

# The Effect of Board Diversity on CEO Pay

## 1 Introduction

In this study we address how board and remuneration committee diversity affect CEO pay. We do so without making a judgment whether CEO pay is too high or too low. Whereas the issue of board diversity has been addressed in relation to corporate governance and firm performance (e.g., Campbell and Minquex-Vera, 2007; Adams and Ferreira, 2004), the issue of CEO pay and board and remuneration committee diversity has to our knowledge not been addressed by past research. We argue that this issue is particularly interesting, since several Nordic policy makers have called for stronger monitoring of CEO pay (for example: [www.regjeringen.no/nn/dep/aid](http://www.regjeringen.no/nn/dep/aid)), this issue is also of great concern in many other nations.

During the last decade CEO compensation has increased globally (Economist, 2007), as well as in the Nordic countries (Oxelheim and Wihlborg, 2008). Stock option compensation plans became common among the Nordic countries by the end of the 1990s – and stock options were the major vehicle for large pay increases (Oxelheim and Randøy, 2005). Whereas there is a strong element of globalization of CEO pay practices – the convergence in executive pay levels across countries is much weaker (Ruigrok and Greve, 2008). Hence, we argue that the institutional setting and corporate governance practices of the specific country still matter for the determination of CEO compensation. Specifically, the impact of board diversity on CEO pay would most likely vary with the corporate governance system.

In this empirical study we use data from the four Nordic countries: Denmark, Finland, Norway and Sweden. We argue that by focusing on these four countries we get a “natural laboratory” in terms of variation in board diversity – but within the context of a culturally and economically homogenous region (Sinani et al., 2008). Furthermore, the Nordic countries are known for their corporate transparency (Randøy and Nielsen, 2002), which provides us with relatively easy access to firm specific information on board diversity. This allows us to address issues that are harder to address in less transparent countries.

## 2 Theoretical background

Agency theory has been one of the major theoretical pillars of studies on CEO compensation. Agency theory focuses on the incentive and monitoring challenges between owners and managers (particularly the CEO). Agency theory takes a positive approach to the CEO compensation issue. In other words, how can the interests of potentially absent and less informed owners become aligned with that of powerful and sometime opportunistic executives (Fama, 1980; Fama and Jensen, 1983)? Within this framework, a potential weak link between CEO pay and firm performance is due to a lack of correctly designed incentives – some policy makers have suggested that more board diversity is a way to promote better corporate governance (OECD, 2008). In order to reduce the conflict of interest between absent owners and insightful CEOs, the linkage of pay and company performance is the number one suggested remedy. We argue that board diversity promotes CEO monitoring and thus is expected to reduce CEO pay – beyond what is an appropriate pay level to

provide sufficient incentives to the CEO. Given that past research has highlighted that the pay-performance relationship is rather weak – or even not significant in some studies (Tosi et al, 2000), we need to look beyond agency theory to understand how board diversity affects CEO pay.

Organizational theorists have addressed some of the limitations of the agency theory by examining CEO compensation as a political process, and thus taken a descriptive approach to the issue. This is a line of reasoning that goes back to Berle and Means (1932) work on managerial power in large US firms. Organizational scholars have focused particularly on CEO power and board power in attempting to open the “black-box” of what affects the CEO compensation decision (Findelstein, 1992; Boyd, 1994; Zajac and Westphal, 1996). The argument is that CEOs are in a unique position to determine their own compensation, based on their ability to influence board decisions. The ability to affect the remuneration committee, however, might be more limited, as the existence of such a committee (with no CEO presence) is an acknowledgement of the need for independent decision making vis-à-vis the CEO. Previous studies suggest a number of factors that potentially affect CEO power in relation to the board, and we have included the following in this study – with the indicated expected effect on CEO pay; ownership concentration (-), board size (+), and remuneration committee size (+).

