Competitive Paper

THE EFFECT OF INTERNATIONALIZATION ON CEO COMPENSATION: A STUDY OF SWEDISH FIRMS

Paper submitted for EIBA 2002

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DRAFT DATE: SEPTEMBER 10, 2002

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Abstract:

This study addresses how firms' internationalization affect compensation and tenure of CEOs. Based on a sample of Swedish listed firms we analyze internationalization related to the product market (export), capital market (foreign exchange listing), and corporate governance market (foreign board membership). Our conclusions are that all three markets contribute positively to the compensation level of CEOs. This study also shows that a higher degree of internationalization via the capital and corporate governance markets is associated with shorter CEO tenure. We argue that part of the higher CEO compensation in international oriented firms reflects a risk premium for lower job security in these firms.

Keywords: CEO compensation, internationalization, corporate governance, Sweden

INTRODUCTION

During the last decade CEO compensation has increased substantially and so has the degree of internationalization. Then, is there a link between the two observations explaining the total level as well as the division between the base level of compensation and the potential risk premium. A number of studies suggest that the internationalization of a firm affects its performance in the product market and materializes as higher profitability (e.g., Geringer, Beamish and daCosta, 1989). The higher profitability is often claimed to be a compensation for higher risk in international business. Here we claim that the higher risk should also reflect itself in the compensation to CEOs involved in international business.

With the exception of one study based on US-firms (Sanders and Carpenter, 1998), we find no studies that address the impact of internationalization on the labor market for top executives. Based on the conceptual foundation of managerial discretion theory and micro-economic theory, we here argue that several dimensions of internationalization – such as internationalization of ownership, internationalization of sales, and internationalization of corporate governance – enhance CEO compensation in an environment of an internationalized labor market for top executives.

This study suggests that CEO compensation is a neglected cost of internationalization. Countries with a relatively low level of CEO compensation can expect to see higher compensation levels as their firms internationalize and they get integrated into the global market for top executives. The cost implications could potentially be large, as shown by the fact the a typical Continental European CEO makes 20-50 times less than their US peers (*Economist*: September 28, 2000). Based on these statistics, we argue that firms could potentially incur substantial costs if they have to narrow the current pay gap between coutries with low and high CEO compensation due to the creation of a global market for top executives. This study is also an attempt to address the lack of research on the broader issue of internationalization and corporate governance (Melin, 1992).

The empirical part of this paper is based on a sample of Swedish firms. Sweden provides a particularly suitable case for analyzing the effect of internationalization on CEO compensation. First, Sweden has some of the the most internationally oriented companies in the world and was recently ranked #6 in terms of relative transnationality (UNCTAD, 2000). Second, the general CEO compensation levels in Sweden is among the lowest among E.U. countries (*Economist*: January 21, 1999), which makes it particularly interesting as the object of this study is the linkage between firms' internationalization and CEO pay.

Section 2 of this paper reviews past studies on CEO compensation and pays special attention to the relevance of microeconomic theory, agency theory, managerial discretion theory, and organizational theory on CEO power. Section 3 proposes six relevant research hypotheses to be tested. Section 4 describes the data and methodology. In Section 5, the hypothesized relationships are tested in a multivariate setting. Section 6 summarizes the key findings and suggests managerial and policy implications.

THEORY

Research on CEO compensation is rich and has been addressed within economics (e.g., Becker, 1975), finance (e.g., Jensen and Murphy, 1990), and management (e.g., Finkelstein and Boyd, 1998; Gomez-Mejia and Wiseman, 1997). However, the issue of CEO compensation as a function of the firm's internationalization has not - to our knowledge - been addressed explicitly in non-U.S. studies. We argue that the incremental effect of internationalization on CEO's compensation reflects the demand and supply for internationally competent CEOs. We also suggest that the compensation level of internationally oriented firms reflect a risk premium as a result of a harsher monitoring by international owners and board members. This study applies an eclectic approach and capitalizes on microeconomic theory and managerial discretion theory. We also discuss the research issues in relation to agency theory and organizational theory on CEO power. We emphasize how a combination of existing theories may explain the linkage between internationalization and CEO pay.

