The Determination of Directors' Remuneration in Selected FTSE 350 Companies

by

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ERRATA

During the course of completing this thesis, the computerised document became fragile, and, despite seeking technical advice, formatting anomalies could not be corrected. In particular, it became impossible to ensure that all footnotes were placed on the pages to which they related. Accordingly, some footnotes appear on the page after the relevant page, or are split over two or three pages. I apologise for these errors, and hope that they do not cause too much inconvenience to readers.

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ABSTRACT

This thesis has adopted a qualitative approach to research into executive remuneration, to look inside the 'black box' of process. Executives, non-executives and others involved in the remuneration-setting process were interviewed in order to establish how executive remuneration is determined. In all, 40 interviews were conducted, covering 12 FTSE 350 companies plus other stakeholder bodies.

The interviews yielded rich data illuminating the processes followed by the companies, and highlighting their similarities and differences. These data were considered in the light of existing economic, social-psychological and organisational theory approaches, none of which proved sufficient, either alone or in combination, to explain what was happening.

Companies determine the level of their executive pay based on their interpretation of 'the market', but the research shows that such a market is a construct that does not exist independently. They determine the structure of their executive pay based mainly on structures successfully adopted by other companies, and those considered acceptable to the investing institutions and regulators. Institutional theory explanations and the need for legitimacy are clearly seen in the data.

A further finding of the research was that all of the companies had made changes to their remuneration schemes, some major. The various reasons for these changes included changes (actual or desired) to the corporate environment, changes to key personnel, and, notably, the need to increase pay packages that were 'below-market'. Incentive schemes that did not pay out were also changed.

Finally, as regards process, it was clear that each of the case companies followed 'good governance' practices. It was also clear that each did this in a different way. For some, the process was managed by the non-executives; in others the executives had a leading role. The relationships between the protagonists had an important impact on the resultant governance processes.

1. INTRODUCTION AND OVERVIEW

1.1 Preamble

In 1997 I was asked to speak at a Strategic Planning Society conference on shareholder value, specifically addressing the topic of Shareholder Value-Based Reward Schemes. At the time I knew a lot about shareholder value, but little about reward schemes. In my preparation I discovered that the design of executive reward schemes was complex, and that there appeared to be no obvious 'right answer'. Accordingly, after the conference I started to explore how companies actually make their remuneration decisions, what they do when faced with these different choices. It was then I discovered that there was little academic research on the subject – I could not find the answer from books or papers.

It was trying to find the answer to that original question – 'what happens?' – that provided the motivation that ultimately led to this thesis.

1.2 Introduction

This thesis explores how executive directors' pay is determined in large listed companies in the United Kingdom (UK).

In recent years the subject of executive pay has captured the imagination of shareholders, regulators and, through the media, the general public. It has also been the focus of much academic research. In this chapter I describe some of the background to the debate, and set this research project in the context of the work done by others, and the governance debate on remuneration[1].

1.3 The public debate

One reason that directors' pay has captured so much attention is the perception that the amounts being paid are very high, and growing. This is seen in the many surveys published in the media, particularly those which highlight the growing differential between executive pay and that of lesser employees (e.g. Toynbee, 2003). However, it seems likely that it is not just the amounts themselves that cause the unease – footballers and movie stars often earn far more – but rather, the potential for conflict of interest. Board executives receive large pay awards; board executives are in a position to influence their own pay. It is that juxtaposition that is a root cause of the controversy, and undoubtedly the high pay awards could be interpreted as evidence of a conflict of interest being resolved in the executives' favour.

Because of this potential for a conflict, regulators have taken many opportunities to pronounce on how directors' pay should be governed.

The regulatory context

Institutional shareholders, generally represented by bodies such as the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) have issued many pronouncements on what does and does not represent good practice amongst companies. For example, in 1995 the ABI

[1] In this thesis, following common usage the words 'pay', 'remuneration' and 'compensation' are

issued guidelines on how share option schemes should be constructed; in 1996 they issued a guideline on long term incentive schemes; further guidance on share incentive schemes was issued in 2002. Such pronouncements have helped to shape the nature of remuneration contracts. Individual shareholders also play a role; those with large holdings will let their views be known if they are not satisfied with a company's remuneration arrangements (Holland, 2002).

Regulators, both governmental and non-governmental, have had an even more significant influence on directors' remuneration in the UK. Although the Cadbury committee (1992) and the Myners report (1995) had both made reference to directors' remuneration, the greatest influence was the report of the Greenbury study group in 1995.

The Greenbury study group was set up on the initiative of the Confederation for British Industry (CBI) in early 1995, when public interest was stirred by large pay increases and option awards for directors of the recently-privatised utilities. Its terms of reference were "To identify good practice in determining Directors'[2] remuneration and prepare a Code of Practice for use by UK PLCs" (para 1.2). The report's Code of Best Practice stated, *inter alia*, that companies should set up remuneration committees of non-executive directors to determine the executive directors' remuneration; that rewards should be linked to performance; and that detailed disclosure be made of the company's remuneration policy and of each individual director's remuneration package. The Greenbury report was published

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used interchangeably.

[2] Implicit in the Greenbury report is that the term "Director" refers to executive directors. The report was not concerned with the pay of non-executive directors, and refers separately to "Non-

in July 1995, and incorporated into the London Stock Exchange Listing Rules with effect from 31st December 1995.

After 1995, no doubt because of the regulatory requirements, there was an increase in the number of remuneration schemes identifying variable remuneration for directors (Conyon and Mallin, 1997). However, public concern at the levels of such remuneration did not abate: indeed, possibly due to the increased disclosure required by Greenbury, it rose. The overall tenor of comments on the subject of directors' remuneration has been negative. Few publicly go as far as the then Shadow Minister, Frank Dobson, who in 1992 referred to "fat cat executives" as "stinking, lousy, thieving, incompetent scum" (Landale, 1997). However, there is certainly an attitude that top directors are overpaid for what they do; that large salaries and bonuses and, particularly, large awards of share options are not justified; and that there is unease about a growing inequality in society, with directors' pay being far greater than the average employee's. The continued interest of the media provides a backdrop to remuneration committees' decisions, of which all participants are very aware.

Since Greenbury there have been several major reports and regulations relating to directors' remuneration. Hampel (1998) reviewed the implementation of the Cadbury and Greenbury reports, and produced the Combined Code, to be followed by companies listed on the London Stock Exchange. Higgs (2003) reviewed the role of the non-executive director, and in so doing made further pronouncements on directors' remuneration and the role of the remuneration

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Executive Directors" where appropriate. The same convention is used in this thesis. The committee. The recommendations of the Higgs report were largely adopted in the revised Combined Code (2003).[3]

The government also takes an interest in the level of pay for executive directors of quoted companies. In 1999 the Department of Trade and Industry (DTI) issued a consultation document on directors' remuneration which assessed the then-current situation and set out the government's view on the approach to be taken on setting remuneration policies and packages. This was followed by a second consultation document in 2001, the results of which ultimately led to the publication of The Directors' Remuneration Report Regulations (DTI, 2002). These regulations were introduced as a result of a perceived need to introduce greater transparency into the remuneration decision. They set out in great detail the disclosures that companies must make about the remuneration policies and packages for all of their directors, and required shareholders to have an advisory vote on the published remuneration report.

The increasing amount of regulation surrounding directors' remuneration has had several effects. It has seen the almost universal use of remuneration committees in order to determine pay (according to the Higgs dataset (2003) only two companies in the FTSE 350 did not have a remuneration committee). More significantly, it has been a contributing factor in the increased sophistication of directors' remuneration arrangements, as companies try to comply with all of the

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American term "executive" is also used to describe executive directors in this thesis.

[3] Although most of the research work for this thesis was carried out before the 2003 Code was issued, where possible references have been made to the 2003 Code rather than its predecessor, to facilitate referencing.

institutional and regulatory pronouncements.[4] What it has not necessarily achieved is 'better' remuneration schemes; schemes which, in the words of the Financial Times, are "simple, transparent and justifiable" (Fuller, 2003). It is possible that one reason for this is that regulators have focused on the outcome of the process, the amount awarded, and may have ignored the process itself. One motivation for this research is to shed light on the *processes* companies and their remuneration committees undertake, in the anticipation that this will possibly inform future regulation and debate on the whole issue of appropriate and justifiable remuneration practices.

1.4 The academic debate

Directors' remuneration has been a source of interest to scholars since Taussig and Barker's paper in 1925. However, Murphy (1999: 2487) noted that academic interest in the subject accelerated in the mid-1980s. His analysis showed that in 1996 (the latest year he examined) the annual number of academic papers published on CEO pay had risen to 60; the literature review carried out for this thesis gives no reason to believe that the number has fallen since then, and so one can see that there are literally hundreds of papers on the subject. The majority of the work has been carried out in the United States (US), but the same issues arise in the substantial body of UK-based research. Much of the research echoes (or leads) the regulatory focus on the link between pay and various aspects of corporate performance (Barkema and Gomez-Mejia, 1998), but many factors and combinations of factors have been considered.

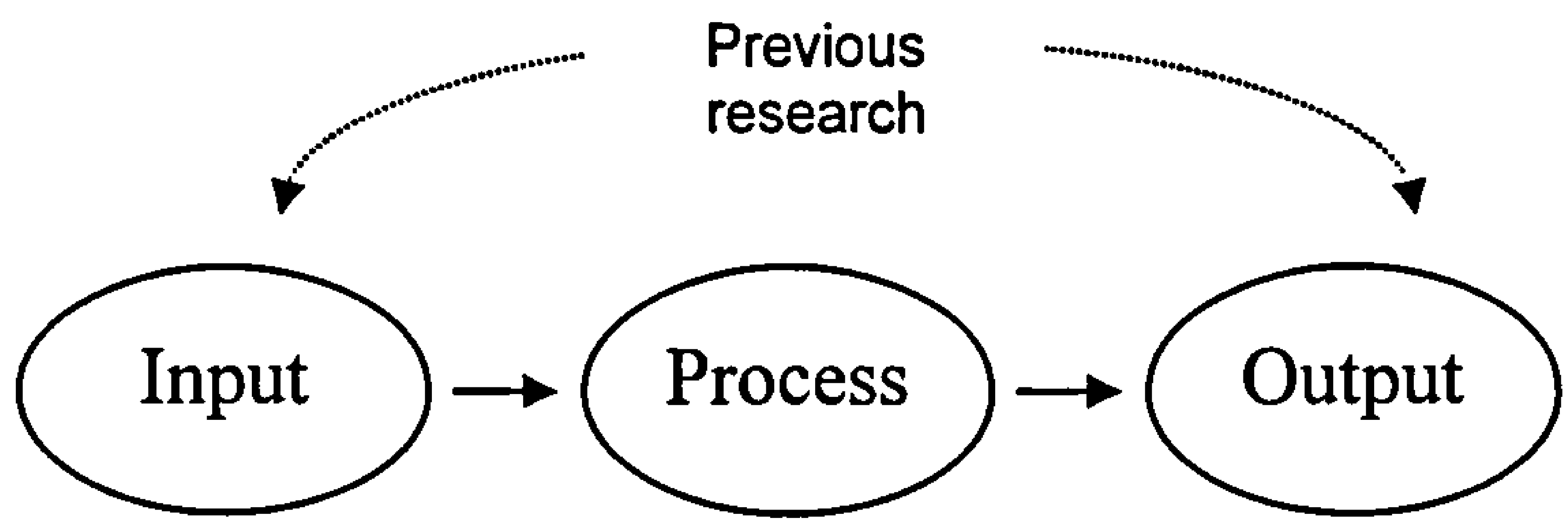
[4] Appendix 1 sets out an overview of how remuneration schemes are structured.

Researchers have, for example, tested the links between directors' pay and corporate size (Lambert, Larcker and Weigelt, 1991), industry (Ely, 1991), profitability (McKnight, 1996), ownership (Gomez-Mejia, Tosi and Hinkin, 1987), shareholder return (Jensen and Murphy, 1990a), and human capital attributes such as age and qualifications (Agarwal, 1981). They have also considered how changes in tax and regulatory systems affect the level and currency of directors' remuneration (Finkelstein and Hambrick, 1988), and investigated the impact of the remuneration committee (Conyon and Peck, 1998).

Almost all of these studies involve testing hypotheses by taking one or more of the variables mentioned above and comparing them with the remuneration (defined in various ways) actually received by the directors. Conclusions are then drawn as to the validity or otherwise of the propositions being tested. However, there appear to be almost no studies which examine what actually happens[5]. As Figure 1-1 indicates, if we consider the setting of remuneration as a simple input-process-output model, prior researchers have correlated inputs (the variables) with outputs (the remuneration paid), but have ignored the process in the middle.

[5] Notable exceptions are Main (1993), Conyon et al. (2000), and Ogden and Watson (2004). These papers are discussed in detail in chapter 2.

Figure 1-1 The territory covered by previous researchers



Such research has proved conceptually important and added considerably to our understanding of executive remuneration issues. However, studies to date have not addressed the question: what is the process by which executive directors' remuneration policies and packages are determined?

This issue has been raised in passing by several researchers over the last two decades. For example, Kerr and Bettis, in a study which examined archival data for a sample of Fortune 500 companies, noted the following:

> *It is difficult not to concur with critics who claim that there is no rational basis for the compensation paid to top management ... research thus far has failed to provide solid evidence to refute the charge. Perhaps what is needed are studies that look closely at the process by which boards make compensation decisions. Most research has attempted to infer the critical variables in the process by examining decision outcomes in relation to performance. As a result, we continue to guess at the inputs to the compensation decision. Given the importance of the topic and of the corporate governance process in general, it is clear that we must get closer to the process of top management compensation if we are to understand it. (1987: 661) [emphasis added]*

Since Kerr and Bettis's observation, other authors have echoed the sentiment. For example, Tosi and Gomez-Mejia, in their conclusion to a paper reporting survey-based research into executive pay (one of relatively few studies using this methodology) stated:

> *All things considered, overreliance on archival data that treats the executive compensation process as a black box has led us into a blind alley. While easy to use, it is doubtful that continued "number crunching" of these data bases will provide much additional insight on the determinants of executive pay. This study suggests that a more fruitful avenue to pursue in understanding executive pay issues is to focus more on the process and less on the observed "objective" measures. ... Some of the process questions that need to be addressed in the future include the following: How do compensation committees design executive pay packages? Who are the main actors in that committee and what roles do they play? How do political considerations enter into the CEO pay-setting process? How are those decisions legitimized? How are goals established by the board of directors for the CEO? What is the nature of the relationship between the board, the CEO, and major stockholders as it pertains to executive pay? How does the board "filter out" factors beyond the executive's control in determining the CEO pay level (e.g., a general market downturn)? What "checks and balances" are established within a firm to ensure that conflict of interest does not arise in determining executive pay?*
>
> *The answers to such process questions will likely reveal more about executive compensation than have past studies done from archival databases, but researchers will need to be both more creative and more diligent to obtain the data needed to shed new light on the sensitive realm of the executive pay-setting process. (1989: 185)*

Almost a decade later little progress appeared to have been made, as one of the authors reiterated in a paper with a new co-author:

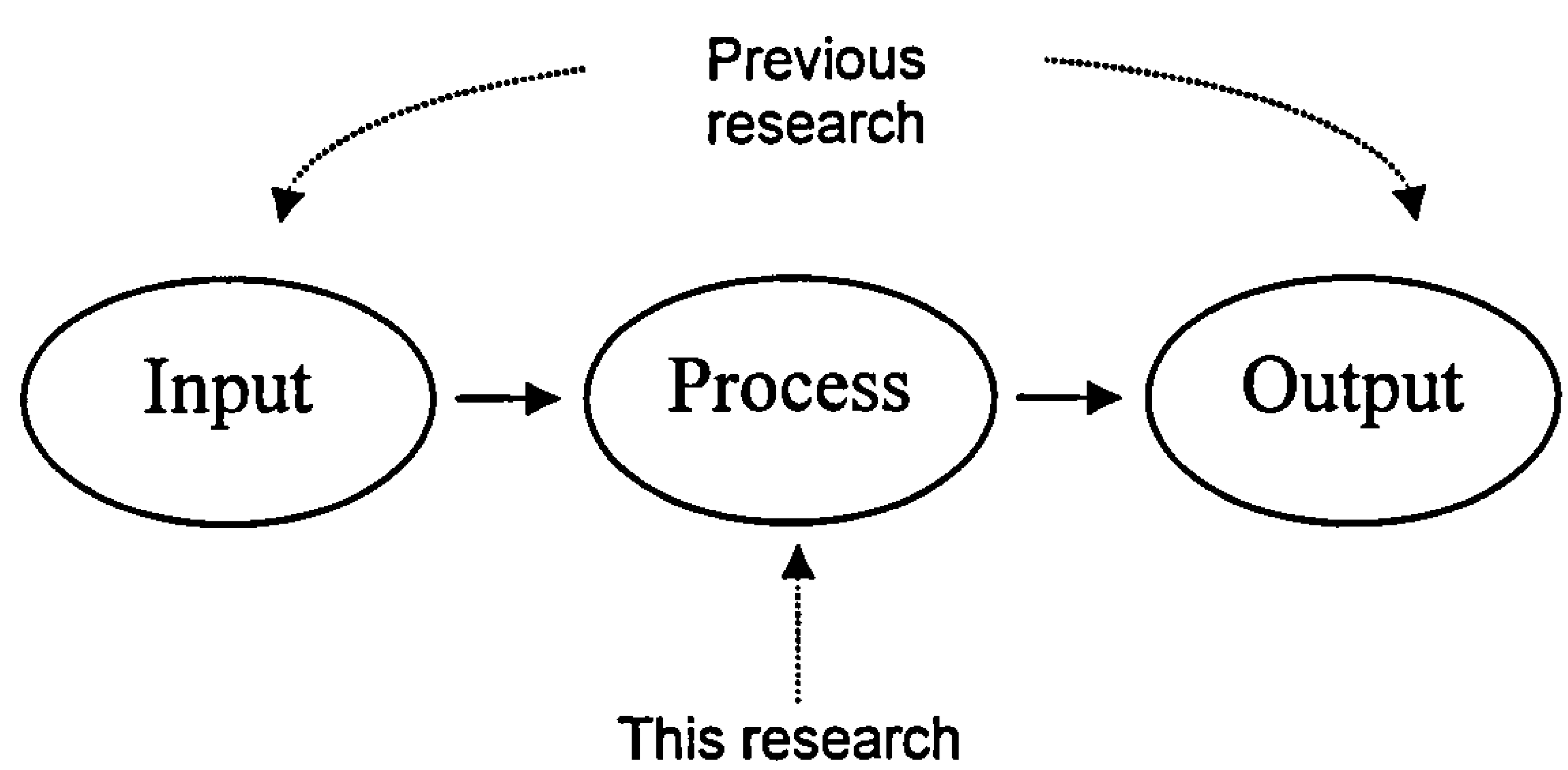
> *In short, after at least six decades of research ... the failure to identify a robust relationship between top management compensation and firm performance has led scholars into a blind alley. To move this stream of research forward requires that greater efforts be devoted to examining alternative mechanisms and criteria for how top management compensation is set.*
>
> *(Barkema and Gomez-Mejia, 1998: 135)*

Pettigrew, in a more general discussion of research into managerial elites, articulated the same problem:

> *... these studies also suffer from their distance from the phenomenon they are addressing. As a result, great inferential leaps are made from input variables such as board composition to output variables such as board performance with no direct evidence on the processes and mechanisms which presumably link the inputs to the outputs. (1992b: 171)*

The research undertaken for this thesis is an attempt to address the gap in the literature identified by these various authors, and examines in detail the process of determining directors' remuneration. The difference between this and previous work is shown diagrammatically in Figure 1-2.

