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**ONWARDS AND UPWARDS: WHY
COMPANIES CHANGE THEIR EXECUTIVE
REMUNERATION SCHEMES, AND WHY
THIS LEADS TO INCREASES IN PAY**

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Abstract

Much has been written about the phenomenon of ever-increasing executive pay in listed companies. This paper examines some of the underlying reasons for this continued increase in executive directors' remuneration. It reports the results of 40 interviews with protagonists in the remuneration debate in FTSE 350 companies, exploring the types of change made and the reasons given for these changes. This issue has not specifically been addressed by previous studies.

Reasons given for making changes included: increases due to being below market; changing performance-related schemes that did not pay out or paid less than the anticipated amount; changes in the company's culture or strategy; changes to senior personnel (executive and non-executive); compliance with good human resources practice; and a perceived need to comply with best practice in corporate governance.

The results are analysed through two theoretical lenses. An agency theory explanation provides insight into the structure of executive remuneration contracts, and expectancy theory suggests why schemes might be changed to motivate the executives. The expectancy theory explanation tempers the agency theory explanation, showing why changes are made even though this may lead to moral hazard.

Keywords: executive remuneration, agency theory, performance-related pay

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1. Introduction

Much has been written about the large increase in executive pay over the last decade in the United States (US) (e.g. Bebchuk and Grinstein, 2005) and the United Kingdom (UK) (e.g. Deloitte, 2005). This rise has come about due to the absolute increases in levels of salary, and also from a change in the structure of packages, with a proportionately higher level of variable pay being available. Explanations given for this phenomenon include an over-reliance on size-based surveys, leading to a ratcheting up of pay levels (Jensen, Murphy and Wruck, 2004; Ezzamel and Watson, 2002) and the increase in importance of complex equity-based compensation schemes (Bebchuk and Grinstein, 2005; Buck, et al., 2003). This paper adds to the body of work in this area by examining, in a UK context, some of the underlying reasons for this continued increase in executive directors' remuneration. This is done from two theoretical perspectives: agency theory and expectancy theory.

The use of these theoretical perspectives ties in with the two roles of the non-executive director (NED) as discussed by many authors, including Ezzamel and Watson (1997) and McNulty et al (2003). The NEDs, who sit on the remuneration committees that determine remuneration, have roles both as monitors, interested in conformance to governance regulation, and as strategists, focusing on business performance. Both of these roles are important, but their demands are different.

The governance role of NEDs in relation to executive remuneration is explored through an agency theory lens, considering how pay is structured to align executives' actions with the needs of shareholders. Examination of the performance role is done using an expectancy theory perspective, looking at how the pay structure motivates the executives to make decisions or take actions in line with the business strategy.

In examining the reasons why executive pay appears to be continually increasing this study takes the results of interview-based research in selected FTSE 350 companies, and examines the reasons given in the companies for making changes to their remuneration schemes and practices. Interviews were conducted at 12 companies: each of them had made significant changes to its remuneration over a period of a few years, and some had made many such changes. Those changes reflected issues relating to corporate performance (for example executive motivation, changes in company strategy or culture) and changes relating to corporate governance (for example, changing schemes to be in line with best practice). In no case did those changes appear to reduce the actual or potential remuneration of executives.

The paper proceeds as follows. Section 2 explains the structure of executive remuneration schemes used in the UK and sets out the theoretical backgrounds against which the results of this study are set. Section 3 explains the research approach adopted in this study. This is followed in section 4 by a presentation of the findings of the research: how elements of the schemes changed, and the reasons given by the interviewees for these changes. The findings are discussed in section 5, and section 6 concludes.

2. Background

2.1 Executive pay in the UK

The remuneration package of an executive director of a UK listed company generally comprises base salary, an annual bonus (possibly including a deferred element) and one or more long-term awards, plus pension arrangements and perks (New Bridge Street, 2004a and 2004b). The long-term awards will take the form either of options, or of share-based long term incentive plans (ltips). Until very recently, when pensions became an issue of public debate, most of the attention of academics (Murphy, 1999: 2517; Werner and Ward, 2004: 217) and investors has been on the salary and the variable awards (bonus, options and ltips) probably due to the fact that these have been reported in most detail, and are most easily understood. In line with this academic tradition, this paper treats remuneration as comprising the salary and variable pay elements, excluding pension and perks.

Salary is the fixed element of the package, the others being variable. Two factors influence the level of variable pay an executive receives. The first is the way that the elements of variable pay are set as a function of salary (e.g. potential bonus being up to 80% of annual salary; options award being up to 150% of salary). The second factor affecting the amount of pay received is whether, and to what extent, the executive achieves the targets set for the variable pay: lower performance will result in a reduced bonus. For example, in a scheme where the maximum potential bonus is 80% of salary, an executive might receive an actual award, based on performance, of 50%. What is significant to the executive is the amount of pay actually awarded, not just the upper limit. Thus, in considering the overall level of executive pay, attention needs to be paid to each element of the package, and to both targets and achieved results.

2.2 Theoretical approaches

In examining why companies make changes to their executive remuneration schemes, two theoretical lenses have been adopted, from different perspectives but having aspects in common. These are agency theory, which is an economics-based approach, and expectancy theory, a process theory of motivation which reflects a social-psychological approach. Eisenhardt (1989: 71) suggests that agency theory provides a partial view of the world, and that using it with complementary perspectives helps capture the complexity of organisations. Agency theory explains *why* the board, acting on behalf of the shareholders, seeks for governance reasons to use executive remuneration contracts that are performance-related; expectancy theory suggests *how* that variable pay might motivate individual performance.