Microeconomic theory suggests that any job requirement that would limit the supply of CEO candidates would *enhance* CEO pay (e.g., Ciscel and Carrol, 1980). This suggests that internationalization affects the labor markets for CEOs. The skills and competencies necessary to manage an international firm is more scarse than the skills required for a domestic focused business – i.e., the supply of capable international CEOs is limited. The argument is based on a given degree of integration of the global market for top executives. An increasing degree of integration in this respect can mitigate the limitations put on the supply of top executives as a result of an increased internationalization of the firm.

From the perspective of managerial discretion theory, internationalization provides a complex task environment for the CEO (Finkelstein and Boyd, 1998). Specifically, a successful internationally oriented CEO needs to relate to both domestic *and* foreign customers, domestic *and* foreign board members, domestic and foreign regulators, as well as domestic and foreign investors. The firm is in greater need for competence when facing a highly international product and capital market. In accordance with the managerial discretion theory we can also here expect an e*nhanced* CEO compensation.

Agency theory provides a normative approach to the compensation issue, and focuses on how the compensation package (including options) should brigde the incentive gap between managers and owners (e.g., Fama, 1980; Fama and Jensen, 1983). The focus of the agency theory is not on the starting salary but rather on how incentives can affect managerial behavior. The implication is that companies should be paying CEOs more than what a perfectly competitive market would suggest. However, research on the pay-performance relationship has in general produced inconclusive results. For example, a US-based study by Jensen and Murphy (1990) finds a weak but significant relationship between profitability and CEO compensation. A study by Madura et al. (1996), however, fails to identify a significant relationship between pay and performance among small publicly traded companies. Furthermore, two Scandinavian studies failed to identify a significant relationship between company performance and CEO pay (Firth et al., 1995; Randøy & Nielsen, 2002). However, these studies are based on performance estimates that are not "filtered" from noise generated by the macroeconomic environment (Oxelheim, 2002). By that they run the risk of failing to sort out the intrinsic performance that should be the basis for compensation. Based on the above discussion, we will later use the pay-performance sensitivity only as a control factor.

Organizational power imply that the labor market for CEOs can deviate from the characteristics of a competitive labor market. Past research suggest that some CEOs have been "successfully" in build such an in-house power base (Boyd, 1994; Zajac and Westphal, 1996). The possible characteristics of such a market could be the existence of unproductive large boards with few outside directors. Past research suggest that that these factors are of minor importance in the Scandinavian context due to the strong egalitarian culture there (Randøy and Nielsen, 2002). Hence, we have here chosen to include these factors merely as control factors.

HYPOTHESES

An export-dominated business faces a more complex customer environment than a domestic firm. We argue that the complexity of managing an export intensive firm would significantly reduce the supply of potentially qualified CEOs for such businesses. A common requirement is that potential CEOs are truly bi-lingual and multi-cultural. Another usual demand is that CEO candidates should have significant work experience abroad, or an international educational background. Moreover the higher macroeconomic and political risks of international business (Oxelheim and Wihlborg, 1997) will further limit the supply of potential CEO candidates. With the prevailing low labor mobility in Europe, this reduces the number of qualified CEOs.

On the demand side, we would expect to see a risk premium for being a CEO of an international firm. We expect such a premium since export intensive firms provide more managerial discretion. We hypothesize that such firms would more frequently change their CEOs. Hence some of the higher pay of an CEO comes to compensate for a weaker job security. Taken together, the demand and supply factors suggest that firms with a high percentage of export would be paying higher compensation.