Figure 1-2 The territory covered by this research study



The research question consequently arising from the above is:

How do companies determine the remuneration of their executive directors?

1.5 The research approach

Given the processual focus of this question, a predominantly qualitative approach has been taken to this research, using face-to-face interviews with protagonists in the debate to attempt to establish how, at the process level, individual companies have made and make their pay decisions. As will be seen from the literature summarised above (and analysed in more detail in chapter 2), this is an unusual approach to research into directors' remuneration. However, it is one that is well-suited to the research question, and potentially opens up a new phase in research into this vexed area of corporate governance.

The research commenced with a review of prior academic research into directors' pay. This literature review also covered the practitioner literature, since this was clearly relevant. Articles in the broadsheet press were also reviewed, given the apparent role of the media as an influence on regulation and practice.

From a comprehensive review of relevant academic, professional and regulatory literature it became apparent that there are certain questions common to all companies. In order to devise a remuneration policy which generates remuneration packages that are congruent with (a) the company's strategy, (b) the needs of individual directors, and (c) the requirements of the company's shareholders and regulators, remuneration committees need to address the following five generic questions:

1. How much should the company's executive directors be paid for expected performance?
2. What relative proportions of this amount should be basic salary and performance-related?
3. For the performance-related components, how should performance be measured?
4. How should performance targets be determined?
5. What form should the remuneration take? (For example, shares, share options, cash or a mix thereof?)

Broadly, these questions address the two key issues that need to be decided – what is an appropriate level of pay, and how is it to be structured? These questions initially formed a basis for gaining an understanding of the area, and have been used throughout this thesis as a means to organise the analysis.

1.6 Outline of this thesis

Following this introductory chapter, chapter 2 provides a review of the academic literature on directors' pay, for the purpose of mapping the territory and demonstrating the gap to be filled by this thesis. It does this by setting out a typology of theories used by previous researchers, divided into three generic types, based on whether they utilised economic, social-psychological or organisational perspectives. This chapter also analyses the literature overall to derive a list of factors that researchers to date have identified as potential inputs to the remuneration decision; this list was used in forming the interview questions. A further task of this chapter is to set out the advantages and disadvantages of the performance measures and forms of payment in common use, an analysis of which indicated, at this preliminary stage, that there is no one correct answer to the question 'how should we pay the directors?'.

Chapter 3 sets out two preliminary models derived during the literature review process and before fieldwork commenced. A process model builds on the input-output form suggested by Figure 1-2, to generate an initial view of what might be taking place in the remuneration committee. Legitimacy-comparison theory builds upon four of the theories discussed in chapter 2, and was a framework adopted early in the research process for looking at the remuneration decision. While both of these models informed the research process at first, neither, as the analysis in chapter 6 indicates, proved to be an ultimately satisfactory explanation of how in practice pay is set.

The methodological approach to the research is set out in chapter 4, which discusses the philosophical underpinnings of the qualitative approach adopted, as well as how the sample companies were selected, and how the fieldwork was conducted.

In chapter 5 the fieldwork and empirical findings of that work are set out. This chapter therefore begins to uncover in detail the process by which companies determine the level and structure of directors' pay. An issue that arose over and again in the interviews was the fact that almost all the companies had made recent changes to their remuneration policies: this too is explored in this chapter. Lastly within this chapter, and as part of the empirical findings, I consider the range of relationships between the different protagonists in the remuneration-setting decision, and review the range of processes that companies adopt in practice, as contrasted with the recommended decision-making structures that are set down in regulation.

The data set out in chapter 5 are analysed in chapters 6 and 7 in two complementary ways. In chapter 6, they are set in the context of prior research, which takes a less processual focus than this research. The various theories discussed in chapter 2 are revisited to determine the extent to which they can provide an adequate answer to the question 'how is directors' pay determined?'. My answer is that they cannot, and do not. Accordingly, in chapter 7 the possibility of providing an adequate answer is explored in a different way. The new approach is based on the premise that there is no 'right answer' to the five questions listed earlier. Given that, it looks at the ways in which a decision is made, or emerges, from the remuneration-setting process. In this chapter I suggest that the remuneration committee practices set out in the Combined Code (2003) are in fact an unattainable ideal, and look at how in practice committees end up having to make compromises from this position. I also consider the inner workings of the remuneration committee, beneath its formal structure, and look at the relationships between the different players.

Chapter 8 concludes this thesis, summarising the key findings and exploring the contribution to knowledge. This chapter also includes a discussion of the implications of this study for regulators and for practitioners involved in setting pay in listed companies.

2. REVIEW OF PRIOR RESEARCH

2.1 Introduction

This chapter contains a review of research into directors' pay. Its purpose is three-fold. Firstly, it sets out the ways in which scholars have addressed the issue of executive pay, in order to determine the extent to which the research question of this thesis has been addressed previously and, if so, how it has been addressed. The review found many papers that had addressed this research issue tangentially, but none that directly answered the processual question: 'how is directors' pay determined?'.

The second purpose of this literature review relates to the way the work was approached. The research model set out in Figure 1-2 of chapter 1 takes an input–process–output form. In order to flesh out this model, the literature has been reviewed to determine possible inputs considered by previous scholars. These input factors were later tested with the research participants.

The review also serves a third purpose, in that it considers how academic research has addressed the five generic questions set out in chapter 1.

Accordingly, the structure of this chapter is as follows. A typology of theories used by previous researchers divides them into economic, social-psychological and organisational theories. The individual theories within each type are then considered, and their respective relevance to answering the research question is discussed. Following this, the possible inputs to the remuneration process are considered. Finally, the chapter discusses the five generic questions set out in chapter 1, concerning the level and structure of pay.

2.2 Limitations of prior research in considering this project

There is an extensive body of research into directors' pay, which has provided a wide range of theoretical approaches and much empirical data. However, before addressing that research it is important to set it in context, as this affects its interpretation for this project. It is worth noting the following.

1. Much of the research cited in this chapter, indeed the majority of the extant research, relates to the United States. Whilst some US practices are relevant to the UK context of this research, others are not. In particular:

    a. The board of directors in a US company normally comprises mainly non-executives, led by an individual holding the dual CEO/chairman position (Conyon and Muldoon, 2004). In the UK, the board will include other executives and, since the Cadbury report (1992), the company is likely to separate the positions of chairman and CEO.

    b. Tax laws differ considerably between the US and UK, a factor which may influence the types of scheme or mix of incentives in use. Similarly, legal restrictions on schemes differ between the jurisdictions.

    c. The body of institutional shareholders is more cohesive in the UK than the US, giving UK institutional shareholders relatively more potential influence over governance issues than their US counterparts. For example, in the US there is no equivalent of the ABI or the NAPF, whose members between them control over 40% by value of shares in the UK Stock Exchange.[6]

d. Directors of US companies appear often to be richer than their UK counterparts and to have greater shareholdings in their companies (Marcus and Rhoads, 1997/8).

e. Non-executives of US companies appear to be executive directors of other quoted US companies more often than is the case in UK companies (Hallock, 1997; O'Sullivan, 2000). In particular, the US has a high incidence of interlocks where the CEO of Company A sits on the board (and remuneration committee) of Company B, and vice versa (Bebchuk and Fried, 2004a).

2. The growth in performance-related pay schemes over the last two decades means that some of the results reported in prior research, for example about short- and long-term performance schemes, may not be valid today. As an example, Bruce and Buck, writing in 1997, stated:

> *A further consideration in interpreting empirical investigation of innovations such as the ESO [executive share option] is that they are still, in the mid-1990s, a comparatively novel phenomenon in executive remuneration, particularly in the UK. (1997: 90)*

At the time of undertaking this research, these "novel" share options have become ubiquitous.

3. Research undertaken in the UK over the last two decades has been done in different regulatory contexts. Remuneration practices differ considerably before and after 1995; the year that the 'fat cat' debate took off and the year of the Greenbury report. Disclosure of directors' pay is much more

[6] Source: author's evaluation from data supplied on the websites of the ABI and NAPF and the

comprehensive than it has ever been. Furthermore, the evolving regulatory environment described in chapter 1 and the growth in the importance of governance in general together mean that research findings of 10 years ago might not be duplicated if that research were conducted today.

2.3 Overview of the literature

In 1925 Taussig and Barker wrote what appears to be the first scholarly paper discussing directors' remuneration. In an extensive survey of over 400 US companies covering the period 1904 – 1914 they set out statistics of how much the directors were paid, and how much of that was variable, segregating their data in terms of company size and ownership. Taussig and Barker provided little by way of theoretical explanation of the patterns in their data – the very act of collating it was itself a major contribution.

Three quarters of a century have passed since Taussig and Barker's report. In that time, the study of directors' remuneration has become a major branch of academic management and financial research, and many theories have been expounded to explain why directors are paid as they are.

The remuneration of executive directors impacts many fields of study. Economists have considered it (e.g. Jensen and Meckling, 1976), as have strategists (e.g. Finkelstein and Hambrick, 1989), psychologists (e.g. Belliveau, O'Reilly and Wade, 1996), accountants (e.g. Healy, 1985) and writers on corporate governance (e.g. Conyon, 1997). This is not unreasonable – it is an area

National Statistics Office.

which has an impact on many different aspects of business, and so is of wide interest.

In examining this scholarly research, a typology was developed, as already noted, which categorises the various theories into the three main theoretical stances: economic, social-psychological and organisational. The typology was developed from ideas suggested by Finkelstein and Hambrick, (1996: 266), but has departed from and extended their work.

Figure 2-1 Overview of extant theories of directors' remuneration

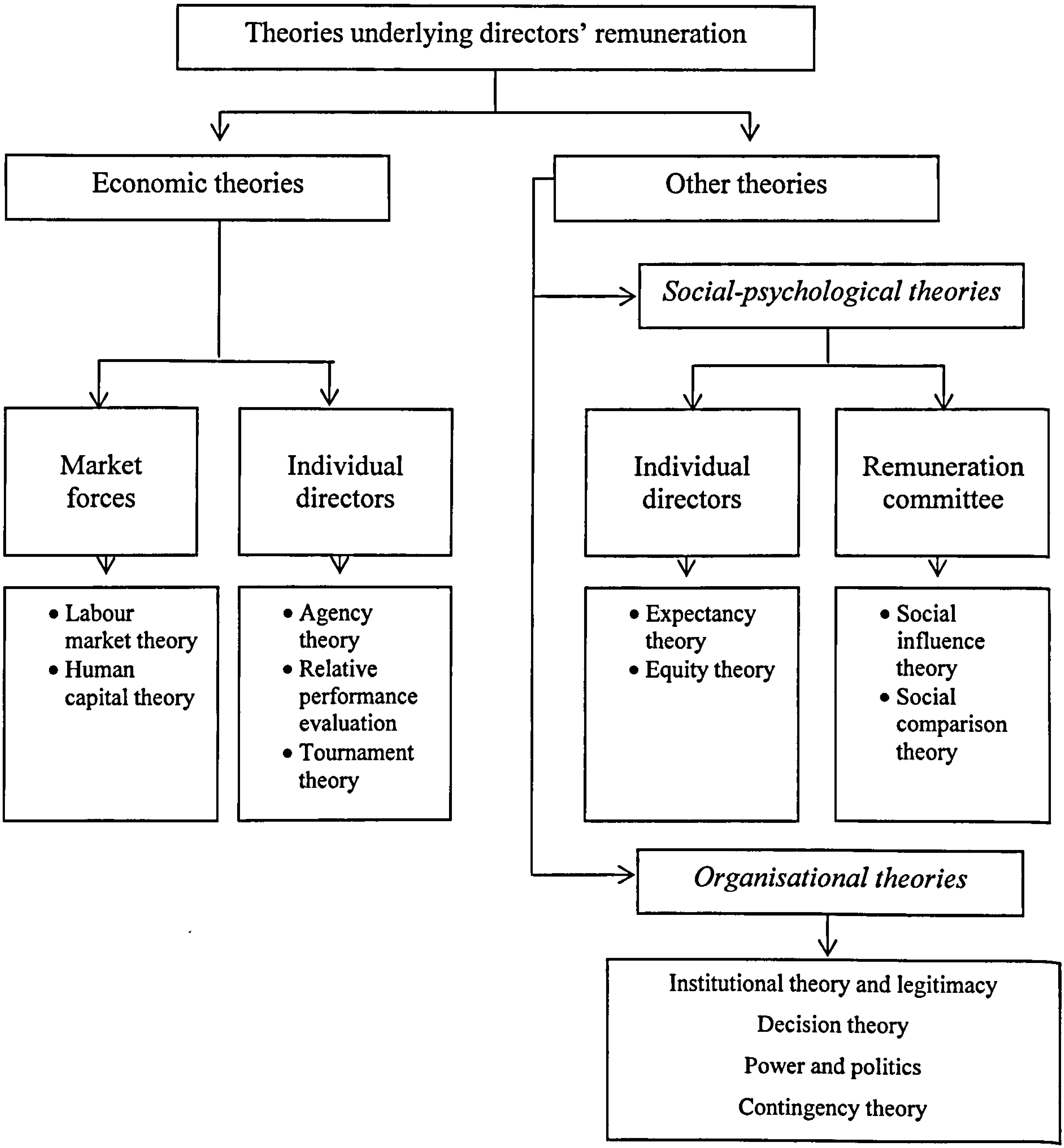


Figure 2-1 shows how theories have been divided into those that take an economic perspective and others, which take either a social-psychological or an organisational view.

It has been observed in the literature that there is little overlap between economic and other perspectives. Merchant, Van der Stede and Zheng (2003) reported just such a segregation in their citation analysis of remuneration-related papers (not just executive pay) published in four major accounting journals between 1989 and 1999. Of the 67 papers in their study, the citations of 61% were economics-based and 28% took a behavioural perspective; only 11% of the papers seemed to draw from both disciplines. Merchant et al. (2003) noted that in many cases the different theories seemed to provide different explanations of the same phenomena, and suggested that the narrow approach of adopting only one theoretical perspective may mean that the research conclusions were too limited, and incomplete. Further, they reported that the two approaches used different terminology to explain what appeared to be the same phenomena (a finding which is noted later in this review when discussing the overlap between several of the theories). Therefore, they put forward the case for more cross-disciplinary research to provide greater understanding.

The structure of Figure 2-1 merits a comment. The heading 'organisational theories' has been used to describe institutional theory and legitimacy, decision theory, theories of power and politics, and contingency theory. This defines the heading quite broadly – some may consider that not all of these are organisational theories – but this typology is convenient as a way to signpost the discussions that follow.

Having introduced the typology, I use it to structure the following sections, which set out an explanation of the various theories shown, the perspectives they adopt, and how each can inform this research. Explanation is also given as to why none of the theories is sufficient on its own to provide an answer to the processual research question posed here.

2.4 Economic perspectives

Traditional or neo-classical approaches to economics have developed a view of the world based on a series of simplifying assumptions. For example, economists have assumed that 'Economic Man' acts rationally in such as way as to maximise his utility (Davis, Schoorman and Donaldson, 1997); or they have assumed perfect markets in which prices are determined by the influences of supply and demand (Begg, Fischer and Dornbusch, 1991). Within those constraints they have developed some powerful theories which have advanced our understanding of the world. In this section I examine the theories put forward by economists to explain directors' remuneration, dividing them between those that see market forces as a significant influence and those that regard remuneration as a driver of behaviour of what are assumed to be rational individuals.

2.4.1 Market forces

Much of the economics-based remuneration literature relates to the action of market forces. In considering how market forces are seen as operating in this literature, one can adopt a definition put forward by Begg et al., who define a market as "a set of arrangements by which buyers and sellers are in contract to exchange goods or services" (1991: 32). Begg et al. go on to explain that in any market there will be an "equilibrium price" at which, with the operation of supply and demand, the quantity demanded just equals the quantity supplied. Market-based theories using this neo-classical view of market operation thus aim to explain the level of pay (at the equilibrium position), rather than its structure.

Labour market theory

Researchers adopting a labour market theory approach apply supply-and-demand principles to the market for company executives, and argue that this can be used to explain the level of executive pay (Gomez-Mejia and Wiseman, 1997; Finkelstein and Hambrick, 1996). They suggest that there is a limited pool of talented individuals who have the ability to run large businesses successfully, and accordingly their price is high.

The 'labour market' is a broad concept and, as with any other market, it can be understood more clearly if appropriately segmented. This segmentation has been undertaken in various ways by scholars interested in different aspects of the subject. Some researchers (for example Deckop, 1988; Palia, 2000) have demonstrated that remuneration levels differ considerably by industry. Others have taken company size as a differentiating factor in the labour market, for example adopting an argument put forward by Gomez-Mejia (1994) that executives running larger companies need to be more skilled, and this effectively segments the market. (Both of these arguments can also be and have been adopted in studies that draw upon human capital theory to explain remuneration decisions, as discussed later.) The way in which the market is defined will have a significant effect on the level of pay (if the segmentation is done by the company) or on the outcome of the study (if segments are chosen by scholars).

Executives and remuneration consultants have also adopted labour market explanations of remuneration, arguing that there is a "tight labour market for senior executives that can manage business of the scope of today's global companies" (Skapinker, 2001). They use the argument to explain (or perhaps to justify) the relatively high levels of executive remuneration paid in the UK and US. The line of reasoning also reflects aspects of managerialist theory (Davis, 1991; Gomez-Mejia, 1994; Combs and Skill, 2003), in that the directors, who can control a company's size more easily than its profitability, have an incentive to grow the company, regardless of profitability, because company size impacts directly on directors' pay.

An aspect of labour market theory can be seen indirectly in the UK, in the pronouncements of the Greenbury study group on directors' remuneration. This stated (1995: para. 1.10) that the level of remuneration should be "sufficient to attract, retain and motivate" high quality directors and managers, but not in excess of that amount. One implication of this is that a market-clearing rate does indeed exist.

In their published remuneration reports, companies often cite their use of remuneration surveys as a means of tacitly demonstrating compliance with this principle of 'sufficient but not excessive'. They use both aspects of market segmentation introduced above: industry and size. For example, The Abbey National Group plc, a UK bank, referred in its 2001 remuneration report to salaries being based on "pay levels in other financial services companies, major retailers and in other UK companies with a similar market capitalisation". In the

US, Porac, Wade and Pollock (1999) found that companies' compensation reports showed that they anchored their comparability judgements within a firm's primary industry.