Much of the literature that discusses executive pay uses an agency theory approach. This theory, which arises from the separation of ownership and management (Berle and Means, 1932), is developed and discussed by Jensen and Meckling (1976), Fama (1980) and Eisenhardt (1989), amongst others. It relates to the differences in motivation and payoff between the shareholders (the principals who own the firm) and the executive directors (the agents to whom is delegated its day to day running). Proponents of agency theory see the remuneration contract as a way to mitigate this potential conflict of interest. By relating executive remuneration to an appropriate measure of performance, shareholders have some means of ensuring that executives behave in their (i.e. the shareholders') interests. Thus performance-related contracts, that measure outcomes rather than behaviours, are seen as a useful mechanism. By having their reward linked to suitable performance measures, executives should be motivated to perform in areas seen as important by the board and shareholders. A greater link between pay and performance implies greater alignment. However, as Hodak (2005: 116) points out, the fact that a package aligns, does not mean that it motivates.

Implicit in the agency theory approach is the assumption that linking pay to performance will in fact motivate the executives to perform. In examining how this motivation of executives might be effected, expectancy theory (Vroom, 1964; Pinder, 1987; Lawler, 1991) states that if variable pay is to act as a motivator then (a) the individual has to expect that by exerting effort s/he will be able to meet the targets set; and (b) that meeting the targets will result in receiving the reward, which (c) s/he believes is worth having. Proponents of expectancy theory argue that an individual's effort will be based on his/her expectation of the probability of success (expectancy) and the attractiveness of the final outcome (the value of the reward). The theory suggests that it is the individual's *perception* of the link between effort and performance, and between performance and reward that is important. The individual must understand that link and feel confident that by adapting their performance in the direction suggested by the performance management system, they will be able to achieve the goals and thus receive the reward.

Because expectancy theory relates to individuals' perceptions, a significant aspect of the theory is that it explicitly recognises the differing preferences of individuals, and implicitly assumes that differently structured packages might be appropriate in different contexts.

From the above, it can be seen that both agency theory and expectancy theory have at their heart the assumption that an individual can be motivated into certain actions by the opportunity to receive a reward. It is for the designer of the contract (agency theory) or the performance management system (expectancy theory) to ensure that the performance criteria set are appropriate for the company's objectives and the individual's capabilities. These are the assumptions underlying the use of performance-related pay. From the remuneration committee's point of view, contracts have to be set so as to comply with relevant governance regulations and 'best practice', and to manage the individuals' requirements. This can result in a tension for the NEDs trying to reconcile these two imperatives (Spira and Bender, 2004).

3. Research approach

This study examined how executive directors' pay was determined in selected UK listed companies. It was an exploratory study, adopting a multiple case approach as suggested by Yin (1994). As others have pointed out (Stiles, 2001; Pettigrew, 1992) much of the research on boards of directors has used archival sources, at one remove from the participants themselves. This work focuses on the views of the individuals, by means of semi-structured face-to-face interviews with protagonists in the remuneration-setting process in FTSE 350 companies.

A perennial problem with research amongst elites is obtaining access, and a certain amount of opportunism in sample selection is inevitable (Silverman, 2001: 249; Perkins and Hendry, 2005). For this study, the case companies were obtained in several ways.

Initially, a sample was taken from the PricewaterhouseCoopers Corporate Register (a commercial database of companies and directors). Companies from the utilities sectors and the finance sectors were selected from the database, and those with 'good governance' (i.e. not obviously breaching any governance guidelines) were listed¹. The

¹ Four of the companies were from the utilities sector, this emphasis on utilities being part of the research design. Utilities in the UK have an interesting position as regards directors' remuneration – it was the high pay and option awards made to directors of the newly-privatised utilities that led to the 'fat cat' debate which resulted in the Greenbury report of 1995. Further, utilities are governed by regulators, who determine the prices they can charge, such that a utility's potential for economic profit is reset at zero every five years, in order to drive future efficiencies. These various factors make utilities an interesting

companies selected from this list were those where the directors (executive or non-executive) sat on the remuneration committees of more than one company, the thought being that interviewing such individuals would produce richer results. 25 companies were approached by telephone contact, of which six agreed to participate. The sample was extended through contact with a group of executive remuneration professionals in FTSE 100 companies, to whom details of the research were circulated. Four other companies joined the research through that process, with the final two arising due to individuals at those companies expressed interest in a paper presenting some early results of the research (Bender, 2003).

Table 1 sets out details of the corporate interviewees.

Table 1: Company interviewees by role

Co.	HR professional	Remuneration Committee chairman	NED	Consultant	CEO	Company secretary	Company chairman	Total
1	2	1	1	1	1			6
2	1	1	1	1	1			5
3	1							1
4	1	1			1			3
5	1		1	1		1	1	5
6	2							2
7	1	1	2	1	1	1		7
8	1			1				2
9	1							1
10	1							1
11						1		1
12		1						1
Total	12	5	5	5	4	3	1	35

context in which to examine executive pay in the UK. The original research plan was to investigate utilities and finance companies, the latter being chosen as an example of an industry where pay is much higher than utilities, and structured with a higher performance-related element. Early in the fieldwork, it was realised that the remuneration-setting process in finance companies was no different to that in other industries, and this industry requirement was relaxed.