Hypothesis 1a: *There is a positive relationship between firm's level of export and CEO compensation.*

Hypothesis 1b: *There is a negative relationship between firm's level of export and CEO tenure.*

We, then, turn to the internationalization of the firm from the perspective of the capital market and corporate governance. In accordance with what was earlier mentioned, we here expect to find an increased CEO compensation due to harsher international corporate governance monitoring. We emphasize two activities aimed at sending a signal to the international investor community of a willingness on the part of the firm of exposing itself for such a monitoring. The two activities are the undertaking of a dual listing, i.e. a listing on a foreign stock exchange and the recruiting of at least one independent board member representing a more demanding corporate governance system, i.e. predominantly the US system. Also here we can identify demand and supply factors as well as a risk premium. The logic behind the risk premium is that a harsher monitoring will decrease the CEOs job security as manifested in a shorter CEO tenure.

Corporate governance within the Swedish capital market, as also the case for most countries in Continental Europe, is a so called insider or "control-oriented system (Berglöf, 2000; La Porta, 1999). This corporate governance system puts emphasis on large shareholders ability to monitor corporate behavior (Angblad et al, 2001). With an Anglo-American stock exchange listing, the corporate governance of that firm moves toward the Anglo-American outsider corporate governance system (Oxelheim *et al*, 1998). We argue that potential CEOs with the necessary regulatory understanding of exchanges such as NYSE (New York Stock Exchange) are in short supply in most countries. Foreign listing in a prestigous capital market (commonly London or New York for Swedish firms) is also considered a corporate milestone among Scandinavian firms (Randøy, Oxelheim & Stonehill, 2001). The potential firm-specific rewards for a listing in a prestigous (Anglo-American) - such as lower cost of capital and enhance capital availability (Stulz, 1999) – makes CEOs with foreign stock market listing experience more costly.

We suggest that an Anglo-American exchange listing would boost the public scrutiny of CEOs, such that their expected tenure would decrease. Once again, we argue that their higher pay comes at the price of a shorter expected tenure.

Hypothesis 2a: *There is a positive relationship between Anglo-American exchange listing and CEO compensation.*

Hypothesis 2b: *There is a negative relationship between Anglo-American exchange listing and CEO tenure.*

The second alternative to signal willingness to a harsher monitoring is to change the composition of the board. Corporate governance research indicates that board structure (such as board size, board independence) can potentially affect CEO compensation (Conyon and Peck, 1998; Dalton et al., 1999; Yermack, 1996) However, the findings appears to be somewhat contradictory.

The issue of internationalization of boards have only recently been addressed in the literature. A Scandinavian study by Randøy and Nielsen (2002) found a positive effect of Anglo-American board membership on CEO compensation. Specifically, they argue that Anglo-American board members bring with them the corporate governance culture of their home country – i.e. these board members are used to significantly higher pay checks than the Scandinavian norm.

Oxelheim and Randøy (2002) find that CEOs of Scandinavian firms with Anglo-American board membership are significantly more likely to be ousted if their firms' under-perform. We suggest that this imply that CEOs of firms with Anglo-American board membership can expect a shorter tenure than firms without such board membership. CEOs of such firms are expected to charge a risk premium for decreased job security.

Hypothesis 3a: *There is a positive relationship between Anglo-American board membership and CEO compensation.*

Hypothesis 3b: *There is a negative relationship between Anglo-American board membership and CEO tenure.*

Control variables

We control for *firm size* since past research have shown that size has a significant effect on CEO performance (e.g., Baumol, 1967). We also include past profitability, although past research is inconclusive on the linkage between profitability and CEO compensation in Scandinavia (e.g., Randøy and Nielsen, 2002; Firth et al., 1995) and in Anglo-American markets (e.g., Jensen and Murphy, 1990; Miller, 1995; Gregg, Machin and Szymanski, 1993; Madura et al., 1996). Based on past CEO compensation research we control for *board size* (e.g., Core et al., 1999). Finally, based on general corporate governance considerations (e.g., OECD, 1999; Dalton et al, 1998) we control for *board independence.*

DATA AND METHODOLOGY

Data

The data is based on a random sample of 120 firms out of a population of 304 Swedish publicly listed firms (all industries). We included companies from all industries, except banking and insurance. Twenty-four companies were later excluded because we were not able to get three years of complete information for these companies (the dependent variable is registered for 1998 and 1997, and the independent variables are measured for 1996 and 1997). This left us with data from 96 companies. The twenty-four companies were excluded for the following reasons. Nine companies were later excluded because of unusual reporting intervals, and seven companies were omitted because they did not respond to our request for information, and finally eight firms where excluded since they were de-listed or were infrequently traded on the stock market.