This paper specifically addresses how board diversity might affect CEO pay, and we explicitly address three diversity issues; board nationality, board age and female board membership. We also address the two diversity issues in relation to the remuneration committee; female and foreign committee membership. The antithesis of good corporate governance is unrestricted CEO power (at the expense of the board) and fragmentation of board power, and we seek to identify how board and remuneration committee diversity affects CEO pay. We address both the *level* of CEO pay (Model 1), and the *growth* in CEO pay (Model 2). First, we want to understand the structural reasons for why CEOs are paid as they are (Model 1 – below). This does not imply that we get a complete picture of what drives CEO pay. Our second approach (Model 2 – below), addressing CEO pay growth, is therefore very important in order address what causes CEO pay changes. Such knowledge can potentially be used by national policy makers, owners, board members, and members of remuneration committees – to determine CEO pay in the future. Based on the above discussion, we address the research issue with two models:

Model 1:  $\log$  of CEO pay level 2006 = f (board diversity 2005 + control variables in 2005)

Model 2:  $\log$  CEO yearly pay growth<sub>t</sub> = f (board diversity<sub>t-1</sub> + control variables in 2004<sub>t-1</sub>)

### 3 Expected effect of diversity on CEO pay

From an agency point of view, greater board diversity might lead to a higher level of board independence - which is something that should benefit shareholders. Specifically, we expect that independent directors have greater incentives to take actions consistent with value maximization since they have concerns about their reputation affecting their ability to take on additional board appointments (Fama, 1980). We suggest that greater diversity is a sure way to promote greater board independence – and therefore we expect that diversity might promote appropriate CEO incentives. However, from an *agency point* of view – the *level* of pay should not be affected by greater board diversity – but the incentive alignment with owners (i.e., the combination of fixed and variable pay).

We will argue that from a *managerial power* perspective greater board diversity increase managerial discretion – including the CEOs ability to influence pay. Specifically, with great managerial power the CEO is able to take away the linkage between pay and performance; such that greater diversity produces higher salary. This is similar to the effect that previous studies on CEO pay have found for other board composition variables; such as board size – which is also expected to enhance managerial discretion (Yermack, 1996). This argument is also consistent with the social choice literature, specifically arguing for higher costs of collective decision making when the decision-makers are heterogeneous (Adams and Ferreira, 2004). Board diversity may necessitate longer, less efficient board meetings, the probability of ambiguities, misunderstandings and decision errors may increase, and conflicts of interest may be more likely to occur. Specifically, great diversity makes it hard to develop the board as a coherent unit – and from a managerial power perspective – this can enhance the CEOs bargaining power vis-à-vis the board. We therefore suggest that:

*Hypothesis 1a: There is a positive relationship between female board membership and CEO compensation.*

*Hypothesis 1b: There is a positive relationship between female remuneration committee membership and CEO compensation*

In line with past research, we argue that there is also a special effect from greater internationalisation of the board on CEO compensation – specifically an effect from Anglo-American board membership in Scandinavian firms (Oxelheim and Randøy, 2005). Such Anglo-American board membership provides a risk premium (of being dismissed) from the harsher monitoring commonly provided by independent board members from Anglo-American countries (Oxelheim and Randøy, 2003). Specifically, Oxelheim and Randøy (2005) show how the likelihood of dismissal given poor performance – is enhanced with Anglo-American board membership. The rational CEO will ask to be compensated for such harsher monitoring – and thus the level of CEO pay increases with foreign board membership. Social choice theory also would support the notion that a foreign board member would add complexity and communication problems within the board room – and thus weakens the board’s power vis-à-vis the CEO. This observation, together with the previous arguments, underpins our next hypotheses:

*Hypothesis 2a: There is a positive relationship between foreign board membership and CEO compensation.*

*Hypothesis 2b: There is a positive relationship between foreign remuneration committee membership and CEO compensation.*

One of the main political arguments for greater board diversity, and then more age variation of board members, is the potential greater board independence. The argument is that so-called “old boys” networks tend to develop in similar age groups – often affiliated with common educational

institutions, and as such provides strong social ties between board members and the CEO – and thus less independence. This is clearly a pattern in the Nordic countries, with a limited number of significant business and law scholars (often with a national champion – such as Copenhagen Business School or Helsinki School of Economics). This same argument can also be applied in the context of performance sensitivity – as greater variation in board age makes the CEO less able to influence (increase) CEO pay.