The comparisons chosen by companies appear to be reasonable, but not unique – other valid comparators could perhaps be used instead. The comparators adopted are almost always based on surveys. In their deliberations on the labour market, Gomez-Mejia and Wiseman discussed remuneration surveys, referring to:

> *... a cottage industry of consultants that specializes in conducting surveys to measure a wide range of CEO compensation statistics ... [which suggests that] surprisingly, very little is known about the use of "competitive market going rates" as a criterion to set CEO pay, despite the lip service paid to it in economic theory, the human resource management literature, and compensation practice. (1997: 327)*

They suggested that compensation survey data are often used to justify and legitimise rather than rationally determine executive pay.

The widespread use of remuneration surveys (Ungson and Steers, 1984; Baker, Jensen and Murphy, 1988; Lorsch, 1999) to benchmark appropriate remuneration levels might indeed indicate that market forces are at work in some way, but does not therefore prove that the remuneration levels paid do in fact represent a market-clearing rate at which executive supply and company demand exactly equate[7]. The surveys show that larger companies pay higher remuneration, but can by their nature only indicate what *is* paid, rather than what *should be* paid. Baker (1978) long ago highlighted this aspect of the 'is-ought' problem, in his critique of the use of such surveys. He pointed out that the surveys provide data on the average pay level for companies of a certain size, but say nothing about whether this average is justified. In an elegant simile, he wrote of a hypothetical survey determining the average weight of six foot high men; the result would be a valid average but it would not be a valid justification of weight.

Nonetheless, the published surveys set a benchmark for remuneration which is often seen as a proxy for a director's 'worth' (Finkelstein and Hambrick, 1988: 550). Accordingly, no director would wish to be below average in his or her remuneration as this might imply below-par value to the company. However, if most directors and their companies' remuneration committees see the rightful position of the directors as in the median or upper quartile, and award pay accordingly, then, inevitably, average remuneration will be ratcheted up for future surveys.

The impact of comparative surveys on ever-rising remuneration levels is widely acknowledged. Hampel (1998), for example, referred to the danger of uncritical use of such surveys causing an "upward ratchet" in remuneration, and Ezzamel and Watson (1998) presented strong evidence of the importance of such external pay comparisons in explaining rises in executive remuneration to meet the "going market rate". Along similar lines, Patton observed that the compensation survey "may well be the most important ingredient in rising executive compensation, for it lends itself to often well-meaning actions that lead to unwarranted compensation" (1991: 47). A decade later, Roberts stated (2001: 1558): "The market mechanisms that are held to constrain opportunism and the pursuit of self

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[7] Ezzamel and Watson (2002: 210) refer to it as "a labour market which, though competitive, is

interest can be seen actually to feed it".

The use of remuneration surveys not only provides a link between size and remuneration but also between industry and remuneration. Companies use industry referents as well as size referents in their survey data, and so the industry in which a company's business is positioned will be an important factor in determining an appropriate level of pay (Murphy, 1999: 2493). Furthermore, the country in which a company operates will influence the choice of comparator for the survey, and so country factors too are relevant (Murphy, 1999: 2496).

Human capital theory

Labour market theory regards executives as a 'commodity' being needed to fill a particular role in a company, whose remuneration is subject to the laws of supply and demand. However, human capital theory (Agarwal, 1981; Finkelstein and Hambrick, 1989, 1996; Combs and Skill, 2003) suggests that the level of remuneration paid to an executive does not reflect solely the job that s/he is asked to do, but also reflects the qualities that s/he brings to it. Human capital is a signal to a prospective employer that an individual is capable of doing a job (Gerhart and Rynes, 2003). The human capital of the individual includes their age, qualifications and experience. Proponents of the theory argue that individuals with better qualifications for a job will attract higher pay:

> *... an executive with a greater amount of human capital would be better able to perform his job and, thus, be paid more. (Agarwal, 1981: 39)*

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characterized by costly and incomplete contracting".

Agarwal (1981), in one of the earliest studies on human capital theory in this arena, found that human capital variables were a factor in influencing executive remuneration, but that they were not as significant as other factors such as job complexity or the employer's ability to pay. Gerhart and Milkovich (1990), in a sample of about 14,000 managers, found that base pay and pay mix were related to human capital. Palia (2000) found that the labour market slotted executives with lower educational qualifications into more regulated business environments which, with less growth potential, paid lower remuneration. From this it is clear that human capital attributes could be inputs to the remuneration-setting decision.

Gomez-Mejia (1994) linked labour market and human capital approaches, suggesting that one reason for the phenomenon of larger companies paying higher remuneration is that the executives running those companies need greater human capital to cope with the complexities of the job, and it is this human capital that is rewarded.

Labour market theory and human capital theory are in some ways complementary. Both see an explanation for directors' remuneration in terms of market structures and supply and demand. Both implicitly suggest that there is a 'true value' for remuneration, captured in some way by using market forces or human capital attributes. Furthermore, both also have a bearing on remuneration practices, in that the ideas behind them are used by companies to explain some of their remuneration choices. Researchers adopting these theories have focused on the level of remuneration rather than its structure, and have examined this level in the context of a company's size and industry (for example, Ezzamel and Watson, 2002; Combs and Skill, 2003). This research has been useful in highlighting some factors which appear to influence remuneration policies. However, although providing insight into the level of executive pay, these theories do not attempt to explain its structure.

2.4.2 Shaping individual directors' behaviour

Another aspect of economics-based research approaches to executive remuneration considers the way in which remuneration affects the individual directors. The fundamental driver of theories in this arena is that the individual directors will wish to maximise their utility – i.e. increase their pay, reduce their effort, and minimise their risk. In this context, theorists have suggested that one role of the remuneration contract is to constrain the executives in their choices so that maximising their own utility will result in their acting for the ultimate benefit of the company's shareholders.

Three main economics-based theories are relevant here. *Agency theory* is the oldest, dominating the executive remuneration literature, with *relative performance evaluation* forming a significant offshoot thereof. Both of these theories focus on how pay contracts are structured. *Tournament theory* takes a different perspective, considering the level of pay rather than its structure, and looking at hierarchical rankings. However, this also follows the theme of motivating the rationally-behaving individual to behave in a particular way. Each of these theories is now considered.

Agency theory

Studies examining the economic justification for directors' remuneration mostly revolve around agency theory. This theory, which arises from the separation of ownership and management (Berle and Means, 1932), is developed and discussed by Jensen and Meckling (1976) and reviewed by Eisenhardt (1989a) and Hart (1995) amongst others.

Agency theory in this context relates to the differences in motivation and payoff between the shareholders (the principals who own the firm) and the directors (the agents to whom is delegated its day to day running). Risk-neutral shareholders, whose interest in the company is likely to be as part of a diversified investment portfolio, seek to maximise their returns by way of dividend and/or capital gain. However the directors (whose jobs are not part of a diversified portfolio), who have day-to-day control over the assets and the operations of the business, may prefer to increase their own utility rather than maximise returns to their principals. Thus there is potentially a conflict of interest. Indeed, Jensen and Meckling clearly set out their presupposition that there will be a conflict of interest by defining their terms as follows: "[w]e retain the notion of [utility] maximizing behavior on the part of all individuals in the analysis to follow" (1976: 307).

Lambert and Larcker (1991) identified three types of potential conflict of interest between shareholders and directors, namely: (i) non-pecuniary benefits or expenditure which has a higher value to directors than to shareholders ("perks"); (ii) risk-aversion in directors' pursuit of potential opportunities, leading to potentially value-enhancing projects being rejected; and (iii) differences in the decision-making time horizons of directors and shareholders, leading to a reluctance to undertake profitable long-term investments.

The proponents of agency theory suggest that in order to avoid the adverse effects of these potential conflicts of interest, shareholders need some mechanism to control the directors. Two 'direct' methods of control could be envisaged: they could monitor directors' actions closely, or they could specify exactly what directors should do in all circumstances. However, neither such control is possible in practice. In most listed companies it is not practical for shareholders to monitor directors' actions in detail. Similarly, it is not feasible for shareholders and directors to enter into contracts that specify tightly the appropriate behaviour for directors in every possible situation. Furthermore, it is difficult for shareholders to evaluate the level of directors' effort by considering the output of the company (for example its profits) as many external factors impact on results, creating 'noise' which makes it difficult to judge individual or team performance.

Other approaches not being satisfactory, agency theorists see the remuneration contract as a practical way to align directors' interests with those of the shareholders. By relating the directors' remuneration to an appropriate measure of performance, shareholders have some means of ensuring that directors behave in their (i.e. the shareholders') interests. Thus, researchers adopting an agency theory perspective have investigated whether pay varies with the company's performance, to identify such an alignment. For example, Jensen and Murphy (1990a), testing for a relationship between directors' pay and shareholder return in over 1,000 companies from the Forbes Executive Compensation Surveys 1974 -

1986, found a weak relationship.[8] Similarly, Conyon (1997) examined 213 large UK companies from 1988 and 1993 and found a relationship between directors' pay and shareholder returns in the current period, although not with preceding periods. Theorists argue that if there is no relationship (or only a weak one) then this implies that agency theory is not working, inasmuch as the contracts are not linking pay to performance. However, this could just indicate that the measures being tested are not sophisticated enough to reflect the contracts being adopted (Tosi et al., 2000).

Literally hundreds of studies[9] have examined the relationship between indicators of company performance and directors' remuneration but no universal conclusions have been reached. While many studies, including those by Lewellen and Huntsman (1970), Murphy (1985), Deckop (1988), and Main, Bruce and Buck (1996) found a strong relationship between company performance and directors' remuneration, others, such as that by Ezzamel and Watson (1997), did not. The position was aptly summarised by Barkema and Gomez-Mejia who stated:

> *In short, after at least six decades of research ... the failure to identify a robust relationship between top management compensation and firm performance has led scholars into a blind alley. (1998: 135)*

Tosi et al. (2000) suggested that one reason for the inability of researchers to find a consistent relationship between directors' remuneration and company performance could lie in the variety of techniques used to test hypotheses and analyse results. In their meta-analysis of the directors' remuneration literature,

[8] Some researchers have argued that Jensen and Murphy's conclusions on their data, i.e. that the link is weak, were wrong. Murphy (1999: 2532) acknowledges this, and states that the results may well be consistent with the predictions of agency theory. The research has been updated, for example by Hall and Liebman (1998), again in a US context, who found a much greater sensitivity.

they referred to:

> *... different methods of data collection, different statistical techniques, different samples, the presence of moderator variables, and differences in how the constructs of interest have been operationalized in the various studies. (2000: 305)*

In their sample of 137 manuscripts which examined CEO pay, they found 16 different measures of company size and 30 different measures of company performance. As different variables have been tested under different conditions it is not surprising that the findings of prior studies have varied markedly.

Relative performance evaluation

Proponents of agency theory suggest that executives be rewarded based on the company's performance. However, they may not have full control over aspects of that performance. For example, a company could do well (in terms of profitability or share price performance) due to market conditions rather than executive initiatives. Likewise, in a bad market its poor performance in absolute terms might be regarded in a much more favourable light when set against that of its peers.

In order to accommodate such anomalies, Holmstrom (1982) developed agency theory to consider relative performance evaluation (RPE). Under RPE, it is acknowledged that, due to the interference of external noise, an individual director's or company's 'good' or 'bad' results may not be an appropriate indicator of how well the director or company has performed. However, the effects of that noise can be reduced or eliminated by comparing the individual's

[9] Source: the database compiled for this research.

results to those of a suitable peer group: the noise is common to all, and the individual's relative performance can be determined and rewarded. This additional information has benefits for both parties: the shareholders will be better able to evaluate performance, and the managers will not be penalised for poor environmental conditions. As Holmstrom stated:

> *I show that aggregate measures like peer averages may often provide sufficient information about common uncertainties and thus schemes that compare agents with such aggregate measures will be efficient. An example of relative performance evaluation of this kind is given by the new executive incentive packages, which base rewards on explicit comparisons with firms in the same industry. (1982: 325)*

Gibbons and Murphy (1990) examined a similar sample of US listed companies to Jensen and Murphy (1990a). They looked at RPE in the context of chief executive officers (CEOs), examining both market-relative and industry-relative performance. They found evidence that RPE contracts were in place, in that boards of directors appeared to incorporate both industry and market performance in their determination of CEO compensation. The widespread use of total shareholder return (TSR) as a performance measure benchmarked against comparator companies (as discussed, for example, in New Bridge Street, 2003b) is a further example of RPE in practice.[10]

Tournament theory

Agency theory and RPE are economics-based theories that focus mainly on the structure of pay, seeing the remuneration contract as a means to influence the individual director's actions. Tournament theory, developed by Lazear and

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[10] Referring to an earlier point, on surveys, it is worth noting that by adopting TSR, companies are rewarding what 'is', rather than what 'ought to be'. This particular measure is embedded in the

Rosen (1981), is also economics-based, but its focus is on the level of pay. Although also considering the effect of the remuneration on the individual, tournament theory differs substantially from the theories previously discussed, in that the individual executive's remuneration is seen not as the product of supply and demand, or as a means of controlling their contribution to the business, but solely as a reflection of his/her position in the company.

Researchers taking this view see the workplace hierarchy as a tournament in which managers compete for the prize of promotion and a higher salary. The predictions of tournament theory are that as a manager rises through the executive ranks, because there are fewer opportunities at each level, the pay differential will increase at each stage. So, it is hypothesised that one reason for high pay at the top of a company is to motivate the people lower down the organisation.

The findings of research investigating tournament theory are mixed. Lambert, Larcker and Weigelt (1993) found support for the theory in a review of four organisational levels for a sample of 303 listed US companies between 1982 and 1984, using private data from a compensation consultant. Similarly, Conyon, Peck and Sadler (2001) found some supporting evidence in a study of 100 large listed UK companies. However, O'Reilly, Main and Crystal (1988), who examined CEO pay in relation to the number of vice presidents in their sample of 105 US listed companies, found no support for tournament theory. On a wider note, the concept of CEO compensation relating at least partly to their roles as

comparator universe rather than reflecting performance against a timeless benchmark (for figureheads is discussed by Gomez-Mejia and Wiseman (1997), and by Ungson and Steers (1984), although neither of these papers includes empirical work to support the proposition. Overall, although the ideas behind tournament theory may have influence in some instances, the evidence of its effect on executive pay is limited. Of the three theories discussed in this section, this one appears to have the least currency amongst academics.

Although tournament theory is evidenced only slightly in practice, the ideas underlying the other economics-based theories discussed in this section, agency theory and relative performance evaluation, appear to be clear influences on the debate around the structure of remuneration contracts. For example, in the UK the report of the Greenbury committee stated that remuneration contracts should:

> *... link rewards to performance, by both company and individual; and align the interests of directors and shareholders in promoting the company's progress. (1995: para 1.15)*

The need for a pay-performance link was reiterated by the DTI in its consultation document on directors' remuneration, which stated in its introduction:

> *... it is damaging to business itself if companies fail to achieve an effective link between directors' remuneration and company and individual performance. (1999: 1)*

The consultation document did not elaborate on why it would be "damaging" were there not a pay-performance link. However, by inference one might assume that their argument could relate to aspects of shareholders' need to control directors' actions and eliminate conflicts of interest – an agency theory argument.

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example, cost of capital). The choice of comparators influences the performance outcome.

At the time of writing this thesis, the latest pronouncement on corporate governance is the Combined Code (2003). This reinforces the messages from the other reports, and states (B1): "A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance". This differs from previous versions of the Code by the insertion of the word "significant" – an indication of the perceived importance of this aspect of pay structuring.[11]

Thus the ideas underlying the economics-based theories of executive remuneration appear to be echoed in common practice, and provide some insight into the construction of executive remuneration contracts. However, the purpose of this section is to review these theories and determine whether they are sufficient to provide a full explanation of how executive directors' remuneration is determined. This seems unlikely, for two reasons.

The first reason that the economics-based theories, whether they relate to the market or to the individual, do not appear to be sufficient to answer the research question in that each of them tends to focus either on the level of remuneration (market theories) or on its structure (agency and RPE), but no theory explains both. Individually the theories are incomplete in the context of this research question and, even if combined, they would still fail to address the processual issues of this thesis.

[11] There is little evidence that relating pay to performance, and, in particular, using equity incentives, has any positive impact on shareholder value. See, for example, Daily, Dalton and Cannella (2003).

A second issue is that economics-based perspectives deliberately focus on only one model of human behaviour, and thus provide a partial but one-dimensional view of remuneration. Simon (1957) critiqued the economists' model of Economic Man who maximises his utility, and behaves rationally in so doing. He pointed out that the economic model assumes nothing about the wider psychological characteristics of Man. Davis (1991) expanded on this point. He suggested that managerial action is "embedded in ongoing social structures", and thus economic incentives provide only a partial picture of what is happening. This is a practical point as well: Brennan (1994) argued persuasively that schemes that are economically rational, to the exclusion of behavioural issues, are unlikely to work effectively for senior executives. Davis, Schoorman and Donaldson (1997) saw two competing "models of man": a "homo economicus" who acts rationally, and a steward, whose interests are aligned with the principals' and who acts from intrinsic motivation. It can be difficult to reconcile the two views. Moreover, although there is much media comment on 'fat cat' directors, this researcher finds it difficult (albeit not totally impossible) to believe that the individuals who have made it to the top of large companies are *solely* driven by utility maximisation, with its presuppositions of risk-averseness and its focus on monetary reward. Thus, even if economics researchers had chosen to examine process (which they have not) such an approach is unlikely to be able to produce a satisfactory answer.

Taking the economic theories on their own terms, these points are not criticisms: they work (by and large) in the context of their own assumptions. But their assumptions are not those of this study, which sees the executives' behaviour in a much more rounded fashion. As Eisenhardt (1989a: 71) stated, in the conclusion to her review of the agency literature:

> *A recent article by Hirsch et al. (1987) eloquently compared economics with sociology. They argued that economics is dominated by a single paradigm, price theory, and a single view of human nature, self interest. In contrast, the authors maintained that a strength of organizational research is its polyglot of theories that yield a more realistic view of organizations.*
>
> *Consistent with the Hirsch et al. arguments, the recommendation here is to use agency theory with complementary theories. Agency theory presents a partial view of the world that, although it is valid, also ignores a good bit of the complexity of organizations. Additional perspectives can help to capture the greater complexity.*

Accordingly, the next section of this review considers theories developed through a different lens, one that engages directly with the complexity of the remuneration decision.

2.5 Social-psychological and organisational perspectives

Although economics provides the dominant paradigm in the executive remuneration literature, many researchers have considered other theories that rest on the notion that remuneration committees, and the executives whose rewards they set, make decisions based on factors that reflect a richer reality than an economics-based approach would suggest. Such theories, which address level and structure of pay, are the subject of this section. The theories are considered in two categories: those which relate specifically to the executive being remunerated, and those relating to the remuneration committee and the processes that determine the remuneration.