The financial variables were collected from annual reports and sources based on annual reports (e.g., Dagens Nyheter, 1999; Sundqvist, 1999). Data such as the nationality of board members and the board independence were not available from secondary sources. Telephone interviews, with fax follow-ups, were for these variables used in the data gathering.

Measures

The dependent variable, *CEO compensation* in 1997 and 1998 (two observations per firm), includes all the major components of CEO remuneration including salary, bonuses (both cash and stock), and publicly traded stock options. By using two observation years per firm we avoid the possibility of identifying one-year effects, however, this comes at the price of possible overstating the statistical relationships due to some auto-correlation. Swedish annual reports generally do provide specific information with regard to bonuses but not stock options – which unfortunately makes it difficult to separate the effect of short term compensation (bonus and salary) and long term compensation (stock options). Even though 42% of the sample companies paid a bonus to the CEO in 1998, the size of this bonus was a mere 23% of their total compensation.

The independent variables are lagged as compared to the dependent variable – such that our independent variables are from 1996 and 1997. Based on the fact that CEO compensation levels are not evaluated constantly (such as the case for stock prices), we argue that using a one year time lag provides a more accurate description of CEO pay practices. I.e., compensation is adjusted in accordance with last years changes in export, corporate governance, etc. This is also consistent with past studies on CEO compensation, which commonly have applied a one year time lag for the effect of performance (e.g., Kerr and Bettis, 1987).

Export intensity is measured by the percentage of total revenues that is export. *Foreign exchange listing* is given a value of 1 if the firm is listed outside the Nordic capital market, 0 otherwise. *Foreign board membership* is given the value of 1 if the firm has one or more non-Nordic board members. *Tenure* is measured as the number of years a CEO stays in power.

Firm size is measured by taking the natural logarithm of total market capitalization, as size alone was not normally distributed. *Profitability* is measured by Return on Equity (ROE). *Board size* is the number of directors on the board. *Board independence* is the percentage of independent outside directors on the board. A director is considered an inside director when he/she is or has been directly or indirectly employed by the firm, either as an employee or as a manager.

Methods

We use a cross-sectional ordinary least-squares (OLS) regression model to test the hypotheses presented in the preceding section. In addition to the hypothesized effects we apply a variety of control variables to minimize specification bias in the hypothesis testing, drawing on previous research on CEO compensation. Specifically, we control for corporate governance variables (board independence and board size) and general firm characteristics (firm size) and industry effects (using five industry dummies).

Given the fact that the three internationalization factors are somewhat correlated (as high as 0.403), we perform seperate tests for each factor (Model 1-3) and one model with all international factors combined (Model 4). Equation (1) describes the relationships described in Model 4.

(1) CEO Compensation one year lagged = α + β_1*Export Intensity + β_2*Foreign Exchange Listing +β_3* Foreign Board Membership + β_4*Firm Size + β_5*Profitability + β_6*Board Size + β_7*Board Independence + β_i*Industry Dummies

ANALYSIS AND RESULTS

Analysis of the regression residuals did not indicate any problems with either heteroscedasticity or non-normal distributions. Except for the board size/firm size correlation (.695), the correlation coefficients do not indicate multicollinearity problems. In order to address this problem separate tests were performed with and without (see Table 2) the board size variable – however the results did not change significantly. Finally, the Variance Inflation Factor (VIF) statistics (<10) did not indicate multicollinearity concerns.

[Insert Table 1 about here]

Table 1 shows the correlations between the various constructs of the study. As suggested by Hypothesis 1a, we find a significant positive correlation (0.418) between export intensity and CEO compensation. When we examine the effect of export intensity on CEO compensation in a multivariate setting (Table 2), we draw the same conclusion. As predicted by Hypothesis 1b, we find a significant negative relationship (Table 1) between export intensity and CEO tenure (-0.148). We argue that this providing a justification for expecting a risk premium embedded in the CEO compensation package.