*Hypothesis 3: There is a positive relationship between age variation of board and CEO compensation.*

## **4 Methodology, choice of control variables and data**

### **Data**

We use data as described in Chapter 1: the database of all publicly traded firms in Norway, Sweden, Denmark and Finland. From this database we have figures on firm characteristics, ownership structure, board structure and financial data. We have CEO pay figures for all countries in 2006, and between 2005 to 2007 for Norway and Sweden. Getting access to CEO compensation data provided multiple challenges, and secondary databases do not provide these figures consistently. We collected this data based on the information provided in annual reports. Sweden and Norway require that CEO pay figures to be displayed in the annual report, whereas Finland and Denmark only require such figures for the total top management team (however, a number of firm still present these figures separately).

Whereas the cash part of CEO compensation has been a reporting requirement for a long time in Norway and Sweden, the stock option plans have not been consistently reported. However, due to a new 2005 International Financial Reporting Standards (IFRS) requirement, the Nordic companies now provide consistent reports on the total value (cost to the firm) of all elements of CEO compensation (this implies using the Black-Scholes option pricing model).

### **Methodology**

A cross-sectional ordinary least-square (OLS) regression model is used to test the hypotheses presented in model 1 – focusing on the level of CEO pay in 2006. Drawing on previous research on corporate governance and CEO compensation (OECD, 1999; Core et al., 1999), Model 1 is tested with a variety of independent variables to minimize specification bias in the hypothesis testing. Specifically, we control for financial performance (ROA), industry, country, ownership structure, board size and size (sales). Analysis of the regression residuals did not indicate any problems with either heteroscedasticity or non-normal distributions.

To address the CEO pay growth issue, we apply an unbalanced data set of firms. Due to data limitations we only have these observations from Norway and Sweden between 2005 and 2007. While a fixed-effect specification could be attractive, the analysis includes industry, and other

variables (remuneration committee figures) that are invariant over time, such that a random effect model is necessary.

There is no established literature on how rapid board characteristics; including diversity, firm performance and other characteristics of the firm - affect CEO compensation. Past studies tend to apply a one-year time lag (e.g., Coombs and Gilley, 2005). Given that CEO pay is determined at least annually – a one year time lag seems appropriate.

## Measures

Since the objective of this study is the effect of board diversity on total CEO pay, we use the aggregate figure of CEO compensation – including fixed pay, cash bonuses, pension contributions, stocks, stock options etc. The CEO pay figure is measured in Euros at the exchange rate at the end of the year – as only Finland uses the Euro in the study period. In order to reduce heteroscedasticity, the natural log of CEO compensation is used as the dependent variable. This approach was previously used by Finkelstein and Hambrick (1989), Boyd (1994), and Elhagrasy et al. (1998/1999). The CEO pay growth figure is produced by taking the log of CEO pay in year<sub>t</sub>, and then subtracted by the CEO pay in year<sub>t-1</sub>.

The female board percentage is calculated based on all board members – including possible employee elected members. Foreign board membership is based on the citizenship of the board members – which might both understate and overstate the actual degree of non-national influence in the board. Dual nationalities have not been identified among the board members. The age variation of the board is measured as the standard deviation of the age of the individual board members. Similar to the measures of female and foreign board membership, we also measure female and foreign remuneration committee membership.

We apply a number of control variables in line with past studies. We use the log of total sales (measured in US dollars) as the measure of firm size. Another control variable is ownership concentration which is measured as a percentage of ownership by the largest owner. In the case of more than one share class, we used the share class most actively traded. Firm performance is measured using return on assets (ROA), with a one year lag. Board size and remuneration committee size – is measured by the total number of members – including possible employee elected members.

## 5 Discussion

Among the sample firms, the average Nordic CEO received 415 000 Euros in total pay in 2006. CEO pay was highest in Finland with the lowest salary in Denmark. These numbers can not be directly compared – since the sample includes more or less all publicly traded firms from Norway and Sweden – but a much smaller sample of firms from Finland and Denmark. Furthermore, the structural differences between the countries also make it inappropriate to compare these figures directly.