2.5.1 Social-psychological theories: the individual

Motivation

As discussed earlier, economics theories see variable pay as a driver that can be used to incentivise the director. However, some authors have queried whether performance-related pay can indeed be used to motivate directors to perform. For example, Deci (1972) maintained that intrinsic rewards (such as the employee's sense of accomplishment of a job well done) can be reduced when employers are perceived as seeking control through offers of money (an extrinsic reward - provided by someone else). Kunz and Pfaff (2002) suggested that although agency theory would predict that increased incentives, such as performance-related pay, raise the agent's productivity, research into intrinsic motivation concludes the exact opposite. Osterloh and Frey (2002) reviewed the motivation literature and concluded that there is strong evidence that extrinsic rewards "crowd out" intrinsic motivation, which may lead to jobs being less well performed.

The finding that reward reduces intrinsic motivation is not universally accepted. For example, although Deci, Koestner and Ryan (1999) present a meta-analysis that shows the negative effects of reward, papers by Eisenberger, Pierce and Cameron (1999) and Gerhart and Rynes (2003: 258) argue otherwise.

In any event, the research into the conflict between intrinsic and extrinsic motivation has tended to focus on employees lower down the hierarchy than CEOs and their board colleagues. It could be argued that matters are different at this top level. For example, one argument put forward by Osterloh and Frey

(2002) is that extrinsic motivation crowds out the job satisfaction if the reward is perceived to be "controlling" and acts as a restriction on the individual. Common sense suggests that this feeling is more likely to occur at lower levels of the organisation than in the CEO, who has considerable autonomy. F Scott Fitzgerald wrote that the very rich are different: the negative impact of monetary reward on performance has yet to be tested at this top level of the organisation.

Although not going so far as to suggest that pay has a negative effect on motivation, Finkelstein and Hambrick asserted that "[p]restige, challenge, and power may rival or even greatly surpass pay in their importance to executives" (1988: 534). For top executives it is perhaps not the absolute level of remuneration in itself that provides motivation, but remuneration in relation to peers and rivals, as a symbol of achievement. To quote Finkelstein and Hambrick in a later paper (1996: 286):

> *Pay is a primary scorecard for managerial success; hence, top managers may not work harder in response to higher pay, but they probably will be dissatisfied with lower pay.*

If this is the case, pay may be seen as a motivating factor for directors who wish to be perceived as 'successful' in the eyes of their peers. Cognitive theories relating to the motivation of the individual director include *expectancy theory* and *equity theory*. These both relate to how the individual perceives the remuneration that s/he is promised.

Expectancy theory

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. Expectancy theory argues 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). A significant aspect of expectancy theory is that it explicitly recognises the differing preferences of individuals, and implicitly assumes that differently structured packages might work differently in different contexts.

Equity theory

Equity theory contributes a different, although complementary, explanation of executive remuneration, one that focuses mainly on the level of pay. Its proponents argue that employees consider the ratio of their inputs (how hard they work) to outcomes (one of which is their remuneration) and compare this ratio with that of a referent 'other'.

Adams (1963) proposed equity theory as a way of understanding how employees respond to situations in which they are treated either more favourably or less favourably in comparison to others (although he did not specify how the 'others' would be determined, nor which inputs and outcomes people would use). He referred not so much to equity as to *inequity*, arguing that inequitable comparisons induce a state of tension which employees are motivated to work to reduce. They can choose to reduce that tension, restoring the equity of balance between inputs and outcomes, by such actions as raising or lowering their work efforts, changing their pay, inducing the referent other to make such changes, or by changing their referent other to someone whose ratio is in line with theirs. Any of these could re-establish equity, without which the employee will be demotivated.

Finkelstein and Hambrick (1996: 286) suggested that equity theory may not be directly applicable to the senior management of a company, as money is not their sole driver – top management tend also to covet acclaim and other non-monetary rewards of success. However, theirs appears to be a minority view. Other commentators have noted that equity theory does have application at this level of the company. For example, Williams (1994: 60) described how directors make comparisons to establish pay fairness with others within their company, and with people in other companies in similar positions to themselves. Miller (1995) found that such referents tend to be found within the same industry. For example, finance directors in the media industry will compare their pay to other finance directors in media companies, but not to those in manufacturing companies. (This of course can be related back to the earlier discussion of comparators in remuneration surveys.)

Research indicates that these theories of individual motivation appear to have some practical application. However, on their own they cannot provide a full explanation of how remuneration contracts are structured. As Miller (1995) pointed out, the remuneration-setting process is a negotiation between the remuneration committee and the individuals, and these motivational theories only attempt to explain the actions and reactions of the one party, the individuals. Accordingly, we need to look elsewhere, to theories that may shed light on the committee's perspective.

2.5.2 Social-psychological theories: the remuneration committee

The remuneration committee is a complex social organisation comprising diverse individuals. Accordingly, several different theories have been suggested concerning how the directors' remuneration is set by this group. *Social influence theory* suggests that an explanation can be found in the interaction between the individual executives and non-executives. *Social comparison theory* relates to the way in which the remuneration committee takes its external pay referents. These are discussed below.

Social influence theory

Proponents of social influence theory see 'social influence' as referring to several different types of relationship that may occur in a board of directors. It may be seen in the desire to reciprocate favours done by one director for another; in deference shown to figures of authority; in social relationships between individuals who get on well; or in the influence that similarities and differences in social status bring to a relationship. Main, O'Reilly and Wade (1995) investigated the role of social influence on compensation in two samples of listed US companies (an original sample of 89 companies was augmented with a further sample of 291 companies, using more sophisticated data). They considered the extent to which boards of directors may be influenced or captured by their CEOs, and hypothesised that companies in which social influence could be seen would pay greater executive remuneration than other companies. Main et al. determined that social influence factors did indeed affect directors' pay. For example, they found that CEO compensation was significantly higher if the non-executive director who served as chair of the compensation committee had been appointed after the CEO joined the company; they saw this as an indication of influence due to reciprocity.

Finkelstein and Hambrick (1996: 275) suggested other social effects which might influence the remuneration-setting process: for example, the publication of directors' remuneration details in annual reports, which facilitates comparisons between individuals and between companies. They cited the wide reporting of remuneration information and the publishing of surveys and other data which act as a scorecard of professional status, setting a benchmark against which companies and directors can measure their remuneration packages. It will be seen that there is a conceptual link with market-based economic theories, discussed earlier, which see these remuneration surveys as an example of labour market theory. There is also a considerable overlap between this view of social influence and social comparison, considered below.

Social comparison theory

The function of the remuneration committee is particularly important in the context of organisational explanations of remuneration strategies. Remuneration policy is set by remuneration committees comprising non-executives, some of whom have executive positions in other companies (Higgs dataset, 2003). According to social comparison theory (Festinger, 1954), individuals evaluate themselves by comparison with others whom they perceive to have similar abilities to themselves. In the context of research into directors' remuneration, it has been argued that executives' salaries will be set with reference to the remuneration committee members' experience of the pay that they and others receive in their own (outside) executive roles: the greater their remuneration, the greater that voted to the CEO.

O'Reilly, Main and Crystal (1988) tested a social comparison theory hypothesis for a sample of 105 US listed firms in 1984 and concluded that CEO pay was indeed positively related to the outside pay of the compensation committee members. A few years later Main, O'Reilly and Wade (1995) tested a separate sample of companies and noted again that the compensation of outside directors on the compensation committee had a significant and positive effect on the focal CEO's compensation (although the magnitude of the effect was lower in the second sample than in the first). However, it should be noted that both these studies used US data: in the US it is far more common for non-executives to be CEOs of other listed companies than it is in the UK, thus the results of this research may not be transferable to a UK context.

Researchers have also suggested the use of social comparison theory to explain the phenomenon of 'bidding up' executive remuneration, whereby the overall salary benchmark rises significantly each year. Ezzamel and Watson (1998) argued that if non-executives do make comparisons between themselves and the executives, they are unlikely to wish to underpay the executives compared to the market. In a UK study of 94 FTSE 100 companies, Conyon and Peck (1998) found that the existence of remuneration committees was associated with higher levels of remuneration (they had originally hypothesized the opposite) and suggested social comparison as one explanation for that phenomenon. Continuing the theme of overlaps between the theories, this social comparison explanation can be related to the remuneration surveys discussed earlier in this chapter; it can also be seen as an equivalent to equity theory, benchmarking an individual against others in similar roles.

Social comparison and social influence theories would appear to have relevance in the remuneration decision, given that it is made by individuals who exist in a social environment. However, although they go some way towards providing an explanation for the level of pay, they do not necessarily explain its structure. Thus, further explanations are still required.

2.5.3 Organisational theories

Institutional theory

Institutional theory, which considers the isomorphic pressures that influence companies to act in similar ways, provides another theoretical approach which may be used to explain directors' pay from an organisational viewpoint rather than an economic one. DiMaggio and Powell's 1983 paper defines three types of isomorphism: coercive, mimetic and normative, each of which may have a part to play in the determination of directors' remuneration policies and packages.

<u>Coercive isomorphism.</u> Coercive isomorphism results from pressures exerted on organisations by other organisations on which they are dependent, and by the

cultural expectations of society. One example of this may be the organisation's response to government mandate: in the remuneration arena, companies' responses to the pronouncements of regulators from Cadbury (1992) to the Combined Code (2003) appear to fall into this category.

Mimetic isomorphism. Institutional theorists suggest that mimetic processes occur when organisations imitate others because the way forward is not obvious and other organisations appear to have found a successful formula: if there is no clear course of action to take, it appears that organisations often copy others. It is suggested that the imitation may be deliberate, or may be diffused unintentionally through the work of consultants. The relative homogeneity of performance measures and targets adopted by UK listed companies (New Bridge Street, 2003a, 2003b) may indicate mimetic isomorphism in action.

Normative isomorphism. The professional practices of the remuneration consultants may also display normative pressures. Normative isomorphism relates to the desire of professionals to control and legitimise their professional practices. This may be seen, for example, in the recognised practice of using compensation surveys as a key tool in determining remuneration (Baker, Jensen and Murphy, 1988). Johnson and Greenwood (2002) suggest that director interlocks between boards also provide strong normative pressures of conformity.

Isomorphic pressures may thus provide a coherent explanation for the homogeneity of companies' remuneration practices. Finkelstein and Hambrick (1996: 275) discussed the isomorphic pressures which may lead to similarity in pay structures between companies, and more particularly within industries. They noted that many industries have distinct pay patterns and suggested that isomorphism, in particular, practices passed on by consultants, might be an explanation of this. (The same phenomenon was attributed earlier in this chapter to labour market theory, and will be discussed later in the context of contingency theory.)

As DiMaggio and Powell stated: "Large organizations choose from a relatively small set of major consulting firms, which, like Johnny Appleseeds, spread a few organizational models throughout the land" (1983: 152). This statement was amplified by a director of a UK listed company:

> *"[Consultants] keep promoting what they think is the industry norm ... and then they promote it to another company and then to a third company ... so it's become an industry norm" (quoted by Conyon et al., 2000: 488)*

Institutional theory takes as one of its premises that organisations structure themselves not so much for reasons of economic efficiency but in order to gain legitimacy (Staw and Epstein, 2000). Legitimacy relates to the way in which organisations fit in with what society expects in order to gain acceptance. It was defined by Suchman (1995: 574) as "a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, beliefs and definitions".

Legitimacy would appear to have relevance to directors' remuneration policies and packages as the way in which society perceives these may have an impact on the company's status in the domains from which it draws resources. Gomez-Mejia and Wiseman (1997) suggested that one reason companies adopt compensation practices that are widely accepted in their industry is in order to gain legitimacy. Legitimacy theory suggests that this can make it easier for them to gain the resources (financial, political, etc) necessary to continue their operations. For example, if a company is seen as being over-generous in paying its directors, its reputation may suffer and it may lose valuable support. This was evidenced when the UK lottery company, Camelot, paid large performance bonuses to its directors. To quote The Economist (26th August 2000): "Camelot's public image was dented by the claim that its directors were 'fat cats' who had awarded themselves excessive salaries and bonuses at the expense of good causes". The Economist went on to suggest that this negative impact on the company's image was one reason why Camelot was not initially favoured in the contest for the award of a further lottery licence; using the terminology of legitimacy, the company was being denied necessary resources[12].

Ezzamel and Watson (2002: 208) continued this line of thought, discussing the "potentially high political costs that arise whenever an unusually high cash bonus or share option arrangement is disclosed". They suggested that this is a constraint on the way in which pay is made contingent on performance – the potential upside might be limited, for reasons of presentation.

Theorists in this area argue that legitimacy can also be seen to have an impact upon the way that boards operate and structure themselves (Meyer and Rowan,

[12] There are many similarities between the institutional perspective and the resource dependence perspective. Oliver (1991) points out that the two are complementary. Barringer and Milkovich (1998: 310) comment on the "remarkable resemblance between the external pressures of resource dependence and the coercive pressures of institutional theory. Resource dependence theory was considered for this thesis, but it was eventually decided that it offered no better explanation than institutional theory.

1977). Harrison (1987) suggested that board committees have at least two roles: to carry out their stated duties and to legitimise the acts of the company. For example, a remuneration committee determines the remuneration policy and packages for the executive directors; in addition, its very existence is a signal to the outside world that the company is undertaking governance in accordance with accepted practice. (However, having that committee is not in itself a guarantee of good practices; Cascio (2004) pointed out that a board is a social system in itself, and structural factors such as the existence of committees do not themselves distinguish good boards from bad.)

Institutional theory may provide an explanation of the structure of remuneration, but is less convincing as an explanation of the level. Furthermore, as discussed above, remuneration contracts in practice seem to be a matter for negotiation between the various parties – so any theory that *only* looks at the board or the committee without considering the individual director is by definition incomplete.

Decision theory

The term 'decision theory' covers a wide spectrum of academic propositions, and the aspect of decision theory that is particularly relevant to this discussion is Tversky and Kahneman's (1974) adjustment and anchoring heuristic ("anchoring"). Tversky and Kahneman maintained that in many situations people make numerical estimates by starting from an initial value (the anchor), and adjusting this to yield a final answer. They suggested that the adjustments made are usually insufficient: different starting points yield different estimates, which are biased towards the initial values.

The anchoring phenomenon was illustrated in a study conducted by Northcraft and Neale (1987). They examined the decisions of 21 real estate agents and 48 business school students on valuing a property. Each of the subjects was given all of the information needed for pricing the property and understood how it should be used. One piece of information was manipulated – the "listing price", which is the seller's best guess of the property's fair market value. Different levels of listing price, ranging between $65,900 and $83,900, were given to two different experimental groups. The researchers found that the level of the listing price had a significant influence on the amounts at which the subjects valued the property: both experts and amateurs biased their answers towards the listing price they were given.

The findings of Northcraft and Neale may be interpreted as relevant to the deliberations of remuneration committees: given the widespread use of remuneration surveys, the figures supplied by those surveys could provide an anchor for the committee's final decision. Anchoring was also considered by O'Reilly, Main and Crystal (1988) in their discussion of social comparison theory: they suggested that the level of remuneration with which committee members were familiar (i.e. their own) could act as an anchor to their setting of suitable compensation. Similarly, it could be contended that the level of remuneration considered reasonable by the executive, using the 'equity theory' argument above, might be an anchor for what s/he considers acceptable. Current levels of pay could also act as an anchor for future pay negotiations.

Power and politics

The determination of directors' remuneration is in part a process of negotiation between the protagonists (Williams, 1994; Clapman et al., 2004), and the outcome of negotiations is often favourable to those with power, who negotiate from strength. Furthermore, the remuneration contract represents the outcome of a decision, or series of decisions, and writers on decision theory acknowledge the importance of power relationships and politics (Pettigrew, 1973; Eisenhardt and Zbaracki, 1992). In discussing organisational perspectives on directors' remuneration, it is thus vital to look at power, and the organisational politics in which it is set.

Research in this area focuses mainly on the power that the executives (normally proxied as the CEO) have over the committee, as evidenced by favourable terms in their remuneration contracts. Such favourable terms might include higher pay, or contracts with less pay-risk[13], limiting the executives' downside in the event of poor performance (Bebchuk and Fried, 2003).

Finkelstein (1992) defined power as the capacity of individual actors to exert their will. Researchers into directors' remuneration have suggested that such power can and does arise from a number of sources, including, for example: executive share ownership (Finkelstein and Hambrick, 1989; Barkema and Pennings, 1998); executive tenure (Hill and Phan, 1991; Sanders, Davis-Blake and Fredrickson, 1995); the proportion of non-executives appointed by the CEO (Lambert, Larcker and Weigelt, 1993); or CEOs' social capital (Barkema and Pennings, 1998).

Each of these could be relevant in different circumstances – as will be discussed later in this thesis, power is contextual and relational (Pettigrew and McNulty, 1995).

Related to the 'power' argument is the argument that remuneration contracts are influenced by political considerations within (and without) the organisation. This was discussed by Ungson and Steers (1984). They considered several issues relating to the political nature of the CEO's job: his/her role as a political figurehead; his/her role as a political strategist; and executive succession. Regarding the first of these, they saw the figurehead role of the CEO as an important part of that function, and suggested that the symbolic meaning of a CEO's remuneration may send signals about his/her position (within the company) or about the company (to outsiders). The 'political strategist' view is that the CEO role is a complex one, managing coalitions within and between the organisation and external parties, and is difficult to evaluate, thus making it difficult to establish a link between pay and performance. The executive succession issue could relate to the relative power of incoming CEOs in negotiating packages greater than would be given to those who are promoted from within (Deckop, 1988; Murphy and Zabojnik, 2003).

The paragraphs above describe research that has attempted to demonstrate a power/political influence on executive compensation. However, the literature does not always make a clear distinction between political and other social-psychological or organisational theories. Phenomena described by some

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[13] Pay-risk refers to the percentage of a director's remuneration that is perceived to be at risk due

researchers as being attributable to the influence of managerial power are seen by others as being the product of social influence, as discussed earlier. One example of such a phenomenon is the relationship of CEO remuneration to the proportion of non-executive board members appointed after s/he took office. For example, Lambert et al. (1993), examining 303 US listed companies, reported that the proportion of external directors appointed by the CEO had a positive influence on his/her compensation. They took this as support for a managerial power hypothesis. However, in a similar study Main, O'Reilly and Wade (1995) examined whether CEOs appointed before the chairman had higher pay. They found this to be so, and attributed the result to social influence theory. At the start of this chapter I noted a comment by Merchant et al. (2003) to the effect that different research disciplines use different terms to describe the same phenomena – this would seem to represent such an instance.

Contingency theory

The last theory explored in this chapter is contingency theory, which has a useful part to play in a discussion of executive remuneration. Proponents of contingency theory (for example Gomez-Mejia and Balkin, 1992; Barkema and Gomez-Mejia, 1998) state that different environmental conditions and firm characteristics demand different pay policies, tailored to an individual firm's circumstances. Several studies (for example Milkovich, 1988; Montemayor, 1996) discuss the need to tie performance-related pay to the company's strategy. Barkema and Gomez-Mejia explain the essential logic of the contingency approach as follows:

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to being performance-related, compared to fixed elements such as basic salary.