As well as the corporate interviewees, interviews were conducted with an institutional representative, headhunters, a group of remuneration professionals, and a focus group brought together to discuss the results of the research. In all, 40 individual and group interviews were conducted, between 2001 and 2003. The interviews, which lasted on average one hour, were taped and transcribed.

A standard interview agenda was adopted, although the approach was flexible, and the interviews were very wide-ranging. The interview protocol addressed three main areas:

- (a) Your thoughts on the debate about the level and structure of executive directors' remuneration (6 questions addressing issues of level and structure, performance and motivation);
- (b) How the company arrived at its remuneration policies (11 questions addressing the conduct of committee meetings, the roles of the different parties, matters considered and then rejected, time lines of decisions, comparative pay throughout the organisation); and
- (c) How the company's remuneration policies compare to other companies of which you are aware (3 questions addressing level and structure of pay, and 'good' or 'bad' practice).

Interviewees were also asked to complete a short questionnaire, ranking the various factors that might impact on their pay decisions (e.g. company size, profitability, strategy, individual director needs, etc.)

In addition to the interviews, documentation such as remuneration committee meeting minutes and consultants' reports was obtained from five of the companies (the others would not make such information available). Furthermore, financial statements (which include the published remuneration reports) were obtained for all companies for the preceding, current and immediately subsequent years.

The interview transcripts and company documents were analysed with the help of NVivo to manage the data. These documents were coded to reflect what was happening in the companies, and the theoretical perspectives that this reflected.

4. Findings: changes to schemes

Almost every working individual will experience some changes in their pay and conditions every year, as part of an annual progression. For the purpose of this research, 'change' was defined more explicitly than this. Levels of pay that moved in line with

market conditions or with promotion were not treated as changes, but increases (there were no decreases) considerably above market levels were included. Amendments to the variable pay policies and packages were all defined as changes for this research, as normally one would expect the status quo to apply, and schemes would continue unchanged each year. Thus such amendments, in response to an outside stimulus, were examined.

Discussion with the interviewees focused on changes made to policies and packages within the current or preceding year, except in one company where the interviewees were anxious also to discuss significant changes which had taken place five years previously. Within the twelve companies, some had undertaken a complete review of their executive remuneration structures whilst others had just changed one aspect of their pay.

The changes were all implemented by the companies' remuneration committees, as is required under the Combined Code (2003). However, in some instances it was clear that the remuneration committee had itself initiated the change; in some it was apparent that the review was initiated by the executives; and in some instances it was not clear from the interviews how the change had arisen.

Before commenting on the changes, it is useful to set out details of what was done, and by whom. Table 2 summarises the main changes that were made to the schemes, showing the number of companies to which they related.

Table 2: Summary of changes made to remuneration schemes

Change	Number of companies to which this relates
Long term incentive scheme changed.	10
Nature of the annual bonus scheme changed.	6
Long term performance measures changed.	6
Level of bonus target and/or cap increased.	5
Salary levels increased by considerably more than market trend.	4
Short term performance measures changed.	4
Bonus deferral and/or share match introduced to the package.	4
Perks improved.	1
Introduced a shareholding requirement for executives.	1

In addition to the above, three of the companies were undertaking major reviews of their remuneration practices at the time of the research fieldwork. The outcomes of those reviews are not known².

It is notable that all of the changes indicated above, except the shareholding requirement, have the potential to increase the overall level of executive pay. Some automatically led to a rise. Others, for example the additional bonus potential, could lead to such an increase, although some of the companies also changed their performance targets at the same time, making direct comparison difficult. Nevertheless, these changes are one explanation for why published surveys of executive pay continually show significant growth in remuneration (e.g. Taylor, 2005).

Table 3 sets out in more detail how these changes related to the individual case companies. Table 4 relates this information on changes made to the stimuli for making those changes.

As stated, none of the changes led directly to a decrease in executive pay: all except the shareholding requirement appeared to result in an actual or potential increase. This was reflected, indirectly, in a comment of one of the interviewees discussing why the changes to their scheme had taken place when they did, and not several years earlier.

'As far as options is concerned, options had been very popular with management, as you can imagine, during a period of a constantly rising share price, and no performance conditions attached to them. And I think that it would have been a very brave management that would decide to take away something that was delivering significant rewards to people and replace it ...'

Company secretary

A change that deliberately reduced executives' actual or potential earnings would be unpopular and very unusual – no such changes were noted. However, occasional changes which reduced one part of remuneration were seen in the case companies – for example in one company when an option scheme was introduced to run alongside an existing ltip, the potential payout on the ltip was reduced in order that the incentives overall were not unreasonable when compared to the market. Also, in some cases interviewees reported that a change to a higher bonus potential was accompanied by tougher performance targets, making the ultimate pay outcome difficult to prejudge. (As detailed information on bonus measures and targets is not disclosable, this could not always be verified.)

² Although the remuneration reports of those companies have since become available, the scheme detail (e.g. bonus measures and targets) is not published.

Some of the changes made were significant, and came about as the result of an extensive review. Other changes, such as adapting performance measures or increasing bonus levels, were considered (by the parties and the researcher) to be more minor. The explanations given by the interviewees for making the changes, as set out in Tables 3 and 4, are discussed in the next section.