Table 6.1 Correlations - CEO pay and diversity

	CEO pay (ln) in Euro	# Female board	Anglo-American board	Sales (US\$)	# of member remuneration com.	# Foreign Renum. Members	# Female remun. Committee	Leverage	Foreign board members	Standard dev. Board age	# Total employees	# Board members	Total assets (US\$)	Market capitalization (US\$)	ROA	
CEO pay (ln) in Euro	1.0000															
# Female board members	0.1227*	1.0000														
Anglo-American board	0.2345*	0.0504*	1.0000													
Sales (US\$)	0.4493*	0.1104*	0.1237*	1.0000												
# of member remu. com.	0.3942*	0.1436*	0.1465*	0.2715*	1.0000											
# Foreign Board Members	0.2877*	-0.0060	0.3085*	0.3039*	0.3050*	1.0000										
# Female remun. Committee	0.1680*	0.2270*	0.1294*	0.1562*	0.5685*	0.1740*	1.0000									
Leverage	0.0393	-0.0586*	-0.0519*	-0.0001	-0.0739*	-0.0690*	-0.0441*	1.0000								
Foreign board %	0.2413*	0.0515*	0.5880*	0.1640*	0.1858*	0.3906*	0.0829*	-0.0420*	1.0000							
Standard dev. Board age	-0.0283	0.0949*	0.0535*	-0.0803*	-0.0084	0.0238	0.0047	-0.0450*	0.0356*	1.0000						
# Total employees	0.2850*	0.1890*	-0.0697*	0.2010*	0.0744*	0.0176	0.0212	0.0292	-0.0498*	0.1136*	1.0000					
# Board members	0.4744*	0.2282*	0.0272	0.3569*	0.4009*	0.1328*	0.2144*	0.0291	0.0527*	0.1107*	0.6886*	1.0000				
Total assets (US\$)	0.2494*	0.1284*	0.0543*	0.5881*	0.1586*	0.1406*	0.1177*	0.0378*	0.0960*	-0.0469*	0.1687*	0.2644*	1.0000			
Market capitalization	0.4950*	0.1117*	0.1445*	0.7686*	0.2245*	0.4001*	0.1452*	-0.0295*	0.1653*	-0.0486*	0.1361*	0.2803*	0.4623*	1.0000		
ROA	0.1524*	0.0876*	-0.1210*	0.0822*	0.0742*	0.0170	0.0783*	0.0667*	-0.1440*	0.0190	0.1219*	0.1334*	0.0530*	0.0829*	1.0000	

The correlations show that there is a significant association between two of our measures of board diversity and CEO pay. The correlation with female board membership is 0.13, with foreign board membership 0.24 – both in line with H1a and H2a. These findings do not imply causality – as the level of compensation is also driven by a number of other factors – and the causal direction could potentially be reversed (as highly paid CEOs also could attract foreign board members and more female directors). Furthermore, in line with past research, we see that particular firm size (measure either in terms of employees, sales or market capitalization) is highly correlated with CEO pay. As expected, financial performance (ROA) is significantly associated with higher pay (but only at 0.15), as well as board size (.47) and the size of the remuneration committee (0.39). Other control variables that show significant correlation with CEO pay are: ownership concentration (-.17), dual share classes (0.39) and three out of the four country dummies.

*Table 6.2: The effect of board diversity on CEO pay (ln) in 2006.*

*OLS regression (standard errors reported in the brackets)*

OLS REGRESSION	
Dependent variable: CEO Pay (in logarithms)	
Percentage of females on board	0.005 (0.003)**
Percentage of foreigners on board	0.007(0.002)***
Board age (standard deviation)	0.008 (0.013)
Sales (in logarithms)	0.1777(0.025)***
Largest owner share (in percent)	-0.006(0.002)***
Board size (n of members)	0.072(0.02)***
Norway	-0.456(0.173)***
Sweden	-0.189(0.158)
Finland	-0.317 (0.176)*
Return on assets	0.0013 (0.002)
Remuneration committee (size)	0.127 (0.033)***
Number of foreigners on the remuneration committee	0.090 (0.869)
Number of females on the remuneration committee	-0.139 (0.081)
Industry dummies	Included
Const.	11.547 (0.216)***
R-squared	0.588
Number observations of	373