> *(1) diverse environmental conditions, organizational strategies and firm characteristics require different pay policies and practices, (2) the relative effectiveness of different pay policies and practices varies across contexts, and (3) significant deviations from the ideal compensation profile that would be most appropriate given a firm's environment, strategies and characteristics will result in lower performance. (1998: 139)*

There is no one universally ideal pay structure for all organisations, and accordingly an organisation's remuneration practices should be appropriate to its unique characteristics and reflect the external environment in which it operates. Without an appropriate match between compensation policy and strategy it will be difficult to achieve high performance. Montemayor (1996) undertook questionnaire research with members of the American Compensation Association and established that there was indeed an association between pay policy and business strategy. Milkovich (1988) also made this point, but noted that although it is important to reward behaviours that are consistent with the organisation's objectives, it can also be difficult to design systems that create an exact fit.

2.6 Summary of the theories described in this chapter

So far in this chapter some key theories that have been used to explain directors' remuneration have been reviewed. Each of the theories has been shown to have validity in its own area. However, none of them on its own can be used to explain both the level and structure of executive remuneration, which is the focus of this research. The application of these theories is summarised in Table 2-1.

Table 2-1 How theories explain level and structure of remuneration

Theory	**Aims to explain level of remuneration**	**Aims to explain structure of remuneration**
Economic		
Labour market theory	Yes	No
Human capital theory	Yes	No
Agency theory and relative performance evaluation	Only to the extent that poorly designed contracts might enable executives to extract higher rents	Yes
Tournament theory	Yes	No
Social-psychological		
Expectancy theory	No	Yes
Equity theory	Yes	No
Social influence theory	Yes	Only to the extent that influence may reduce the pay-risk
Social comparison theory	Yes	No
Organisational		
Institutional theory and legitimacy	Only to the extent that level must seem to be legitimate	Yes
Decision theory	Yes	No
Power and politics	Yes	Only to the extent that power may reduce the pay-risk
Contingency theory	No	Yes

It can be seen that, for the most part, each theory focuses on either the level of pay or its structure. Agency theory has some application in both areas, but its contribution as regards explaining the level of pay is limited. Social influence and power theories, which, as explained earlier, have sometimes been used interchangeably, may also impact on both areas. They clearly have the potential to enable executives to increase pay levels. They might also be used to explain executive contracts where pay-risk is low, but could not act as an explanation for situations where the pay-risk is high.

Furthermore, each of the theories approaches the issue from the point of view of one of the participants in the remuneration decision, either the individual director or the remuneration committee, whereas in practice the negotiation involves all the parties. Also, it is apparent from this review that none of the theories has been used to consider the *processes* by which pay is set. Accordingly, none of the extant theories can provide an answer to the research question 'how is the remuneration of executive directors determined?'. It was this thought which led to the development of a tentative theory of remuneration, to be outlined in chapter 3.

2.7 Inputs to the remuneration decision

In chapter 1, Figure 1-2 shows remuneration-setting as an input-process-output model. Such a model is described further in chapter 3. One of the purposes of reviewing the literature was to determine possible inputs to the model, as considered by previous scholars.

Some of these factors are clear from the summary of theories set out above. These include: company size, performance, industry, strategy, remuneration surveys and other forms of comparison, and human capital. The academic literature was also reviewed to examine the variables used in previous research, to determine further inputs. The tables in Appendix 2 set out examples of some of the research papers reviewed, and the variables they considered. In total, the potential inputs from the literature are as set out in Figure 2-2.

Figure 2-2 Variables which may impact on directors' remuneration

Company size	Ownership of the company
Company performance	Institutional influence
Remuneration surveys	Board/committee structure
Industry	Cash resources
Country	Directors' requirements
Human capital	Financial accounting
Social comparison factors	Tax – individual and corporate
Strategy and stage in lifecycle	Retention needs

2.8 Other factors influencing the remuneration decision

Before completing the literature review, it is necessary to consider again the five generic questions set out in chapter 1. For convenience, these are set out below.

Relating to the level of pay

1. How much should the company's executive directors be paid for expected performance?

Relating to the structure of pay

2. What relative proportions of this amount should be basic salary and performance-related?
3. For the performance-related components, how should performance be measured?
4. How should performance targets be determined?
5. What form should the remuneration take? (For example, shares, share options, cash or a mix thereof?)

So far in this chapter, prior research relating to questions 1 and 2 has been considered. It is now necessary to see what researchers have written about the other three questions.

2.8.1 Performance measures and targets

If directors' pay is structured to encourage good performance, it is important that the performance measures and targets are set appropriately. Two of the key drivers of success in performance-related pay are the determination of appropriate performance measures and then the setting of suitable targets.

Performance measures

Surveys by New Bridge Street Consultants (2003a, 2003b) show that 98% of FTSE 350 companies have annual bonus schemes for their directors, mostly rewarding performance measured by a profit measure or personal performance. A similar percentage also had in place a long term incentive scheme, either a share option scheme or an ltip (long term incentive plan). The most common performance criteria for the longer term schemes were eps (earnings per share) growth or total shareholder return (TSR) over a performance period extending, at the mode, for three years.

Eps and TSR are the most commonly-used performance measures, but they are not the only ones available. The performance measures used as a basis for performance-related pay can be accounting-based, economic profit-based, market-based or non-financial. For the remuneration committee addressing the question 'how should performance be measured?' each of these types of measures has both advantages and disadvantages.

Table 2-2 summarises some of the advantages and disadvantages, from the point of view of the remuneration committee, of the different types of performance measure.

Table 2-2 Features of common performance measures

Performance Measures	Advantages	Disadvantages
Accounting measures Profit-based measures: for example profit before or after tax, earnings per share (eps), Return on Assets (RoA) and Return on Equity (RoE).	• Simple to use. • Easy to understand. • Universally acceptable measure. • Information is readily available, often based on audited figures.	• Accounting policies are easy to manipulate. • May encourage short-termism. • Takes no account of risk. • May be distorted by inflation. • Internally-determined targets may be set artificially low. • Ignores the cost of capital: not necessarily a good indicator of shareholder value.
Economic profit And other internally-based shareholder value measures such as Economic Value Added.	• Takes account of underlying capital requirements. • Seen as an indicator of shareholder value.	• Easy to manipulate, as figures are accounts-based, and adjustments may be seen to be subjective. • May encourage short-termism. • Difficult to measure. • Internally-determined targets may be set artificially low. • Not always understood by the participants.
Market-based measures For example share price, or total shareholder return (TSR) - dividend plus change in share price.	• Simple to use (but may be difficult to calculate). • Directly related to shareholder value. • Targets are set based on an external measure. • May be judged against relative performance of a comparator group or index. • Information is readily available for quoted companies. • Determined independently (by the market).	• Share prices may vary for reasons unconnected with company's or directors' performance. • Share prices reflect views of the future, and may be unrelated to past performance. • Changes in share prices reflect performance which differs from original expectations, rather than good/bad performance. • Market imperfections may cause a share to be under/over valued. • It can be difficult to determine an appropriate comparator group. • Difficult for managers to know how the company is progressing against comparators.

Non-financial indicators For example, market share, satisfaction indices, "strategic factors", etc. These can be split between quantifiable and more subjective measures. They may be individual or team-based.	• May be perceived as reflecting business drivers of shareholder value. • Can be used to reinforce a business's strategy. • Qualitative measures may be interpreted more flexibly in the light of external factors.	• Often difficult to establish and evaluate. • Qualitative measures involve considerable judgement, and targets or outcomes may be fudged, or influenced by a powerful executive. • Link to shareholder value may be difficult to confirm.

Sources: Rappaport (1978), Tehranian, Travlos, and Waegelein (1987), Burchman (1991), Brindisi (1991), Stewart (1991), McTaggart, Kontes and Mankins (1994), Langley (1997), Murphy (1999). Also the researcher's general financial knowledge.

Burchman (1991) specified three criteria for performance measures, namely that they should be: highly correlated with shareholder wealth creation; consistent with the company's organisational and management environment; and consistent with the company's compensation philosophy. He noted that market-based measures address shareholder wealth directly but are limited in that they reflect the vagaries of the overall economy rather than the performance of the individual company (and hence its managers). He considered earnings-based measures to be useful, in that they are widely prepared and understood, but pointed out that they have little correlation with shareholder value. Burchman also observed that non-financial measures provide a means to reinforce strategy, although they are often not linked to the business as a whole.

Langley (1997) also examined the features of some commonly used performance measures, taking a UK perspective. He noted difficulties with accounting measures such as eps which, he pointed out, is short-term and does not account for the cost of capital. However, he also noted that the measure does have strengths such as being derived from audited figures. Share price growth, on the other hand, may align directors' interests with those of shareholders, but is forward looking, and reflects market expectations rather than rewarding past performance.

One final consideration on performance measures is that the use of any single measure can distort performance, encouraging the executives to meet that performance measure rather than work for the best outcome for the company (Kaplan and Norton, 1996).

Performance targets

In addition to determining the proportion of directors' remuneration that is to be performance-related, and the measures to use, remuneration committees need to ensure performance targets are set that will motivate directors towards desired performance. However, research by Healy (1985) and Holthausen, Larcker and Sloan (1995) found that performance targets may not achieve their desired outcomes. Both of these studies found that managers use accounting accruals to manipulate profits downwards when the upper limit for bonuses is reached, thus 'banking' any additional profits for the ensuing year when profit targets may not otherwise be reached. Murphy (2001) also found that income-smoothing takes place when companies use internal performance targets[14] such as budgets, thus ensuring a more constant bonus payout year on year. Furthermore, Jensen (2003) gave examples of how paying people for budget-based targets can lead to poor business decisions.

[14] Murphy refers not to targets but to 'standards'. However, that usage is not common in UK companies, hence 'targets' is used here.

2.8.2 The form of remuneration

The fifth question to be addressed by remuneration committees concerns the form in which directors' remuneration is to be paid. Broadly, it may be paid in cash, the company's shares, share options, or a mixture thereof. Researchers have identified a number of factors that influence remuneration committees' decision as to which form(s) of payment to adopt. These include:

- The company's available cash resources and directors' personal need for cash to support their lifestyles (Langley, 1997);
- The desire to retain executives in the company – which encourages payment in shares to be held for the longer term (Jensen and Murphy, 1990b);
- The need to align directors' interests with those of the shareholders – encouraging payment in equity (Hall, 1997);
- The impact of the form(s) of payment on the company's and the individual director's tax liability (Finkelstein and Hambrick, 1988);
- The impact of the form(s) of payment on the company's financial statements (Murray, Smithers and Emerson, 1998).

It is generally accepted that at least part of directors' remuneration should be paid in cash in order to meet their immediate financial needs, and most commentators also agree (for reasons indicated above) that some part of the remuneration should be paid in equity (shares or share options). However, there is considerable debate as to whether payment in shares or options is more appropriate and the use of share options to reward directors has attracted considerable research interest. Main, Bruce and Buck (1996) investigated this issue in a study of 60 FTSE 100 companies and concluded that share options provide a performance-sensitive link between pay and performance. This suggests that companies wishing to enhance their executive directors' performance could adopt share options as a means of payment.

However, Yermack (1997) also investigated companies' use of options to reward their directors and found that a downside of their use arises from the ability of directors to manipulate the timing of the exercise of their options in order to benefit from favourable stock market conditions that have nothing to do with their own performance. The Greenbury Committee (1995: para 6.28) similarly cited what it referred to as "windfall gains" as a disadvantage of options as a form of remunerating directors. Hall (1997) acknowledged this disadvantage of options but still favoured their use over shares as a means of rewarding directors, observing that a properly structured option scheme can provide the leverage of a share scheme but at a lower cost to shareholders. However, a few years later, after some high-profile corporate excesses, he commented on the many disadvantages of options: Hall and Murphy (2003) stated that too many options were granted, and that although attractive in some respects, they were an inefficient way to achieve the objectives.

On a related matter, Jensen and Murphy (1990b) questioned the value of equity as a means of motivating directors towards desired performance. Studying the behaviour of CEOs in large US companies, they concluded that, in order for this form of reward to affect performance, CEOs need to have a substantial investment in the company's shares.

A further issue relating to the use of share options is the tax environment of the company and the directors. Main (1997), for example, traced the history of the use of share options in the UK and noted that companies' propensity to use options has changed over time with changes in tax rules. Similarly, Main, Bruce and Buck (1996) observed that differences in the tax environments of the UK and US may account for the lesser use of options by companies in the UK compared with their US counterparts.

The use of share options to reward directors may also be affected by their treatment in companies' financial statements. The findings of Murray, Smithers and Emerson (1998) and Cooper and Hraiki (1998) showed that the accounting treatment of options can affect reported earnings and that, if options were fully charged against earnings this could result in a significant reduction in reported net income. This factor is of particular relevance given the introduction of IFRS 2 - Share-based Payment – for accounting periods beginning on or after 1st January 2005. Once options are charged against profits in the same way as other forms of remuneration, companies' decisions as to the form of payment for their directors may change to reflect fundamental issues rather than accounting convenience.

As with the different types of performance measure, advantages and disadvantages attach to each of these methods of payment. These are summarised in Table 2-3.

Table 2-3 Features of some common methods of payment

Payment Methods	Advantages	Disadvantages
Shares	• Perceived as creating alignment between directors' and shareholders' interests. • Depending on the source of the shares, may not result in full charge against profits[*].	• Depending on scheme restrictions, may not be retained long-term. • Director can benefit even if share price falls. • Director can benefit from share price rises relating to anticipated future events rather than past performance. • Potential dilution of existing shareholders. • May result in a charge against profits[*]. • May discourage risk-taking behaviour if the shareholding represents a significant part of the director's personal wealth.
Share options	• Perceived as creating alignment between directors' and shareholders' interests. • Directors only benefit if share price increases. • May not result in full charge against profits[*].	• After exercise, the shares may not be retained long-term. • Difficult to value. • May be no downside for the potential recipients. • Possible windfall gains arising from general movements in the market, or inflation. • Director can benefit from share price rises relating to anticipated future events rather than past performance. • Potential dilution of existing shareholders. • If out-of-the-money[15], may not have an incentive effect. • Directors may be unwilling to pay significant dividends. • May encourage the directors to pursue volatility of results.
Cash	• Universally acceptable. • Transparent as to value.	• Does not provide alignment of directors' and shareholders' interests. • Charged to profit & loss account[*]. • Staff are free to leave once bonuses have been paid.

Sources: Jensen and Murphy (1990a), McTaggart, Kontes, and Mankins (1994), Mehran (1995), Main (1997), Rappaport (1999). Also the researcher's general financial knowledge.

[*] It should be noted that although this is shown as an advantage (disadvantage), reflecting current corporate sentiment, many commentators see it as a disadvantage (advantage).
[15] "Out-of-the-money" or "underwater" options are those for which the exercise price of the option exceeds the current share price, meaning that it would not be worthwhile for the director to exercise the option.

Jensen and Murphy (1990a) suggested that directors' shareholdings are a powerful tool in aligning the financial interests of directors with those of shareholders. Accordingly, both option-based and share-based remuneration will have considerable advantages; but only if the executives retain the shares after they become fully vested. In this context, New Bridge Street (2003b) report a growing trend of companies requiring directors to hold substantial shareholdings in the companies for which they work, which would help to secure alignment of interests.

Although share- and option-based schemes can secure alignment, as noted earlier in this chapter, many share option schemes are flawed, producing large monetary gains for directors irrespective of the company's performance (see for example Overell (2002) for a discussion of how CEOs have benefited from "riding the rising tide"). Furthermore, as Murphy (1999) and Meulbroek (2001) point out, share options are worth less to the undiversified director than they would be if issued on the open market; thus the option-based remuneration costs the company more than its value to the directors.

This feature of share options is not an issue for share-based schemes. Schemes that award directors shares, often with vesting contingent on the company's performance, are popular with many companies. There is a wide range of such schemes in existence. Tehranian, Travlos and Waegelein (1987) and Larcker (1983) both set out details of different types of share-based remuneration plan, used particularly in the US. However, share-based remuneration also has its critics. For example, Main (1997) showed that for a given monetary value, more options can be given to directors than can shares, thus increasing the pay-gearing[16] for directors.

2.9 Prior interview-based studies

In chapter 1, while outlining how this study differs from previous research, I made reference to three studies which have used interviews with the protagonists in the remuneration-setting decision: Main (1993), Conyon et al. (2000) and Ogden and Watson (2004). It is appropriate now to discuss these studies, and to explain why they do not address the question asked by this thesis. In this section I will also consider the review conducted for the Higgs report by McNulty, Roberts and Stiles (2003).

Main (1993) conducted interviews between October 1992 and April 1993 with 24 "top executives" at 24 of "Britain's largest companies". The executives included CEOs, chairmen, main board directors with responsibility for pay, company secretaries and human resource professionals. No explanation is given of how these people and companies came to be selected for the research, nor is any detail given of the research methodology (for example, whether the interviews were taped, how long they took, etc.).

Main's work provides a useful description of practices in his companies in the period following the publication of the Cadbury committee's report. All his case companies already had remuneration committees in place (indeed, he suggests that

[16] Pay gearing refers to the relative change in director's remuneration for a given change in

it may be that "those agreeing to participate in this study are more likely than most to have sound governance procedures in place" (1993: 4).[17] His paper covers many matters – the use of comparator surveys, bonus plans, the use of consultants and professional advice, numbers of committee meetings – but at a necessarily superficial level, given the constraints of the length of the paper. This is an interesting description of practices at a time of change in the governance environment, but no attempt is made to apply a theoretical approach to the empirical findings.

The work done by Conyon et al. (2000) combined quantitative and qualitative methods to produce a work that added in many ways to the debate. In their quantitative work they valued the equity-based remuneration earned by directors in 200 of the largest UK companies, and also valued their portfolio of equity and unvested options, to demonstrate the relationship between changes in the firms' wealth and changes in the directors' wealth. They also analysed in detail the elements of the directors' pay (using 1997 data) and showed how much was fixed and variable, and how the variable pay related to performance. Furthermore, they showed that the most commonly-used performance measure – growth in eps – was historically easy to achieve at the target levels set.

Conyon et al. supplemented their quantitative data with taped interviews at 8 large companies (out of a total of 50 companies approached). The interview questionnaire is reproduced in the paper, and is comprehensive. It is not obvious exactly how many interviews were conducted, with how many interviewees: the

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performance; higher gearing means that the total remuneration is more sensitive to performance.

text states "[t]here were typically six high-profile non-executive directors – usually including the Chair of the remuneration committee – and two human resource directors who were responsible for providing information to the remuneration committee". It is not clear if all of these people were interviewed, and if such interviews were on an individual or group basis.

This research provides insights into, for example, why the companies used options or ltips, the difficulties they had in determining appropriate performance measures and targets, and their use of consultants. The qualitative data supplement the statistical analysis to produce a very interesting paper. However, despite the very detailed nature of the questions being asked, the interview results are not reported in detail, and thus the paper skirts around many of the issues. Like the Main (1993) paper discussed above, this paper makes no attempt to relate its findings to theory.