Table 3: Summary by company of the reasons given for changing schemes

<i>Company</i> → <i>Reasons</i> ↓	A	B	C	D	E	F	G	H	I	J	K	L	Total
<i>Below market</i>			■	■	■		■			■		■	6
<i>Not paying out[enough]</i>		■		■			■			■	■	■	6
<i>Incoming execs/ CEO/ Chairman</i>		■			■		■		■	■		■	6
<i>Strategy /commercial markets changed</i>		■					■				■	■	4
<i>Scheme or measure too complex</i>		■			■						■	■	4
<i>Culture change</i>		■					■				■	■	4
<i>Best practice / market practice</i>					■	■	■			■			4
<i>Change in company circumstances</i>	■			■				■	■				4
<i>Peer group not relevant</i>		■									■	■	3
<i>Needed better short/long term balance</i>							■					■	2
<i>Execs dissatisfied / to retain executives</i>							■					■	2
<i>End of scheme life</i>			■		■								2
<i>[May] need to attract people</i>							■			■			2
<i>Retention needs</i>							■			■			2
<i>Other</i>						■	■		■	■			2
<i>Total</i>	1	6	2	3	5	2	11	1	3	7	5	9	

NB – company designators are changed to disguise their identity.

Table 4: Analysis of changes made and reasons given for the changes

<i>Changes made</i> →	<i>Increase in salary levels</i>	<i>Change Short term schemes</i>	<i>Change Short term performance measures</i>	<i>Bonus max increased / Higher % of pay is variable</i>	<i>Bonus match /share match introduced</i>	<i>Change long term performance measures</i>	<i>Change long term scheme</i>	<i>Perks increased</i>	<i>Introduced shareholding requirement</i>	<i>Currently major review</i>
<i>Reasons</i> ↓										
<i>Below market</i>	■	■		■	■		■	■		
<i>Not paying out[enough]</i>				■	■	■	■			■
<i>Incoming execs/ CEO/ Chairman</i>	■	■	■	■		■	■	■		■
<i>Strategy /commercial markets changed</i>		■	■	■	■	■	■			
<i>Scheme or measure too complex</i>		■				■	■			
<i>Culture change</i>		■	■	■		■	■			
<i>Best practice / market practice</i>		■	■	■			■			■
<i>Change in company circumstances</i>		■			■		■			
<i>Peer group not relevant</i>						■	■			
<i>Needed better short/long term balance</i>		■	■	■			■			
<i>Execs dissatisfied / to retain executives</i>	■						■			
<i>End of scheme life</i>							■			
<i>[May] need to attract people</i>		■		■			■			
<i>Retention needs</i>							■		■	
<i>Other</i>		■	■			■	■			

4.1. The Stimuli For Change

There were many different stimuli for change. The analyses in Tables 3 and 4 set out some detail of these; here they are summarised under broad headings, to show the key themes.

4.1.1. Market-related changes

Executive pay is set based on market comparators, for both the level of salary and the levels of bonus and long term award (Bender 2004a). Several of the case companies made changes (for example, increasing the level of salary or bonus) because their existing schemes were considered to be below market. In only one of the companies was it specifically stated that being ‘below market’ had led to executive dissatisfaction; there was generally just a desire to remain in line with ‘the market’.

‘The thing was that we hadn’t had to recruit anybody into those senior positions for a long time. Everybody had been in post for quite a number of years. So there was never a need to test whether those levels were attractive to get people in. So we adjusted those, and we adjusted certain other things, for example things like cars. ... I mean, the whole thing... the bonus scheme was pretty poor in terms of the potential rewards. There was a share option scheme at the time, but no tip. So all in all it was the whole remuneration package was a long way out of line with the rest of the world.’

Company chairman

Many commentators (e.g. Murphy, 1999: 2497; Hall, 2002) have pointed out that a desire by all companies to pay at market median or above will lead automatically to that median ratcheting up every year. Although some have warned against this practice (e.g. Higgs, 2003: B1.2), none has explained how companies are to avoid the situation, whilst still remaining competitive in the labour market.

Market factors related not just to the level of salaries, but also to the level of bonus award available for on-target and maximum performance. The level of performance-related pay (PRP) used by UK companies, on both short- and long-term schemes, is increasing (New Bridge Street, 2004a, 2004b). This partly reflects the ratchet effect discussed above, but in part it is due to the requirements of good governance. The Combined Code, as revised in 2003, states that a “significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance”. This requirement

ups the ante from the previous version of the Code, which required merely that “a proportion” of pay be so structured. In increasing the amount of variable pay, it might have been expected that companies would reduce the level of base salary to compensate: this does not appear to have happened, possibly because additional variable pay means that the executives are taking more pay-risk, and the overall level of package needs to be increased to compensate for that risk (Core et al., 2005). That is the implication of one discussion:

‘...and had made the decision at that time that we wanted pay to be median for a few reasons. One, we actually wanted to ensure that we did introduce this element of variable pay to incentivise people, and therefore we wanted to ensure that we paid everybody a fair rate for the job, but that those who achieved most had the ability to increase their reward.’

HR professional

Here, the company paid median, in order to be fair to its employees. It introduced a highly incentivised package, giving plenty upside if performance were good. However, overall the package was expected to be above median, as the executives were expected to earn their bonuses.

Companies made these increases to performance-related pay levels, both short- and long-term as they saw other companies increasing the potential awards.

‘Well the reason we’re increasing it [long-term incentive] is that we think the market place again has gone more towards a greater than 100% basic.’

HR professional

Thus the level of base pay and performance-related multiple rose continually. In a presentation of early research findings to a group of remuneration professionals, one of them commented, somewhat cynically, “What you won’t find is we’re chasing each other downwards”. They agreed that ‘the market’ against which they benchmarked was affected by the high end comparators, and influenced by leakage from (higher) US norms.