*\*Significant at 10 percent level.*

*\*\*Significant at a 5 percent level.*

*\*\*\*Significant at a 1 percent level.*

The multivariate test in Table 6.2 reveals that after controlling for other factors, female board membership (H1a) is significantly associated with higher CEO pay. We emphasize that our tests shown in Table 6.2 can not detect causality – as we do not test the effects over time and do not control for unobserved firm effects (or other such effects). As we argue in the theory section, there is still a theoretical argument that heterogeneous board membership (one gender versus both genders) might produce weaker collective decision-making, and thus provide the CEO with potentially stronger bargaining power over the pay setting process. This does not imply that women are less successful or less valuable board members – only that board diversity might have both costs and benefits – and higher CEO pay might be one of the cost factors. When we look at the effect of female remuneration committee membership – we actually see the opposite effect: a female membership is associated with lower CEO pay (significant at the 5%-level with one-side test). The argument could be that whereas heterogeneous (with females in this case) boards have abridged monitoring capabilities, this is less of an issue when diverse board members are given a specific task – such as setting CEO pay in the context of a remuneration committee.

Our data shows that foreign board membership (H2a) is significantly associated with higher CEO pay. Whereas Oxelheim and Randøy (2005) found a positive CEO pay effect of Anglo-American board membership in Norwegian and Swedish firms – we identify the same kind of effect related to all foreign board members. Whereas Oxelheim and Randøy (2005) emphasized the contagion effect from highly paid Anglo-American CEOs (and with this harsher monitoring of the CEO), our findings indicate that there is a broad effect from international board membership. We will argue that this effect can be explained by both a contagion effect from abroad, as the Nordic countries have among the lowest CEO pay in the OECD, and due to the weaker monitoring abilities of a diverse board. In line with social choice theory, we argue that differences in culture, language and values makes board coordination and decision making more challenging, and thus the CEO enhances his/her managerial power vis-à-vis the board. We failed to get significant support for the same effect of foreign membership with respect to the remuneration committee. One possible explanation could be that when a board has foreign board membership – and thus have already been “infection” by this effect – then the additional effect of adding foreign remuneration committee members is rather small.

However, the third diversity factor – variation in board age - does not show a significant association with CEO pay. Furthermore, the age diversity of the remuneration committee does not show significant association with CEO pay. Our main argument (H3) has been that board age diversity produces more board independence, whereas, social choice literature makes the opposite prediction. For example, Adams and Ferreira (2004) found higher costs of collective decision making when the decision-makers are heterogeneous. Given that, we find no consistent relationship between the age diversity of the board and CEO pay – a possible explanation might be that the positive effect of more board independence, is cancelled out by the negative effect of more board conflict.

Table 6.3: The effect of board diversity on the growth in the CEO pay (ln) in the Nordic countries over 2001-2007 period OLS regression (standard errors reported in the brackets)

OLS REGRESSION	
Dependent variable: Growth in the CEO pay (lnCeopay(t) - lnCeopay (t-1))	
All explanatory variable are lagged	
Percentage of females on board	-0.0002 (0.001)
Percentage of foreigners on board	0.003(0.001)**
Board age (standard deviation)	0.005 (0.005)
Sales growth	0.067(0.026)***
Largest owner share (in percent)	-0.000(0.001)
Board size (n of members)	-0.005(0.009)
Norway	-0.0001(0.093)
Sweden	0.038 (0.086)
Finland	0.179 (0.316)
Return on assets	0.0006 (0.0001)
Remuneration committee (size)	-0.012 (0.014)
Number of foreigners on the remuneration committee	-0.018 (0.04)
Number of females on the remuneration committee	-0.032 (0.035)
Industry dummies	Included
Year dummies	Included
Const.	-0.12 (0.14)
N of observations	735

R-squared	0.12
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\*Significant at 10 percent level.

