0.391), followed by NOPILL (0.323). As stated earlier, INSIDE is not statistically significant. The log-likelihood ratio statistic (0.1102) suggests that the null hypothesis, that all of the estimated coefficients for the independent variables are equal to zero, can be rejected. The pseudo-R^2, which measures the overall fitness of the model, is a respectable 0.1388.

The results discussed above support the argument that MNC governance structures differ substantially from those of DCs. Not only do MNCs rely less on bonding mechanisms, but there are significant differences in the use of monitoring mechanisms, such as confidential voting rights and poison pill provisions, from DCs. The structural differences documented in these results are consistent with other empirical studies indicating differences between MNCs and DCs on financing (Lee and Kwok 1988; Rahman 1997), valuation (Errunza and Senbet 1981, 1984; Morck and Yeung 1991), and acquisitions (Doukas and Travlos 1988; Morck and Yeung 1992).

5. Summary

This study presents evidence that CEO compensation contracts of MNCs are significantly less aligned with equity performance than those of DCs. This finding appears to be related to the MNCs' investment opportunities, and not multinationality per se. We also find evidence of differences in the use of other corporate governance constructs between MNCs and DCs. These results are consistent with and add to the empirical literature that documents structural differences between MNCs and DCs. To our knowledge, these are some of the first findings documenting differences in corporate governance constructs between

MNCs and DCs, and they provide additional evidence on the cross-sectional differences in the use of corporate governance mechanisms.

Endnotes

1. Agmon and Lessard (1977) and Fatemi (1984).

2. Errunza and Senbet (1981, 1984) and Morck and Yeung (1991).

3. Doukas and Travlos (1988) and Morck and Yeung (1992).

4. For a development of the internalization theory of FDI see Buckley and Casson (1976), Teece (1986), and Dunning (1988).

5. Lee and Kwok's (1988) finding that MNCs have lower leverage than DCs is also consistent with MNCs having higher agency cost of debt.

6. Jacquillat and Solnik (1978) point out that, for the investor, international portfolio investment remains a superior means of achieving diversification benefits than indirect diversification through MNCs.

7. The risk measure is estimated using daily returns over all trading days during the 1991 calendar year.

8. Under rational expectations, actual, subsequent investments should be a good proxy for anticipated investments (Denis 1994 and Pilotte 1992).

9. FTAX is the five-year average of foreign taxes to total taxes ratio over the 1987-1991 period. FTAX proxies the firm's degree of multinationality (Lee and Kwok 1988). MNC is a dummy variable (1 if MNC, 0 otherwise).

10. Although DCs do not have any foreign operations, they may have foreign sales, and thus foreign taxes.

11. A detailed explanation of the sequential response logit model can be found in Theodossiou et al. (1996).

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