4.1.2. Changing schemes because they do not pay out

In addition to changes made if the scheme parameters were below market, all of the utilities, and two other companies had made changes because the performance-related schemes had not paid out, or had paid less than the anticipated payout³.

In making these changes, the argument put forward was that the schemes (either short-term or long-term or both) were “not working”, and so they needed to be amended. In some cases this does not seem unreasonable – for regulated utilities, whose profits are reduced by the regulatory review, targets set several years earlier would be unattainable.

‘Well, basically the reason we decided that it needed to change was because the commercial environment in which we are operating had changed significantly due to the last price reviews in [utility sector], to the extent that it was impossible to pay out anything at all under the ltip because [performance measure] could never be achieved. Because the income of the company had been reduced by about 25%. Therefore you are on a loser. And so with that background it was decided that we needed to introduce another ltip, another long-term incentive scheme which had the potential to pay out and would have different tests...’

Committee chairman

All of the utilities in the sample had made changes to their schemes for reasons related to their not paying out. In one of the other companies, in a technology-related sector where industry conditions had changed dramatically over the previous few years, a review was underway to revise schemes because they were “so far out of the water” that no payout was ever likely to take place. The HR professional explained the change in scheme as follows:

‘... but then if you look at where they are paid. In terms of the way the market has been going, the consensus that came from the experts has been that ours are far too ambitious.’

HR professional

³ For example, one bonus scheme was changed because the anticipated payout of about 40% of salary had turned out for several years to be an actual payout of about 15%-20% of salary. The performance measures and targets were unchanged, but the effective payout limit was doubled by adding a share-match to the annual bonus, with no additional performance conditions.

In considering whether a scheme does not pay out sufficiently, it is important that the parameters are clearly specified. This was illustrated in the following quotation.

'I think the main thing which came out of it was that there was a complete misunderstanding or mismatch of what the short-term bonus was there to achieve. In the sense that we had designed, we the committee, had designed the short-term bonus on the basis that only 50% payout would be achieved for the expected performance. Whereas clearly in the mind set of the executive, they wanted 100 percent every year. And they hadn't really appreciated that our design was designed for an average payout of 50%. ... They thought that if they got less than 100 percent, something was wrong. Whereas we think if they get more than 50 percent on average, something is wrong!'

Committee chairman

The above-mentioned scheme was not changed; executives' expectations were managed down in a series of discussions with the remuneration committee chairman.

Bender (2004b), in a review of why companies use PRP, reported that many interviewees argued that variable pay may not motivate. However, they all argued that a lack of pay can demotivate (as discussed by Herzberg, 1968). This reason was specifically given for the changes in some schemes. An interviewee in one company whose share options were considerably underwater commented that the options being out-of-the money was a significant demotivator.

'... if they are miles underwater the disincentive - it's not as if it's neutral, it's actually almost a negative.'

Company secretary

Changes in the schemes for reasons relating to non-payment included changes to the level of short-term award available, to performance measures and targets, and to the type of long-term scheme. From the interviews, it was very clear that both executives and non-executives, and the consultants who advised them, felt that schemes that did not pay out were not working, and needed to be changed. It was suggested to some of the interviewees (following an agency theory point of view) that if a scheme did not pay out, that meant that the executives had not performed sufficiently well, and so did not deserve a payment. For example, it could be argued that it is the role of utility executives to negotiate an appropriate

agreement with the regulator, and so their pay parameters should not be changed if the review is penal. This, perhaps, is a bit harsh, and although one NED hinted at it, none of the companies implemented this: the feeling was that it was not a very helpful way to approach matters.

Figure 1 illustrates ways in which the case companies altered their plans, or considered altering them, in the light of shortfalls in bonus payment.

4.1.3. Changes in the company

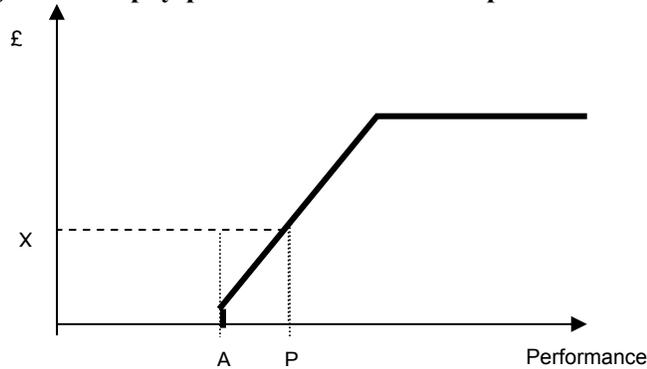
Given the old adage ‘you get what you pay for’, it is important that a company’s performance measures and targets are appropriate. Gomez-Mejia and Balkin (1992) and Montemayor (1996) suggest that companies are more likely to succeed when HR policies, including remuneration, are aligned with the organisation’s operations. Similarly, Rajagopalan (1997) illustrated how different remuneration strategies were appropriate to companies following different strategies. Company strategy is an important input into the design of schemes, and changing the remuneration scheme was seen as a fundamental part of changing the strategy – the performance measures and targets could be seen as symbols of the required commercial change.