The third qualitative paper referred to in chapter 1 is a recent one by Ogden and Watson (2004) that combines quantitative analysis of water companies' pay in 1991-99 with interviews with members of the remuneration committees of four water companies. No details are given as to when the interviews were conducted (although this must have been in/after 2000, as the paper refers to there only being five independent water companies from which to choose, and this was not true before that year). And although the paper refers to interviewing "members of remuneration committees" it does not state how many interviews and how many interviewees.

[17] That same matter is noted in chapter 8 as regards this study.

Ogden and Watson discuss several aspects of directors' remuneration, including the committees' terms of reference, their use of consultants and of surveys, and their practices in committee meetings. In common with the other papers reviewed in this section, no attempt was made to link the findings to theory.

Another qualitative paper written by academics, although not published in a peer-reviewed journal, is the review of the work of NEDs prepared for the Higgs report by McNulty, Roberts and Stiles (2003). This paper, which records the results of interviews with 40 directors of FTSE 350 companies, conducted during the summer of 2002, covers the whole spectrum of NED activities, of which remuneration-setting is a sub-set. McNulty et al. found that the behavioural dynamics of the individuals on the board (and by extension, its committees) played a major part in its effectiveness. As regards remuneration, they cited the need for remuneration committees to be able to defend the remuneration they awarded, and to be sensitive to the perceptions of the wider community. They stated that although committees are composed of non-executives, the executive has a high influence in determining pay. Finally, they commented on the need for the non-executives to be technically competent in the complex area of remuneration.

Although each of the four papers reviewed in this section has made a useful addition to our knowledge about how executive pay is set, none has satisfactorily addressed the gap in the literature and answered the research question of this thesis.

2.10 Summary of chapter

In the eighty years during which academics have researched directors' pay, many approaches have been used. In this chapter I have set out some of the theories adopted, categorising them in terms of whether they take an economic perspective, or a social-psychological or organisational one. I have shown which of the theories reflect the point of view of the individual being remunerated and which the committee; which consider the level of pay and which its structure. By doing this, I have demonstrated that no one theory is adequate to answer the research question set out in chapter 1. Furthermore, I have analysed the few papers that have discussed processual issues, and shown that they have not attempted to link them to theory. It thus appears that no prior research has attempted to answer the research question of this thesis.

The chapter also sets out the factors which previous researchers have considered as potential inputs to the remuneration-setting process. Further, it sets the five generic questions into context of previous research, highlighting the issues that remuneration committees face, and the fact that there is no 'right answer' waiting for them to apply.

3. PRELIMINARY MODELS

3.1 Introduction

In this chapter I describe two models developed from the review of the literature which were used to guide the initial research design. The process model, described first, grew from the representation of prior literature set out in Figure 1-2 in chapter 1, the input-process-output model. It draws directly on the list of potential input factors derived from the literature review in chapter 2. The other, legitimacy-comparison theory, is a tentative framework drawn from the literature review. As noted in chapter 1, both were superseded in the course of the research process, as the need for a different, more comprehensive, approach to theorising the complexity of the remuneration-setting processes became apparent.

3.2 Process model

The Combined Code (2003) of the London Stock Exchange specifies that:

> *Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. (section B2)*

In the order of its wording, placing 'policy' before 'packages', the Code mirrored the Greenbury report (1995) which stated that companies should disclose their policy on executive remuneration (section B2) and they should "... also include full details of the remuneration package of each individual Director ..." (section B4)[18]. Both of these documents seem to envisage a system whereby remuneration committees first develop their company's remuneration policy and then determine individual directors' packages in accordance with that policy. Such a system is depicted in Figure 3-1[19].

Figure 3-1 Illustrative remuneration-setting system

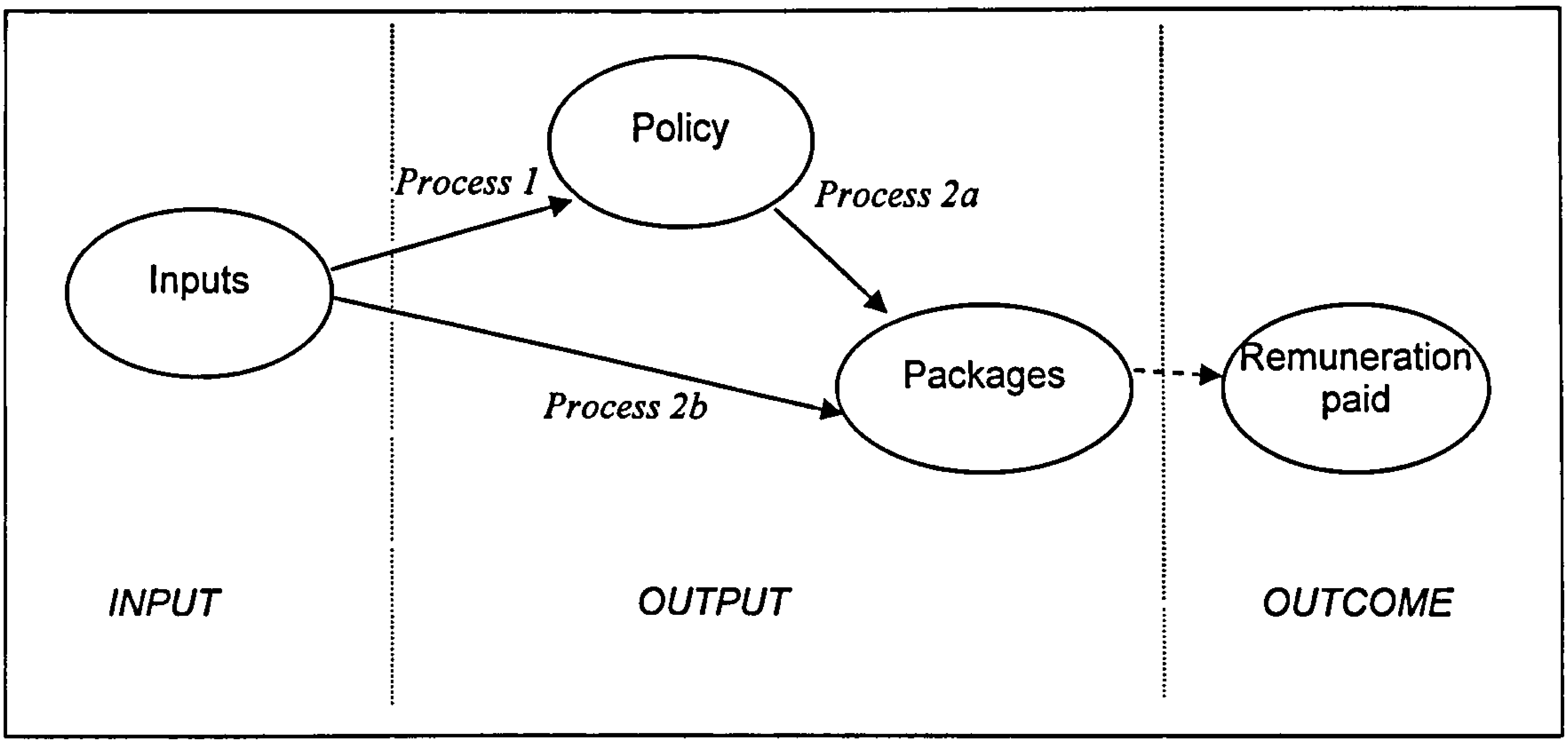


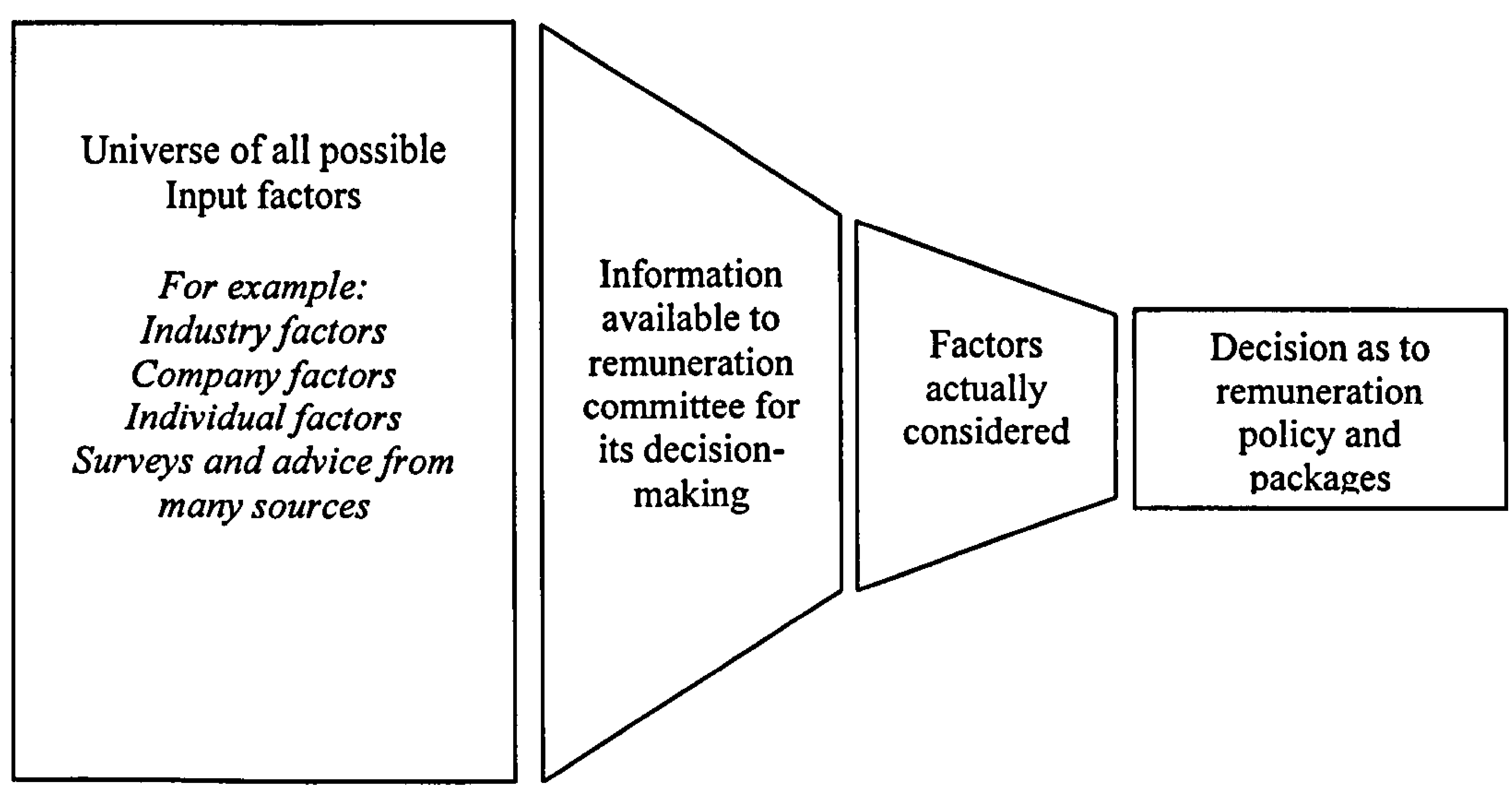
Figure 3-1 indicates that the remuneration-setting process commences with the remuneration committee gathering data (or 'inputs') to inform their decisions. Following from the discussion in chapter 2, it is likely that these data will include, *inter alia*, information about the company's size, industry, strategy and lifecycle phase; personal attributes of the executive directors whose remuneration packages are to be determined; remuneration levels of directors in other companies within the same industry and in the market as a whole; and relevant tax and financial reporting requirements. Such information will be gathered from a variety of sources including, for example, remuneration consultants, internal sources (such as HR personnel), published data, and the acquired knowledge of remuneration committee members obtained from other companies in which they hold (or have held) executive or non-executive directorships.

The information available to the remuneration committee will influence its

[18] The terms 'policy' and 'packages' are defined in the Greenbury report. See glossary.

decisions in developing the company's overall remuneration policy. However, the committee is unlikely to use all of the information at its disposal – nor is it likely to seek to obtain the universe of possible data. Remuneration committee members charged with formulating their company's remuneration policy could not cognitively or physically accommodate all of the information potentially available to make a fully informed decision. Furthermore, time constraints on commercial decisions mean that exhaustive research and data collection are rarely possible in practice. Bounded rationality (see Simon, 1957) suggests that the committee members will obtain sufficient information to reach a decision, basing that decision on their perception of the world, gained from the limited (or bounded) information they consider. The process of bounding in the context of the remuneration-setting decision is illustrated in Figure 3-2.

Figure 3-2 Bounded rationality in the remuneration committee's choice of remuneration policies and packages



Adapted from Finkelstein and Hambrick (1996: 42)

[19] Much of this discussion of the process model was published in Bender and Porter (2003).

An example of bounded rationality in the remuneration-setting context is afforded by the setting of basic salary levels. As noted previously, remuneration committees are usually assisted in their deliberations by remuneration consultants, and they also use survey data when determining appropriate salary levels for their executive directors. However, a review of companies' remuneration reports and discussions with directors indicate that most companies use only one consultant; few use more than three. By using more consultants, access to more information would be possible, but companies choose to satisfice, limiting the information they have available for their decision-making. Even committees that obtain survey data from several sources do not search the market exhaustively for all possible sources of information.

Figure 3-2 suggests that the remuneration committee will use only a subset of the possible input data in making its remuneration decisions. These decisions are illustrated in Figure 3-1. The first stage is to use the relevant data to develop a remuneration policy appropriate to the company's context and its directors' needs. This is shown as Process 1. Its output is the remuneration policy which provides the broad framework within which the remuneration packages of the individual directors will be determined. For example, the remuneration policy might state the comparator group(s) against which the level of pay will be benchmarked, and specify whether it will be at the median or above or below that level. The policy will also set out the structure of the remuneration, giving the broad parameters of the short- and long-term incentive schemes, and provide for the form in which the remuneration is to be paid, for example, by establishing a share option or restricted share scheme.

Based on the sequence suggested in the Greenbury report (1995) and the Combined Code (2003), the remuneration committee next turns its attention to the remuneration packages of the individual directors. This represents Process 2 in the remuneration-setting system but, as Figure 3-1 reveals, it comprises two sub-processes. In the first, Process 2a, the remuneration committee applies its over-arching remuneration policy to the circumstances of each executive director. Simultaneously, the committee engages in Process 2b, that is, it considers some of the system's inputs that will directly impact individual directors' remuneration packages. For example, a remuneration committee may take into account the average level of executive directors' pay in the company's industry (an input) when establishing its overall remuneration policy (in Process 1). Applying that policy (in Process 2a), would give an initial view of what that directors' packages should be. However, when determining the package of an individual director, the committee may (in Process 2b) consider other inputs such as the director's human capital – for instance, their age and experience, or the likelihood of their being poached by a rival firm.

Just as the remuneration policy is the output of Process 1, the remuneration packages of individual directors constitute the output of Process 2 (that is, the combination of sub-processes 2a and 2b). The packages include details of the relevant director's basic salary and any performance-related pay. They also set out the basis for the award of performance-related pay (including specific performance measures and targets, and the level at which the maximum bonus is reached).

An individual director's remuneration package can be likened to a formula embodying a basic salary and (usually) a performance-related component – the latter generally being linked to stated performance targets. Thus, once a director's package has been determined, the remuneration s/he will receive flows automatically from it (the performance-related component being calculated according to the director's performance relative to the stated targets). The remuneration each director receives is the 'outcome' of the remuneration-setting system. No process is indicated in Figure 3-1 to link the system's outputs to its outcome because if the director's remuneration package has been unambiguously designed, and circumstances remain unchanged, no further decision process is required.

In the event that circumstances change (for example, there is a fundamental shift in industry dynamics making existing remuneration arrangements inappropriate), and the remuneration paid to the company's executive directors becomes a matter for the remuneration committee's judgement, such judgement may well be exercised at the end of a multi-year performance period. (Most long-term remuneration schemes have a performance period of at least three years and, as a result, come to fruition some considerable time after the remuneration policy and packages are initially determined.) In such instances, the remuneration committee will, in effect, re-engage in process 2b (the changed conditions being reflected in the inputs used in the process) and new packages for the directors will be devised. These, in turn, will generate the outcome of the remuneration-setting system, that is, the remuneration paid.

One further point to note is that Figure 3-1 portrays a stylised remuneration-setting system, with linear paths linking policy to packages and packages to remuneration paid. In practice, the system will almost certainly be more complex. It is likely that feedback loops will exist at each stage so that, if conditions change (as noted above) or the amount paid is not satisfactory (to the company or to the director concerned) for some other reason, then the directors' packages or, indeed, the remuneration policy may be amended. This is an implication of Ezzamel and Watson's study (1998) which examined a sample of 199 large UK companies between 1992 and 1995 and found that pay anomalies in one period influenced the following period's pay.

This process model was used to inform the research design, and was discussed with two of the research participants. The discussion in chapter 6 explains why the model proved to be incomplete, and how it needed changing to reflect companies' processes.

3.3 Legitimacy-comparison theory

As shown in chapter 2, none of the extant theories adequately explains both the level and structure of directors' remuneration, and none of them addresses the issues from the point of view of both parties to the negotiation, the executives and the remuneration committee. A model of greater explanatory power is needed.

Having undertaken the literature review, and noted the suggestions of authors who recommended a multi-theoretic approach to governance research (for example:

Eisenhardt, 1989a; Barringer and Milkovich, 1998; Young, Stedham and Beekun, 2000; Daily, Dalton and Cannella, 2003) I attempted to derive such a model from four of the theories, which seemed to have some common elements. These theories are: social comparison theory, equity theory, anchoring and institutional theory / legitimacy. A summary of the key ideas behind each of these theories is presented in Figure 3-3.

Figure 3-3 Theoretical approaches underlying legitimacy-comparison theory

Social comparison theory – remuneration committees evaluate executive pay based on a comparison with their own remuneration and other executive jobs elsewhere.

Equity theory – directors judge the fairness of their own remuneration packages based on what other directors in similar positions earn.