\*\*Significant at a 5 percent level.

\*\*\*Significant at a 1 percent level.

Using CEO pay growth as the dependent variable provides several advantages to the cross-sectional approach applied in Model 1 and shown in Table 6.2. First, the need for control variables are limited since changes in CEO pay is regressed against changes in the same firm. Second, this provides a stronger case to assess causality.

Table 6.3 shows that sales growth is the most important factor driving changes in CEO pay in Norway and Sweden between 2005 and 2007. This is in line with other studies from Finland (Mäkinen, 2008), and the UK and US (Conyon and Murphy, 2000). We also see that a high level of foreign board membership significantly increases CEO pay growth – in line with the predictions of H2a. Again, as previously seen in Norway and Sweden in the late 1990s (Oxelheim and Randøy, 2005), foreign board membership appears to continue to spread a culture of high CEO pay to the relatively low paid Nordic executives. We failed to find a linkage between female board membership and CEO pay growth. There might be two offsetting effects leading to this finding. On one hand, female board membership provides potentially weaker monitoring as argued by the social choice theory (as seen in Table 6.2) – on the other hand – this effect might be offset by the stronger **inFeil! Fant ingen stikkord.**dependence of female directors – as expected from agency theory. Given that female directors can not be members of “the old boy’s network” – they need to be recruited from new social networks. Such recruitment will most likely reduce the CEOs ability to influence recruitment, and thus reduce the CEOs wage setting power vis-à-vis the board. Unfortunately, we do not have any data to support such an argument.

## 6 Conclusion

In this study we have addressed the impact of board and remuneration committee diversity on the level and growth of CEO pay in four Nordic countries. We apply two models to assess the impact of board and remuneration committee diversity: one focusing on the CEO pay level across countries and firms in 2006, and another model on the annual CEO pay growth – limited to Norway and Sweden between 2005 and 2007.

We find that female board membership significantly increased the CEO pay level in 2006, and argue that this effect might be explained by the higher coordination and decision making difficulties associated with heterogeneous groups. Furthermore, such board diversity might lead to a stronger pay bargaining position of the CEO vis-à-vis the board. When assessing the impact of female board membership on CEOs annual pay growth – we find a no significant effect. This suggests that female board membership does not contribute to further increases in CEO pay. From a corporate governance point of view – this suggest that female board membership might produce higher CEO pay (or rather in the past) – but that the present and future impact is uncertain.

We find that foreign board membership significantly increases CEO pay and that there is also a significant effect on pay growth. This suggests that foreign board membership reduces the monitoring capabilities of the board – partly motivated by the fact that foreign board members are used to much higher CEO compensation in non-Nordic countries. We do not find a significant effect of board age diversity on CEO pay. This might reflect the fact that age is a “weaker” diversity variable than gender and nationality - at least in relation to the CEO pay setting processes.

We find that remuneration committee gender diversity does significantly reduce the pay level (2006) – but not the annual pay growth (2005-2007) in our sample firms. We argue that the “costs” of diversity, as particularly argued by the social choice theory, are smaller in very task oriented groups – such as a remuneration committee. In fact, the pay reduction from female remuneration committee membership suggests females are better monitors of the pay process. This could potentially be explained by a greater independence vis-à-vis the CEO of female remuneration committee members. One control variable should be noted. Larger remuneration committees pay higher CEO salaries – similar to the effect from board size.

One limitation of this study is the fact that we look at the effect of board and remuneration committee diversity in the context of four civil law countries – with rather similar corporate governance systems. Whereas our main theoretical arguments are built on agency theory, social choice theory and managerial power theory – these arguments should also be applicable to other contexts. However, given the fact that countries vary extensively with regards to dimensions such as the present level of board diversity (as illustrated by Economist, 2008) and the fact that there are limits to diversity (i.e., when the female board percentage reached 50% - then gender diversity can only go down), we expect that the relative impact of diversity is country and time-specific.

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