In line with the above, many of the changes discussed with the participants came about because of fundamental changes, or desired changes, in the company’s strategy, culture or organisation. For example, in some companies the schemes were changed because the company was developing a new line of business, for which the existing scheme parameters were not appropriate. In some companies there was a need to drive a ‘performance culture’ through the organisation, and the change in executive pay was both a driver of this and a symbol of the need for change. Another related reason for changing the remuneration scheme was given by one company where the schemes lower down the organisation had been changed to include more of a performance-related element (again, as part of a culture change) and so it was felt that executive schemes needed changing too, to mirror this and reinforce the message.

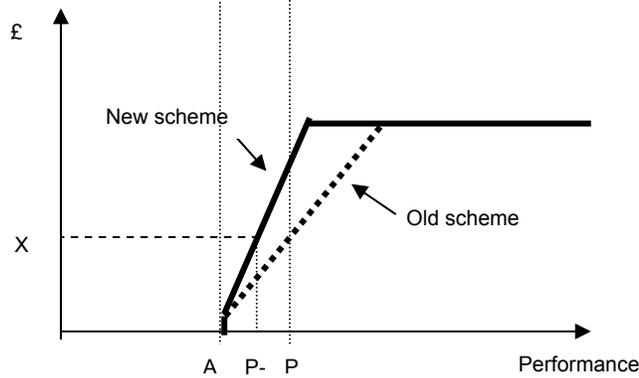
‘There was a recognition among the executive that if we were going to change direction, then remuneration had to be reviewed as part of that change of direction.’

HR professional

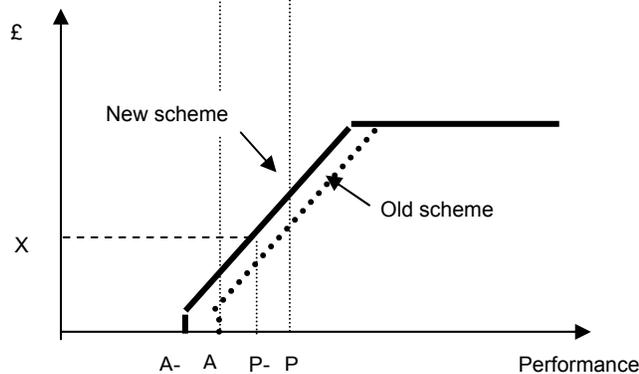
Figure 1 The pay-performance relationship in conditions of poor performance



Expected relationship
 bonus of £X for performance level P.
 Bonus starts at a performance level of A.



Amended for poor performance (1)
 Performance is expected to fall to P-. The rate of earning bonus is changed to restore bonus to £X.
 Bonus still starts at a performance level of A.



Amended for poor performance (2)
 Performance is expected to fall to P-. Bonus start point is moved down from A to A-, and target is changed to P-, to restore bonus to £X

'We all, I think, began to reflect the view that the incentives needed to change, to meet both our aspirations and the changing shape of the business.'

HR professional

'What we've arrived at here is a management team in [company] that is committed to the strategy and understands that the only way that strategy will be delivered is if we change the culture, and we can start to drive a performance culture into the business.'

Committee chairman

This last quote illustrates the importance of the remuneration policies matching the desired culture of the company. Again, several of the participants mentioned the need to change remuneration as a signal throughout the organisation that a culture change was required.

'So we said well we've got to change this culture, and we will want to bring in people who will really, very strongly, feel as if they own the results that we're shooting for. Now we then said, okay, that has got to go hand-in-hand with a pay practice that recognises the fact that we've got, that we want to attract people who feel very good about being personally rewarded for over-achievement, and who are ready to accept the fact that maybe there's going to be bad years in which they will want to suffer with the company for bad results achieved.'

CEO

This reflects the findings of Kessler and Purcell (1992), who discussed the use of PRP in a utility to create a performance-driven culture.

4.1.4. Changes of personnel

The findings presented so far have implied that the schemes a company selects are a rational function of its business environment and needs. Whilst these have a significant impact, other, more idiosyncratic, factors are also involved. In some companies changes to schemes were put forward as a result of changes in personnel. In one, a change in the remuneration committee membership led to a review of policies. The incoming chairman of another company insisted that practices be tightened up so that he would not have to justify non-conforming policies to critical institutional shareholders. And in several companies the arrival of a new CEO or new executives led to changes in the schemes. In some cases

this was so that the new CEO's strategy would be reflected in the remuneration policies:

'Although, having just appointed a new chief executive, he is having a strong input as to what he would like to see in terms of a remuneration package which would underpin his strategy. Because we've just appointed [name] as the chief executive, and he's coming up with a new strategic approach, which we welcome. And we also asked him to consider the sort of remuneration systems and packages that would underpin what he wants to achieve from a strategic point of view.'

NED

Another reason was that schemes needed to be made attractive to incoming executives:

'Because what happened of course was that the kind of people who were in the executive team were changing, they had different expectations from the ones who had been previously on the board when I first came, when they were mainly [company] old hands who had come up through the system and were sort of programmed to a certain kind of reward.'

Committee chairman

However, in one instance the arrival of the new CEO meant the departure of the old one, who had been blocking a scheme change:

'Well I think it also depends on the personalities. The previous year we'd had [name] as the CEO, and he is not actually very strongly in favour of personal objectives. So when he was the CEO he fought against having them. So he was literally linked to the group objective. So he imposed, to some extent, his personality on that I think. And there was some discussion with the remuneration committee as to whether or not he should. But I think if the individual doesn't buy into them it's quite difficult. But with [new CEO] coming in I think he was more open to more detailed personal objectives.'