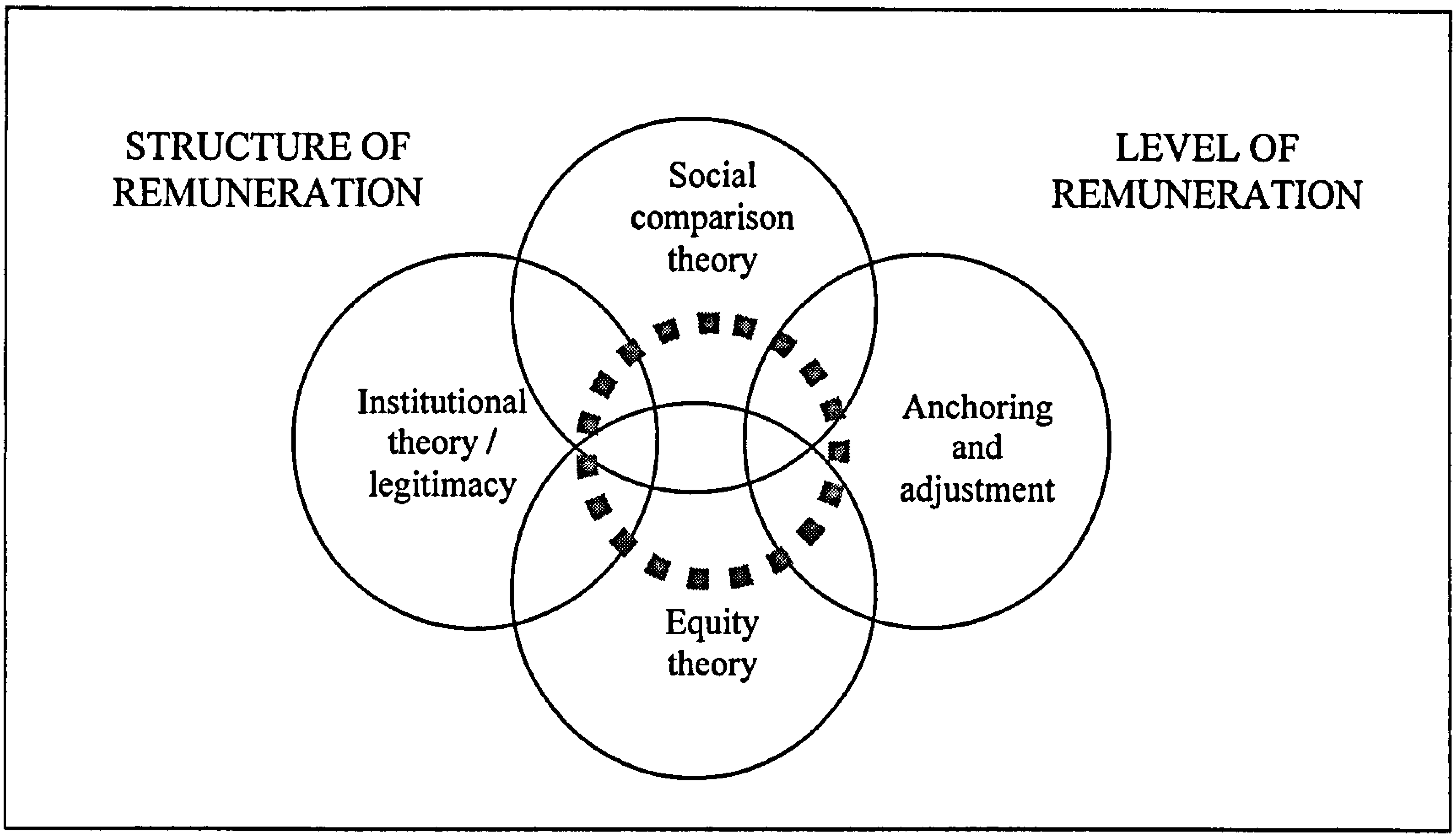
Anchoring and adjustment heuristic ('anchoring') – both the remuneration committee members and the executives will anchor their view of an appropriate level of remuneration based on what they know from other sources.

Institutional theory / legitimacy – homogeneity of practices is explained because companies adopt approaches that legitimise their activities. They follow regulatory directives on directors' remuneration (coercive isomorphism); they look to other companies for best practice (mimetic isomorphism); practices are passed between companies through professional networks (normative isomorphism).

The framework so developed was entitled 'legitimacy-comparison theory' (L-C), because, as will now be discussed, it seemed that the two main influences on directors' pay were (a) whether the remuneration would be seen as legitimate to the stakeholders, and (b) comparisons made by the remuneration committee and by the executives with remuneration being paid in comparable companies.

L-C theory is illustrated in Figure 3-4 below. In this Figure the underlying theories are represented by the interlocking circles[20]. The framework suggests that the level of remuneration can be explained by using a combination of ideas from social comparison theory, equity theory and anchoring. It further suggests that the structure of directors' remuneration can be explained using ideas from institutional theory, with social comparison theory and equity theory also playing a role. The dotted circle in Figure 3-4 represents the theoretical territory covered by the theory.

Figure 3-4 Legitimacy-comparison theory



The following sections explain how the theoretical framework was developed from the literature, and illustrate the connections between the theories used.

3.3.1 Level of remuneration

As noted above, the level of remuneration can be explained by combining aspects of social comparison theory, equity theory and anchoring. O'Reilly et al. (1988),

[20] Although the circles in Figure 3-4 are all the same size, there is no underlying reason for this. Had the model been taken further in the research, they could have been re-drawn to signal greater or lesser input from individual theories.

Main et al. (1993) and Ezzamel and Watson (2002) all noted the connection between social comparison theory and anchoring. Main et al. also made the connection between social comparison theory and wage compression, a form of equity theory. They suggested that top team members need to work well together, and that there is a greater likelihood of this occurring if the team members are satisfied with their pay. Based on social comparison theory and equity theory, they considered this more likely to happen if there is less rather than more wage dispersion.

Miller (1995), observing that remuneration paid is the result of a decision-making process, saw equity theory as providing a link between the compensation literature and the decision-making literature. He noted that directors compare their level of work (inputs) to their remuneration (outcomes) and make comparisons with the relative input/outcome levels of other directors whom they perceive as being in similar positions.

Thus social comparison theory, equity theory and anchoring all contribute to the remuneration literature. Each embodies the suggestion that an external referent is used to determine the level of executive remuneration, although none clearly specifies how that referent is determined, and each contains the possibility of several different equally appropriate comparators.

3.3.2 Structure of remuneration

In addition to determining the level of directors' remuneration, the structure of that remuneration – its gearing, performance measures and targets, and payment methods – must also be determined. Institutional theory (Eisenhardt, 1988; Oliver, 1991; Westphal & Zajac, 1994) provides useful insights into the structure of remuneration, suggesting one explanation for the homogeneity of companies' remuneration schemes, performance measures and targets noted earlier. Such homogeneity could arise through coercive isomorphism (for example, the perceived need for companies to comply with all of the regulatory pronouncements) or through mimetic processes.

Finkelstein & Hambrick (1996), in an extensive review of executive compensation, saw a link between social comparison theory and institutional isomorphism in the work of compensation consultants who disseminate practices and publish comparative figures. They also noted that remuneration within industries tends to follow the same pattern, again reflecting social comparison and isomorphic pressures. However, they cautioned: "... the idea that executive compensation differs by industry because of isomorphic pressures for conformity has yet to be fully tested" (1996: 276). They further stated:

> *Because the notion of comparability leads naturally to an emphasis on social process and the setting of pay in accordance with 'social norms', we should consider ways in which executive compensation is influenced by institutionally driven isomorphic pressures and social comparison processes. (1996: 275)*

The above quotation makes the link between institutional theory and social comparison theory. Figure 3-4 also suggests a link between equity theory and institutional theory in determining the structure of the remuneration. No such link has been found in the literature. However, it seems reasonable to assume that the individuals being remunerated will compare the structure of their pay with that decreed acceptable in other companies, especially those within the same industry.

Thus an association between the two ideas is proposed.

Institutional theorists argue that one reason for companies adopting socially acceptable practices is to gain legitimacy, and this too has relevance in the setting of directors' remuneration. If companies follow the expectations of society in the structure of their remuneration, they are likely to gain legitimacy and thus, as noted earlier, easier access to resources. Legitimacy may also arise through the use of compensation consultants to advise on appropriate remuneration structures. Barkema and Gomez-Mejia, for example, referred to: "... judgements of the committee members, legitimized by the opinions of external consultants" (1998: 141). Further, Gomez-Mejia and Wiseman (1997) observed that compensation survey data are often used to justify and legitimise executive remuneration rather than rationally to determine it. If a company is seen by society as operating outside the accepted norms in paying its directors, its reputation may suffer and this could affect its ability to attract resources.

3.3.3 Legitimacy-comparison theory

From the above observations the proposed L-C theory was developed to provide a possible explanation for level and apparent homogeneity in the structure of listed companies' remuneration packages. It suggests that the level of remuneration is derived from the committee members' and directors' expectations of what is 'reasonable' given their knowledge of pay in other, similar jobs and by reference to pay surveys. Social comparison theory, equity theory and the anchoring heuristic can be seen to be linked to produce an acceptable level of pay. The theoretical framework also provides an explanation of the structure of pay, based on institutional theory and legitimacy. The structure of pay is set with reference to what has 'worked' in other companies and what will be accepted by the domains within which the company operates. As the design of a remuneration scheme is complex, with no obvious 'correct' answer, it is seen as important to follow best practice, as this will be acceptable to outsiders, and legitimise the company's actions.

This may be illustrated by the homogeneity of remuneration schemes and performance targets discussed by New Bridge Street (2003a, 2003b). Prior to the Greenbury and Myners reports in 1995 it was established practice for companies to have share option schemes. Greenbury and Myners suggested that ltips were preferable to share option schemes, and companies began so to make that change (coercive isomorphism). Then, when companies and their consultant advisors realised that ltips also had disadvantages, some companies began to resurrect their share option schemes. Others followed (mimetic isomorphism).

L-C theory was used to guide the initial research approach for this work. However, early in the interview process it was found to be insufficient to explain what was happening in companies.

3.4 Summary of chapter

In this chapter I have introduced two models which guided my thinking in developing a research plan. In the event, neither proved totally appropriate as an explanation of executive pay. In chapter 6 I explain how the process model can be adapted as a representation of what happens, and discuss how L-C theory proved to be insufficiently sophisticated to capture what was happening.

4. THEORETICAL AND METHODOLOGICAL APPROACHES, AND WORK DONE

4.1 Introduction

This chapter sets out my philosophical stance in approaching this work, explaining how the research question and its design fit my philosophical approach.

It then goes on to describe in detail how the research was carried out, using a design of multiple case studies with the unit of analysis being the company. In this section I explain how I started with legitimacy-comparison theory held lightly in mind. This was not borne out by the empirical findings, and the work then progressed inductively, using some of the techniques of grounded theory. The chapter ends with a discussion of the rigour of the research (within its own ontological paradigm), considering the validity and reliability of the results.

4.2 Philosophical approach

As explained in the preamble in chapter 1, I became interested in this research problem when trying to understand how companies determine the pay of their executives. I found no satisfaction in the many research papers on the subject, and was initially at a loss to understand why this should be. It was only when I became familiar with the different philosophical approaches to research that I understood the problem: most of the body of existing research approached the subject from a positivist point of view, and this was not my stance. They were asking more of a 'what' question; I wanted to look primarily at 'how and why', and the rules differed.

4.2.1 Different rules

In defining a philosophical stance, one looks to both ontology and epistemology. Blaikie (1993: 6) defines ontology as: "the claims or assumptions that a particular approach to social enquiry makes about the nature of social reality". It is necessary to have considered what 'reality' looks like before starting to research it. Having determined an ontology, an epistemological stance needs to be established. Again we can turn to Blaikie for a definition: "the claims or assumptions made about the way in which it is possible to gain knowledge of this reality": given what we see as reality, how can the researcher gain evidence of it? This needs to be done to establish a coherent approach to the research, selecting an ontology, epistemology and methodology that are aligned (Burrell and Morgan, 1979: 3).

Although research in the natural sciences (as understood by many social scientists) works on the basis that 'The Truth Is Out There'[21], that paradigm is not universally followed in the social sciences. For example, Easterby-Smith et al. (1991: 22) refer to two extremes in research philosophy: the 'blue corner' of positivism, adopting the approach of natural science, and the 'red corner' of phenomenology, which sees reality as socially constructed rather than objectively determined. Between these lies an array of different philosophical stances, with differing views of reality and how it can be known. These have been described (using different labels) by, inter alia, Burrell and Morgan (1979), Morgan and Smircich (1980), Ryan, Scapens and Theobald (1992), and Tsoukas (1994). Some of these authors set out their arguments as on one side or the other; others present

[21] A slogan from the 20th Century Fox television series, The X-Files.

a continuum of views. This continuum is discussed by Morgan and Smircich (1980: 492), who say:

> *[T]he transition from one perspective to another must be seen as a gradual one, and it is often the case that advocates of any given position may attempt to incorporate insights from others.*

4.2.2 My research philosophy in approaching this work

All FTSE companies are apparently doing much the same thing with their executive pay; the aim of this research was to find out the extent to which they were doing it in the same *way*, and for the same *reasons*.

Years of working in corporate audit and investigation have led me to believe that although companies often do the same things, they do them for different reasons. Whilst there are certain objective facts (for example, the amount that directors are actually paid) examining these will not shed light on the processes behind the pay-setting decisions. At the extreme, each company provides its own context; within each company, each of the actors has his or her own background, understanding and prejudices; accordingly, each decision is different. Thus, a company can only be understood in its own context, from which it follows that there is no reality independent of such context. To quote Pettigrew (1992a: 9): "processes are embedded in contexts and can only be studied as such". At the same time, not everything is context: the facts of 'what happens' matter too.

It is helpful here to consider these issues in the light of the arguments of Mouck (2004). Referring to the work of John Searle, he makes a distinction between epistemological objectivity and subjectivity, and ontological objectivity and subjectivity. The following table, based on Mouck's work, highlights the differences in the concepts.

Table 4-1 Distinctions of reality

	Objective	**Subjective**
Epistemological	The truth or falsity of the statement is not dependent on attitudes or feelings. *Example: the director was paid a salary of £300,000.*	The truth or falsity of the statement depends on an individual's attitudes or feelings. *Example: I think £300,000 is too high a payment for the job.*
Ontological	Ontologically objective entities exist independently of the perceiver or any mental state. *Example (Mouck page 529): atoms, electrons. (No remuneration-related examples could be found.)*	The existence of ontologically subjective entities depends on the mental state of the perceiver. *Examples: remuneration committees, the Combined Code, tax laws, all of which exist as a social construction.*

Thus, although some of the outcomes of remuneration-setting will be epistemologically objective, I am largely working in realms which are socially constructed and subjective, the "ontologically objective" being a realm not affected by human intentionality.

Accordingly, for this research I take the view that reality is constructed and interpreted rather than objectively determined. This position is set out by Easterby-Smith, et al.: "Human action arises from the sense people make of different situations, rather than as a direct response from external stimuli" (1991: 24). Given that, I expect each of the protagonists in each of my companies to have a different perspective on the pay-setting process, just as I will have a perspective on their perspectives. To quote Easterby-Smith et al. again, my aim is to "appreciate the different constructions and meanings that people place upon their experience" (1991: 24).

Thus, although statistical analysis has great use as a research tool in some contexts, it would be the wrong tool for this examination of process. I see knowledge in this area as coming from in-depth discussions with the actors involved, each with their different perspective, to try to construct a coherent and consistent view, but contextually aware. Further, as regards the knowledge collected, this can only be gained in respect of the units examined, and not for a generalisable whole: people and contexts differ. At the same time, certain regularities cannot be ruled out, and may indeed emerge.

If I had to put a label on my philosophical approach, I would follow Crotty (1998: 42) and describe my stance as constructionism. He describes this epistemology as follows:

> *What is constructionism? It is the view that all knowledge, and therefore all meaningful reality as such, is contingent upon human practices, being constructed in and out of interaction between human beings and their world, and developed and transmitted within an essentially social context.*

Crotty (p8-9) argues that this philosophical stance means: "there is no objective truth waiting for us to discover it", and "[m]eaning is not discovered, but constructed". However, he makes the point that constructionism differs significantly from 'pure' phenomenology. Individuals place a social construction on events in order to create their own version of reality, but they do not do so in a vacuum: they build on the basic facts and situations that they find. As he says (p42-3): "The world is always already there". The basic facts exist "pregnant with potential meaning", but it is to the individuals to make that meaning, and for the researcher to interpret it. The researcher, of course, is inevitably constructed as him- or herself, but is a sense-maker who can construct interpretations from that ground.

4.3 Methodological approach and research design

4.3.1 Overall approach

Given the above discussion of my philosophical approach, it seemed appropriate for me to adopt a qualitative methodology. In looking at process, I saw little that could be done with 'hard' data, since I needed to find out about the individuals involved, and how they saw their roles.

Initially I considered using a questionnaire to elicit these responses. However, I very soon dismissed this idea as impractical, and turned to interview-based case studies as the most suitable research method for this study. There are many reasons why this method was an appropriate form to address this research question. The question dealt with the nuances of what happened in companies, in an area that had seldom been researched before. It would be difficult to establish how companies operated primarily by using archival or survey data, although such data can help clarify sectoral context. Furthermore, the subject matter was very politically sensitive, and it was unlikely that the participants would have responded as freely – if at all – to another form of research such as questionnaires or group interviews (Easterby-Smith et al., 1991: 74). And, given my research paradigm, I was encouraged by Yin:

> *The case study is the method of choice when the phenomenon under study is not readily distinguished from its context. (1993: 3)*

Although most previous research in this area has taken the form of data analysis, a powerful argument has been made for getting closer to the subject by using, amongst other research methods, interviews. The quotations (e.g. Kerr and Bettis, 1987; Tosi and Gomez-Mejia, 1989) set out in chapter 1 illustrate the need for research into process. More recently, Werner and Ward (2004: 220), in their extensive review of the compensation literature, comment that the overwhelming use of secondary data in studies of executive pay has resulted in a "paucity of research focusing on behavioral and attitudinal aspects of CEO pay".

Pettigrew (1992b: 178) argued that there is a need for research to "redress the overwhelming prescriptive bias in the literature" in order to find out more about how boards actually work. This argument was taken up by Stiles (2001), who commented:

> *There is, therefore, a very small body of primary research on boards of directors from which to draw any methodological insights. We argue that to understand the nature of boards in operation, we must have the reports of directors themselves. This article is therefore grounded in the perceptions of main board directors through the use of semi structured interviews. (2001: 631) [emphasis in original]*

Although the arguments for interview-based research with directors are powerful, one reason for the dearth of studies in this area might be the difficulties of accessing this elite group (Winkler, 1987; Pettigrew, 1992b). Directors of listed companies are busy and powerful people, who have no need to give their time to research studies. Accordingly, the study commenced in the knowledge that this might prove a constraint. (The sample frame was changed during the study as a result of this, as described later.) And even if access is obtained, actually conducting interviews with elite subjects is in some ways more difficult than conducting other types of interview. Hill (1995) and Easterby-Smith et al. (1991) both discuss the difficulties of interviewing when the interviewee has considerably more status than the interviewer: the discussion may tend to follow the pattern determined by the interviewee rather than the interviewer.

Despite these constraints, an interview-based case method seemed a logical approach to adopt. I then had to understand its strengths and limitations, and to adapt it to my research context. The next sub-section discusses interviews as a research method.

4.3.2 The face-to-face interview as a research method

> *Interviews are not neutral tools of data gathering but active interaction between two (or more) people leading to negotiated, contextually based results.*
>
> *Fontana and Frey (2000: 646)*

The interview is a powerful tool with which to obtain information about process, but it is not a neutral research method. I knew from my experience in due diligence investigations that the interaction between interviewer and interviewee is crucial: if a good bond is formed, the conversation can be broad and illuminating; if there is some personal distance, then the discussion will be less wide-ranging.