[Insert Table 2 about here]

As suggested by Hypothesis 2a, we find a significant positive correlation (0.533) between foreign exchange listing and CEO compensation, as was also the case for our multivariate tests (Table 2). As predicted by Hypothesis 2b, we find that firms with foreign exchange listings provide their CEOs with significantly shorter tenure (Table 3). Hence, also here we find good grounds to believe in a risk premium embedded in the compensation package to a CEO listed on a US or UK stock exchange.

[Insert Table 3 about here]

We find a significant positive correlation (0.403) between Anglo-American board membership and CEO compensation (Hypothesis 3a), as was also the case for our multivariate tests (Table 2). In line with Hypothesis 3b, we find that firms with Anglo-American board membership provide significantly shorter CEO tenure (Table 4). Also in this case we find argument for the existence of a risk premium in the compensation package to a CEO of a firm with board members representing the Anglo-American corporate governance system.

[Insert Table 4 about here]

DISCUSSION AND CONCLUSION

This study suggests that firms' internationalization enhance the compensation of their CEOs. Specifically, we argue that the CEO compensation level is affected by the way (1) internationalization changes the demand and supply of potential CEO candidates and/or (2) affect the risk premium CEO are being offered for being controlled by more demanding international investors and board members.

Based on Swedish data our results indicate that a firm with 50% export to total sales, pay their CEO between SEK 0.5 and 0.7 million (in 1997 SEK value) more than firms without export (approximately $60,000-90,000). First, we attribute this effect to the fact that export intensive firms provide CEOs with more managerial discretion – which makes it attractive to hire more competent CEOs (Finkelstein and Boyd, 1998). This also explain the significant correlation between export intensity and short CEO tenure – as export intensive firms are exposed to more volatile markets. Second, we attribute this effect to the limited supply of competent international oriented CEOs, which boost their pay level.

Ten per cent of the sample firms have an Anglo-American foreign exchange listing. After controlling for industry, size etc., we find that Swedish firms with an Anglo-American foreign exchange listing pay their

CEOs between SEK 0.8 and 1.1 million more than firms without such listings (approximately $95,000-140,000). We suggest that the shortage of internationally competent CEOs (i.e., a supply shortage) and firms' higher willingness to pay for managing these complex firms (i.e., a managerial discretion effect) can explain the significant positive effect of foreign board membership on CEO pay. The Anglo-American foreign exchange listing also puts more pressure on the firm to perform, which explain the significant negative correlation between Anglo-American foreign exchange listing and CEO tenure. Hence, part of the higher compensation may be a risk premium.

Seventeen per cent of the sample firms have one or more Anglo-American board members. The multivariate analysis suggests that Anglo-American board membership positively affect the CEO compensation level. First, we argue that Anglo-American board members would we more willing to pay a higher salary – based on the common pay practices in Anglo-American markets. Second, we suggest that Anglo-American board members would enhance the focus on corporate performance – such that their pay would be higher but so also the probability of being dismissed. Hence, a part of the higher compensation should be labeled risk premium.

We argue that Sweden lends itself well to studies on the issue of internationalization and CEO pay. The results are appealing and robust. However, further research should concentrate on a broader spectrum of countries to find validity for a generalization of the results. Moreover, further research efforts should also be devoted to sorting out the relative magnitudes of supply/demand conditions versus that of a risk premium, respectively. A deeper knowledge of this magnitudes will help the board/compensation committee in designing an adequate compensation scheme.