HR professional

Thus the impact of the individual and his/her personal preferences can be an important influence on remuneration practices.

4.1.5. Improving the schemes for HR reasons

In a similar manner to scheme changes for strategic reasons, some schemes were changed because they were not in line with good HR practice, and so the protagonists made improvements. In several instances schemes were changed to reduce the level of complexity, as there was no direct line of sight from performance to incentive.

'I couldn't understand it! As a senior executive, and a participant, and someone who was supposed to administer and advise on it, it was completely incomprehensible. I was to learn later on that it showed no signs of generating any positive outcomes for people, which it didn't as far as I can see. But to me it might have been as well have been written in classical Greek, 'cos it made no sense.'

HR professional

The comment above related to a particularly complex ltip. However, such comments were also made in relation to some schemes that rewarded total shareholder return (TSR). TSR is generally measured as the combined dividend and capital return to shareholders over a particular period of time (often three years), and is rewarded as a relative measure rather than an absolute. A company's TSR will be benchmarked against the median of its index or a peer group: performance below median will attract no award; performance above median will mean that a progressively larger percentage of the ltip shares vests, until performance in, say, the upper quartile leads to full vesting. This means that the executives' final payout depends not only on their own performance but on that of competitors. Also, as TSR involves a complex series of calculations, it means that they cannot easily determine how they are doing on this performance measure. That lack of sight of the end result, and the complex and sometimes doubtful link between business performance and share price performance, has led some companies to move away from a TSR measure on the basis that measures without a clear line of sight have less motivational effect for employees (McLaughlin, 1991).

4.1.6. Corporate governance reasons for changing schemes

Some companies changed their schemes in order to come in line with what was seen as best practice from a governance perspective. This was particularly common in the mid-1990s (prior to this research), following the Greenbury and Myners reports in 1995:

'At the time... we had a share option scheme from about 1990, and that ran until about 1995. And then Greenbury, general concern about fat cats and so on, and the chief executive of the day, with the remuneration committee, decided that the option scheme was out of favour and it was not something we should continue to operate. Even though it did have in the latter days some specific performance targets. So they introduced the restricted share plan instead.'

Company secretary

However, governance issues are still an important driver of change:

'Coming into line with best practice in remuneration policy terms as viewed by the ABI and the DTI and everybody else who had a view on this.'

HR professional

The influence of the institutional shareholders, and of regulation generally, is significant in this field. In at least one instance, a remuneration committee had changed the performance measures on the annual bonus scheme to be more compliant with 'best practice', despite the fact that an interviewee believed that the existing scheme was more appropriate for the company.

Although some companies made change to their schemes for 'good governance' reasons, such as the performance measures change above, or removing a re-testing of performance conditions on options, it is important to note that others were in breach of such provisions, and did not change in order to comply. Instances that were not changed included two companies where bonuses were partly pensionable, and two companies where there was no performance condition on the bonus match. Both of these practices are frowned upon by investors.

One question asked of the respondent focus group was why some companies made changes to comply with good governance, and others did not. Two explanations were given. One was that companies needed to "think for themselves" and in a 'comply-or-explain' governance regime might ignore best practice if they believed it inappropriate. The other explanation was that companies "decide what they want to fight on" – they comply with trivialities, and then feel able to defend practices that they believe are important.

4.1.7. Other environmental reasons for scheme changes

At the time of the research fieldwork, debate was underway about whether financial reporting standards should be amended to mandate a charge against profits to reflect share options. Discussions with the interviewees about this indicated that they did not expect to change their practices because of this potential accounting change, as there was no fundamental economic change being made. However, the subsequent remuneration report of one of the case companies, relating to a period after the interviews, indicated that they had stopped issuing options and moved instead to share-based schemes. This is in line with research by Deloitte and Touche (2004) which showed that 10% of FTSE 100 and 8% of FTSE 250 companies have ceased using their executive option schemes, whilst others have scaled back the number of options awarded. Other long-term schemes have been introduced, presumably to compensate for this.

5. Discussion

The decision by remuneration committees to set or to change their executive remuneration policies and packages echoes the tension faced by NEDs in their broader duties – the potential conflict between performance and conformance. Remuneration is an HR matter, and remuneration schemes need to be able to motivate executives to perform in a way suited to the business needs. At the same time, remuneration is a governance matter, and remuneration committees must demonstrate compliance with good practice. These two sets of objectives can be in conflict, but both can lead to increases in pay.

This conflict between objectives is most clearly seen in the way in which the case companies made changes to their remuneration policies and packages in order to change schemes that were not paying out. Taking a strict governance line, an agency theory perspective frowns upon such practices, as the whole point of the remuneration contract is to align executives with shareholders, and it could be argued that a scheme that pays out regardless of performance is unlikely to do this. Indeed, this moral hazard argument was put forward by Hudson and Pichler (2004: 103), who stated that a “package that is renegotiated every year undermines the pay-to-performance relation and thus the very nature of an incentive contract”. However, looking at remuneration as a means to enhance performance, through the lens of expectancy theory, it is clear that in order to be motivated the executive must see the targets as achievable, and believe that by achieving the relevant performance measures s/he will receive the reward. From this perspective, changing a ‘non-performing’ scheme makes sense.

In discussing this pay-performance link, Gillan (2001) suggested that the relationship was asymmetrical: executive pay was only performance-related when performance was good, but companies focused instead on peer comparisons when it was poor. This does seem to be reflected in the results of this research. In a similar vein, Garvey and Milbourn (2003) notes that executives were less affected by ‘bad luck’ reducing their pay than they were by ‘good luck’ increasing it. This too is shown in this research: no instance was found of a company reducing awards due to their being in excess of what was expected.

At first sight, this might appear to be an instance of ‘fat cattery’, with executives having large elements of PRP and schemes being manipulated to ensure payout. However, it should be noted that this phenomenon is not limited to executives. There are various examples in the literature of schemes being changed for lower level employees for exactly this reason. For example, Gerhart and Rynes (2003: 173) discussed an incentive pay programme at DuPont which was considered a great success whilst it was paying out, and had to be terminated due to employee discontent when the company could not pay due to poor results. They also cited a similar outcome with the PRP scheme at Saturn. Similarly, Lewis (1998: 68) suggested a feedback loop in his PRP process cycle, such that underperformance may lead to a decrease in performance targets⁴. It thus appears that in many levels of the hierarchy, PRP is only considered workable when the schemes produce a reward.

Even disregarding this particular need to change schemes that did not pay out, many other changes were made to schemes in the case companies, reflecting either a performance or a conformance need. For example, following ‘market practice’ led to continued increases in the elements of pay, viz the base salary, the bonus multiple and the multiples of salary relating to long-term schemes. Given the need that runs through governance regulation (for example Greenbury, 1995; Combined Code, 2003), and the HR literature (for example Lawler, 1987; Kessler, 1993) for remuneration to “attract, retain and motivate”, then meeting market rates is a reasonable thing to do. The ever-increasing levels of pay could be seen as just a side-effect of this need to retain good people in an environment where pay rates are widely published. The problem faced by NEDs on the remuneration committee is how to determine where ‘the market’ lies. This problem was raised in the Greenbury report (1995: 6.4), which noted that within market parameters, the remuneration committee had a wide range of discretion in setting pay levels and forms.

⁴ He also suggested that overachievement would lead to an increase in performance targets. This was not noted in the case companies.

Furthermore, given that the governance environment is constantly changing (Taylor, 2004) and that companies strategies are continually evolving, it is not surprising that the case companies made so many changes in their pay schemes. Nor is it necessarily surprising that these changes were generally in the favour of the executives or, at best, neutral. Murphy discussed this, commenting that remuneration committees do not necessarily comprise cynical members “rubber-stamping increasingly lucrative pay programs with a wink and a nod”. He commented that:

‘judgement calls tend systematically to favour the CEO. Faced with a range of market data on competitive pay levels, committees tend to error on the high side. Faced with a choice between a sensible compensation plan and a slightly inferior plan favored by the CEO, the committee will defer to management. Similarly, faced with a discretionary choice on a bonus-pool funding, the committee will tend to over- rather than under-fund. The amounts at stake in any particular case are typically trivial from a shareholder's perspective, but the overall impact of the bias has likely contributed to the ratcheting of pay levels...’ (1999:2518)

Examination of Table 4, which sets out the reasons given for changing schemes and the changes that resulted shows that companies consistently saw the change stimuli as being a reason to amend their long-term schemes. In some instances these were minor amendments; in others they were more significant. Given that these long-term schemes are put in place to focus executives’ minds on the companies’ longer-term performance, regular changes to schemes or measures could lead to less clarity. Generally, the ‘long-term’ is taken to be three years, and a new scheme award is made each year. Thus an executive could easily be in the situation of trying to manage two different sets of objectives for two schemes that are running concurrently – one to end next year and one the year after. (It is unlikely, although not impossible, that a company would make significant changes to long-term schemes in three consecutive years, as this might lead to friction with institutional investors.)

This research has shown that the case companies made many changes to their remuneration policies and packages. These changes related to the levels of salary and performance-related award, as well as to the structure of the different types of pay scheme. Changes were made for reasons to do with a company’s strategy and the need to follow best HR practice, as well as the need for good governance. Individual changes could be justified in the light of each company’s circumstances, but their overall effect was to increase pay or pay potential in the subject companies.

6. Conclusions

This paper sets out the results of interview-based research with the protagonists in the remuneration-setting decision in 12 FTSE 350 companies. It describes the ways in which these remuneration committees made changes to their executive remuneration schemes, and the reasons behind such changes. The changes were made to the level of fixed salary, and to each element of variable pay: performance measures and targets, scheme parameters and the schemes themselves. Almost all of the changes led to, or had the potential to lead to, increases in executive pay. Thus they explain, for a small group of companies, the ever-increasing levels of executive pay commented upon by, amongst others, Ezzamel and Watson (2002).

The findings of the study have been interpreted through two theoretical lenses. Following an agency theory approach it can be seen that remuneration policies have become more performance-related, both with new schemes brought in, and with increases to the actual and potential levels of payout. Changes to performance measures and targets to reflect revised corporate strategy and culture also reflect an agency theory approach, having the potential to align executives to corporate and shareholder needs. However, the perceived need of remuneration committees to change schemes that do not pay out as much as anticipated is antithetical to agency theory, as it can destroy this alignment.

The scheme changes to ensure payout make sense using an expectancy theory explanation, whereby the executives need to believe that they can meet the required targets, and obtain a reward worth having. Thus, even through this leads to moral hazard, such scheme changes make sense in a broader view of the organisation. NEDs are aware of this tension, but have to balance their monitoring role, enforcing 'good governance', and their performance role, helping to ensure that executives are motivated to work for the benefit of the company.

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