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Table 1: Pearson Correlation Matrix and Descriptive Statistics

Variables	Mean	Std. Deviation	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1. CEO compensation – one year lagged (000 SEK)	2430	1808								
2. Export intensity (%)	40.25	31.21	.418***							
3. Foreign Exchange Listing	.10	.31	.533***	.403***						
4. Foreign board membership	.17	.37	.444***	.201**	.216***					
5. Firm size (ln)	7.41	1.78	.706***	.490***	.573***	.302***				
6. Profitability (ROE)	.15	.17	.182*	.104	.101	.103	.247***			
7. Board size	8.06	1.98	.561***	.293***	.406***	.276***	.695***	.127*		
8. Board independence	.64	.14	.033	-.148*	-.007	-.017	-.137*	-.082	-.131*	
9. CEO tenure (years)	6.91	5.14	-.148*	-.041	-.159*	-.074	-.206**	-.001	-.176*	-.006

One US $ was equal to 8.04 SEK at the end of December 1998.
* p<.05 (two-tailed)
** p<.01 (two-tailed)
*** p<.001 (two-tailed)

Table 2: OLS Estimates of the Association Between Foreign Influence and CEO Compensation in Swedish Firms

Independent variables	Dependent variable: Total CEO Compensation one year lagged – pooled data for 1997 and 1998									
	Control variables only	Control variables only	Model 1	Model 1	Model 2	Model 2	Model 3	Model 3	Model 4: Full model	Model 4: Full model
Constant	-3810.89 (-5.60)***	-4104.20 (-6.33)***	-3854.40 (-6.25)***	-4240.09 (-6.77)***	-2998.31 (-4.42)***	-3308.34 (-4.78)***	-3382.45 (-5.58)***	-3605.67 (-5.73)***	-2712.98 (-4.22)***	-3182.27 (-4.81)***
H1: Export intensity (%)			13.01 (3.23)**	14.20 (3.52)**					9.20 (2.34)*	10.89 (2.76)**
H2: Foreign Exchange Listing					1098.38 (3.02)**	1060.30 (2.92)**			827.84 (2.35)*	767.33 (2.21)*
H3: Foreign board membership							1211.11 (4.91)***	1103.00 (4.40)***	1080.28 (4.44)***	997.33 (4.12)***
Control variables										
Firm size (ln)	770.79 (13.45)***	636.18 (8.57)***	707.64 (11.70)***	536.20 (6.88)***	659.69 (9.82)***	534.67 (6.63)***	95.23 (12.37)***	589.44 (8.23)***	555.64 (8.37)***	444.05 (5.60)***
Profitability (ROE)	-365.56 (-.64)	54.84 (.10)	-319.01 (-.58)	100.41 (.19)	-211.85 (-.38)	155.50 (.29)	-448.01 (-.84)	-55.32 (-.11)	-15.59 (-.03)	61.43 (.12)
Board size		160.38 (2.42)*		199.96 (3.10)**		153.56 (2.37)*		126.01 (1.98)*		154.89 (2.50)*
Board independence	1464.17 (2.20)*	1613.79 (2.44)*	1657.50 (2.55)*	1846.88 (2.87)**	1310.25 (2.00)*	1454.51 (2.23)*	1242.57 (1.97)*	1380.79 (2.18)*	1306.27 (2.10)*	1465.59 (2.38)*
# of firms	96	96	96	96	96	96	96	96	96	96
# of observations (firm-year)	194	194	194	194	194	194	194	194	194	194
Adjusted R-square	0.504	0.512	0.535	0.548	0.524	0.531	0.558	0.556	0.581	0.593
F-Statistic	25.60***	23.58***	25.63***	24.42***	24.75***	22.94***	28.26***	25.26***	25.33***	24.41***

One-digit industry controls are not reported. Beta values reported, and t-statistics in parentheses.

Table 3: CEO Tenure and Anglo-American Exchange Listing

	Firms **without** Anglo-American Exchange Listing	Firms **with** Anglo-American Exchange Listing	T-test for equality of means
Average CEO tenure (years)	7.31	4.03	5.15***

*** p<.001 (two-tailed)

Table 4: CEO Tenure and Anglo-American Board Membership

	Firms **without** Anglo-American Board Membership	Firms **with** Anglo-American Board Membership	T-test for equality of means
Average CEO tenure (years)	7.21	5.51	1.71*

* p<.05 (two-tailed)