Fontana and Frey (2000: 647) discussed this, pointing out that the context of an interview can shape its outcomes:

> *Each interview context is one of interaction and relation; the result is as much a product of this social dynamic as it is a product of accurate accounts and replies.*

And

> *The nature of the social dynamic of the interview can shape the nature of the knowledge generated.*

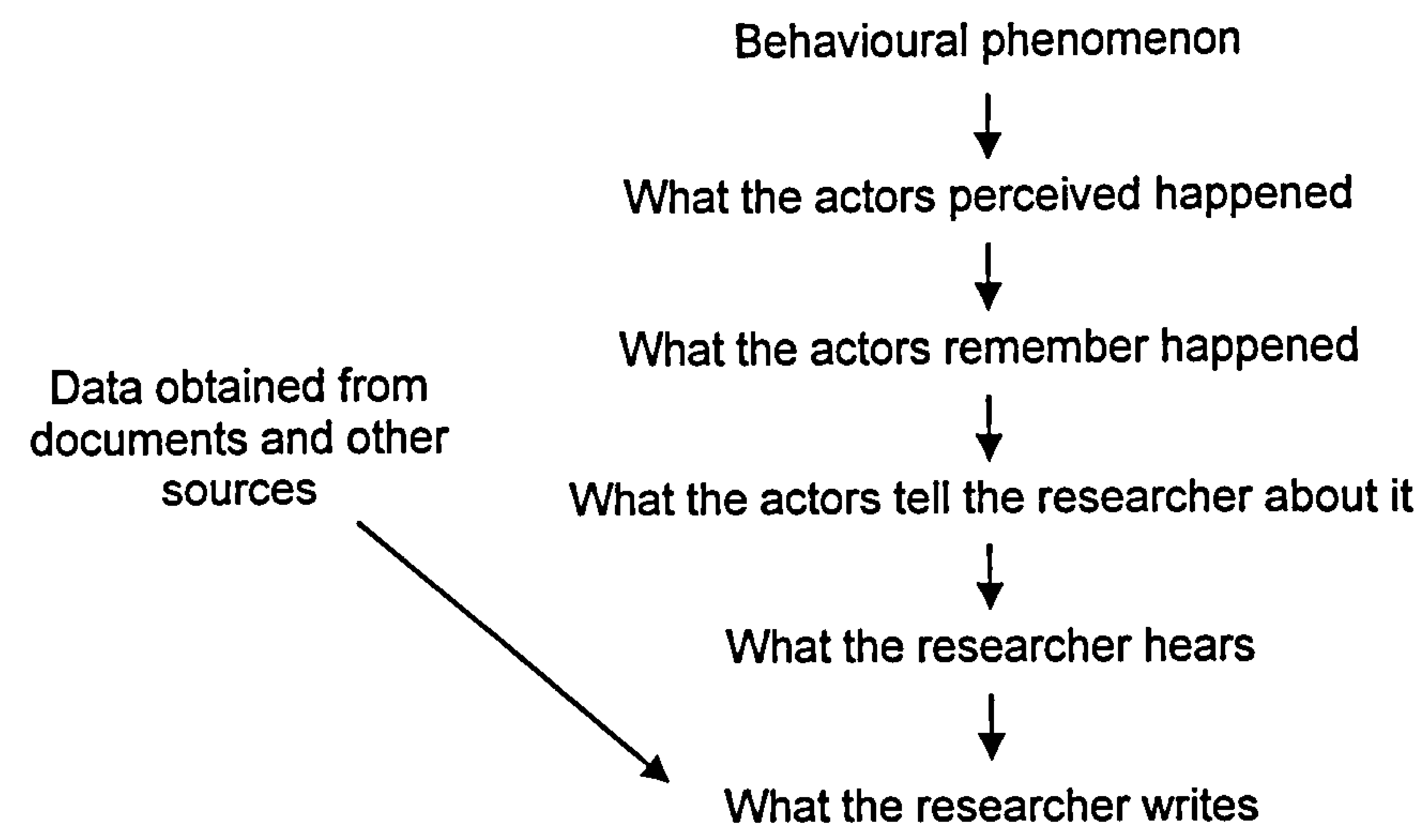
Silverman (2001) also elaborated on the personal nature of interviews. He explained that the questions and answers are not "passive filters" but themselves shape the understanding. He stated that the:

> *... interviewer and interviewee actively construct some version of the world appropriate to what we take to be self-evident about the person to whom we are speaking and the context of the question (2001: 86) [emphasis in original]*

Thus the shape of the interview reflects the both the interviewee's view of the subject, and their beliefs regarding the interviewer's understanding. Furthermore, the latter's understanding colours the interpretation of the interview material. Additionally, the interview is set in the context of the characteristics of the two parties. In my case, I know from past experience that gender can be an issue: I have experienced occasions in my professional life when I have obtained more – or less – from an interviewee than has one of my male colleagues, because a powerful interviewee was unaccustomed to being interviewed by a woman of status. This situation in a research context is discussed by Fontana and Frey (2000: 865).

Given all of the above points, Figure 4-1 represents how I see the interview process.

Figure 4-1 The interview process



Source: author

In line with the philosophical approach stated earlier, there are some facts underlying the process – 'what actually happened' is that a decision was made to implement a certain scheme or pay a given amount of money. However, each of the interviewees will have perceived this differently at the time, will remember different aspects of the process, and will select different things to discuss during the interviews. As Weick (1995: 11) suggests, they will start with the outcome – the remuneration choices that were made – and will render that outcome sensible to themselves, selectively editing the events to produce a plausible story of how they arrived at those choices[22]. It is my job as researcher to distil the commonalities and differences in their accounts and to understand their totality as best as possible across these filters. I also have to manage this process and present the results in such as way as to minimise the prejudices of my own social pre-conditioning.

[22] Furthermore, drawing again on Weick (1995: 30), it is possible that because all of the companies had 'good' schemes (not criticised by institutions or executives) there is a possibility that they will have retrospectively identified that with the idea that they must therefore have had 'good' processes, and this will have influenced their accounts.

4.4 The research process

4.4.1 Overview

In the rest of this chapter I discuss the research process, from the initial investigations through to theory development. In order to put this into context, Table 4-2 sets out a chronological overview of the process, and Table 4-3 displays the numbers and descriptions of the interviewees. Both are expanded upon in later text.

Table 4-2 Overview of the research process

1997-2004	Literature review
1998-2000	Informal interviews with consultants, institutions, an HR director
Sept-Dec 2001	Preparation of interview guide and sample frame
Dec 2001	Commenced pilot studies
April 2001	Commenced finding companies for main study
July 2002	Sample strategy amended due to Remuneration Group introduction
March 2002	Commenced formal data analysis
April 2003	Company interviews completed
Oct-Dec 2003	Writing up and theory generation
Feb 2004	Respondent validation with focus group

Table 4-3 Number and categories of interviewees

Interview category	**Number**
Data gathering	
Companies and their consultants	35
Additional views (outside the unit of analysis)	
Remuneration Group	*1
Institutional professional bodies	1
Headhunters	2
Confirming initial theories	
Focus group of remuneration professionals	*1
Total (*inc two groups)	40

The interviews took place between December 2001 and August 2003. This was an eventful time in corporate governance, and there were several developments in the remuneration arena. Appendix 3 sets out how the timing of the interviews related to the external environment.

4.4.2 Preliminary investigations

The empirical work underlying this thesis commenced informally some time before I registered for the PhD, interviewing various individuals connected with the remuneration-setting process. In 1998 I obtained an introduction to a leading institutional shareholder with an interest in corporate governance and conducted two unstructured interviews, one with a director and one with a senior manager. Having commenced the literature review at that stage, the purpose of these interviews was to establish how the institutional shareholders viewed the debate on directors' remuneration, who they saw as the key players, and what their role was in appraising companies' remuneration schemes.

The next set of interviews was with individuals from a large firm of remuneration consultants. Initial discussions with one of their partners were supplemented by an unstructured interview with a senior remuneration consultant. The purpose of that interview was to establish, for the benefit of the future research project, how the consultants obtain their work and what it is that they do. The unstructured questions were supplemented by showing the consultant a list of factors (an early version of the list displayed in Figure 2-2) to determine if these were relevant to their deliberations. A later interview with another remuneration consultant built on this list of factors by using a repertory grid approach in comparing the schemes and characteristics of the consultant's clients. This confirmed the intended approach to the main research project.

Having interviewed institutions and consultants, a further unstructured interview was conducted in 2000 with an experienced HR director, who had held that position in FTSE 350 companies. The aim of this interview was to obtain his view on the remuneration process generally, the intended research approach, and some of the theories which had been put forward in the academic literature. This individual is a personal friend, and the interview was particularly wide-ranging.

During 2000 and 2001 I continued my informal investigations into how people saw the research subject and their views on my intended research approach. This work included discussions with non-executive directors attending a course on corporate governance; discussions with fellow participants at a seminar on senior remuneration; and discussions and a semi-structured interview with a colleague who sits as chairman of the remuneration committee on an AIM-listed company.

There were several advantages to undertaking this preliminary work. Firstly, it grounded me in the complexities of the phenomenon under investigation. It also confirmed that the proposed research would be relevant to both practitioners and academics. Furthermore, the interviews gave me experience which proved invaluable when designing the interview guide and undertaking the research fieldwork.

4.4.3 The choice of interviewees

As stated earlier, the unit of analysis for this study was the company. From the understanding of the process generated by the initial investigations and the review of the literature, I determined that there were five key parties involved in a company's remuneration-setting process:

i. the chairman of the remuneration committee[23];

ii. the other non-executives on the remuneration committee;

iii. the HR director;

iv. the CEO; and

v. the remuneration consultant employed by the company.

The research design was to interview five individuals from each company, representing each of these categories. In this it was intended that a rounded picture would be obtained of the process in each company. I was very aware that in interview-based research on such a potentially sensitive subject there was likely to be distortion in the discussion, as individuals remembered different aspects of what had happened, and chose to tell their stories in different ways. As Piore (1979: 566) stated:

> *You can never believe the answer to a direct question about behavior, or, more crudely, "businessmen always lie". This interpretation, however, suggests that this law misses the point: what interviews can reveal is not a set of specific answers to specific questions, individual bits and pieces of information. What they reveal are <u>patterns</u> of responses. Each answer, whether true or false, is a piece of that pattern. Individual responses cannot be interpreted in isolation. But the responses grouped together, and taken as a whole, are clues to the mental processes of the economic participants. [emphasis in original]*

[23] Of all of the interviewees, only five were female. Accordingly, in order to preserve confidentiality of company and individual, the masculine form is used to describe all of the participants and their roles.

Although each participant would have constructed his own interpretation of what happened, by designing the research to have several different interviewees from each company a pattern could be established.

In addition to the semi-structured interviews, a review of relevant documentation was also seen as part of the fieldwork process. Companies generate a considerable amount of documentation surrounding the remuneration process, for example: the published remuneration report; scheme details; minutes of the remuneration committee meetings; and consultants' reports. Reviewing this documentation, together with other public domain information such as media reports on companies' remuneration, was a method of extending the interview data.

4.4.4 Selecting the case study companies

From the above discussion it is clear that this research is not generalisable in terms of corporate behaviour; there is no suggestion that the findings can be extrapolated into a wider population. However, as Yin (1994: 31) points out, case study research can be generalisable into theory. Analytic generalisation involves comparing the empirical results of one case study with theory developed from other cases. There is a replication logic if the cases support the same theory.

In an ideal world, the multiple case studies would be selected serially, each one being chosen to serve a specific purpose, aiming either to predict similar results or to produce contrasting results for predictable reasons (Yin, 1994: 46). Strauss and Corbin (1998: 201) refer to this as theoretical sampling, and discuss how the sample evolves during the research process. The results of one case study would guide the choice of the next. However, such an approach was not practical for this study. The time limits on the research funding and on the PhD, together with the uncertainty of being able to gain access to the elite groups, meant that all of the cases were selected in a relatively short period, although the interviews took 16 months.

The research focused on FTSE 350 companies. There were two reasons for limiting the study to these large companies. Firstly, such companies are more likely to comply with good governance principles (Hampel, 1998: 1.10) and there seemed little point in researching companies which had poor governance practices. Secondly, the bulk of the literature on directors' remuneration relates to larger companies (Carr, 1997), and it was felt appropriate to restrict the study to companies similar in size to those studied by previous researchers.

The original research design was to select eight case study companies (including a pilot study), four each from utilities and the finance sector.

The reason for choosing utilities was twofold. Firstly, in considering directors' remuneration in the UK, utilities have an interesting place in history. It was primarily the generous packages awarded to the directors of the newly-privatised utilities that led to adverse public and government attention that ultimately resulted in the setting up of the Greenbury study group, which produced its influential report on directors' remuneration in 1995[24]. Utilities were the perceived home of the original 'fat cats', although much has changed in the sector since that time.

A second reason for choosing utilities as a context for the case studies is that profits in that sector are heavily influenced by a regulator, who makes a regulatory review at five-yearly intervals and effectively wipes out the companies' economic profit potential in their regulated businesses, re-setting prices at a level which is intended to be sufficient only to cover the cost of capital (Ofwat, 2002). As at least part of remuneration is linked to profit in the majority of companies (New Bridge Street, 2003a) the way in which utilities structure their remuneration to adapt to this constraint is also of interest.

Finance sector companies were selected as being at the other end of a scale to utilities. They pay much higher levels of pay than do utilities, but historically there has been less outcry at their pay levels[25]. Furthermore, although the industry is regulated, profits are not, so they do not face the same constraints as utilities.

Having determined that the case study companies would come from these sectors, the next stage was to identify potential companies. This was done using the PricewaterhouseCoopers Corporate Register CDROM dated June 2001. For the utilities sample, searches were run on companies in the Gas distribution, Electricity, Water and Fixed line and wireless telecoms sectors in order to find

[24] There is even a section in the Greenbury report – section 8 – relating specifically to privatised utilities.

regulated utilities in the FTSE 350. For the finance companies, selection was more difficult, as there is no obvious 'finance' sector on the CDROM. Accordingly, 12 separate sectors with some relation to finance were searched.

The searches produced a potential sample frame of 15 utilities and 37 finance companies. Any of these would have met the criteria required for the research, being in the relevant sectors with no obvious defects in their corporate governance (i.e. all of the companies had the requisite number of non-executives and governance committees). In deciding which companies to approach, an analysis was done to identify companies 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 (Stake, 2000: 446). The result of this analysis was that the 'ideal' target companies were reduced to a total of 29: 13 utilities and 16 finance. Financial statements were requested from all of the companies, and the remuneration reports reviewed[26].

4.4.5 The interview guide

Before the interviews could commence an interview guide was developed, based on research aims, in the light of the conceptual framework of legitimacy-comparison (L-C) theory developed from the literature. A copy of this interview guide is included as Appendix 4. In order to establish which inputs were

[25] In the last couple of years, institutional comment has become more pointed for all types of company. However, in the context of this research design the remuneration of finance companies was not a significant issue at the time.

[26] At this point an analysis was done on the remuneration reports of all of the companies in the sample frame. This confirmed that the finance companies on average paid considerably higher remuneration than the utilities, with proportionately more of that being performance-related. That analysis is not reproduced in this thesis as it has no bearing on the research question.

considered important to the decision, a brief questionnaire was designed, to be left with the interviewees and returned by post. This is set out in Appendix 5.

It should be noted that the interview guide was used as a prompt to the conversation rather than followed in detail in each interview. Furthermore, the original plan of sending it to participants in advance was thwarted because several of the HR professionals, my contacts at the companies, did not pass the document on to the directors I was interviewing. There appeared to be no difference in the quality of the interview between those who did have the document in advance and those who did not: in all cases the interviews were wide-ranging, covering far more ground than the bare bones of the interview guide.

As Bryman states (1989: 25), qualitative research aims to "capture people's perspectives and interpretations". The qualitative researcher "seeks to elicit what is important to individuals as well as their interpretations of the environments in which they work". With this in mind, my interview technique was to start the conversation using a topic of relevance to the interviewee (often by asking about a change that had been made in the remuneration schemes, to give them a critical incident on which to focus) and then to follow their conversational direction. In all of the interviews the main points were covered, but this interview technique meant that much more was covered as well, and the areas of significance to the interviewee were highlighted. In this respect, the interviews were towards the unstructured end of a continuum, as described by Bryman (1989: 147).

4.4.6 The pilot studies

Having determined the sample frame, it was time to find a company willing to participate as the pilot study. It was anticipated that this would prove difficult, as writers on elite research always note the problems with gaining access (Winkler, 1987; Pettigrew 1992b). Accordingly, I decided to approach two utilities in the first instance, anticipating rejection from both of them but intending to learn from that experience. As it happened, telephone calls to both companies produced positive responses within a week of the initial contact[27]. Rather than put off a company which had agreed to participate, I decided to run two pilot studies at the same time.

Interviews at the pilot study companies commenced in December 2001 and were mostly complete by early March 2002, although one director could not be seen until the April. The work provided me with a steep learning curve into the intricacies of remuneration schemes, which was very useful[28].

One outcome of the pilot studies was that legitimacy-comparison theory was found to be lacking. Of its four underlying theories (social comparison, anchoring, equity and institutional theory) minimal evidence was found to support social comparison theory, and evidence was found that conflicted with this approach. Furthermore, having entered data collection, other theories – for example, agency theory – appeared more relevant. Accordingly, this lightly-held theory was dropped, and a more inductive approach was adopted.

[27] Once companies agreed to consider participation, I followed up the call with a written explanation of the research. This was done for the main study as well.

Despite the change in approach, the original interview guide remained appropriate as a basis to continue the research. This research approach, using the guide as a prompt to draw reflections from the interviewee, had worked well, and the interviews at the two pilot companies had unearthed a wealth of information about how companies determined their pay.

4.4.7 The main study

Although it had been easy to access the two pilot studies, it was much more problematic to obtain another six companies for the research. For the pilots, I had initially attempted to telephone the chairmen of the remuneration committees, but had immediately been passed to the HR professionals as a more appropriate gateway. Accordingly, for the main study I was cold-calling the HR directors or compensation managers of the target companies.

Cold-calling commenced in April 2002, but with little success. During that month 12 companies were contacted, but of these only one agreed even to consider full participation[29]. In one company the HR director stated that his company would not participate, but agreed in a spirit of generosity that he personally would be interviewed (this became company 3 in the fieldwork). Furthermore, since the sample frame had been selected there had been mergers and acquisitions in the finance sector and particularly in utilities, reducing the number of companies available. By early July I had the provisional agreement of one other company,

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[28] This work was published in Bender (2003).

[29] Varied reasons were given for non-participation. In some companies the HR professional professed to be interested but stated that he would not get the permission of his CEO/board; in some, time constraints were the reason. In one company the HR professional replied to the effect that his remuneration committee and executives would not discuss the subject openly between themselves; so there was no way they would do so with an outsider!

and had interviewed the HR director of company 3. Summer was approaching, when directors were likely to be on holiday. Consideration had to be given to whether access difficulties would prevent completion within the timeframe allowed.

In early July another HR director was interviewed. He had agreed to participate in the research, but had stated that he would not put the project forward for consideration by the other target participants. However, during that interview I persuaded him to let me interview others at the company. Also during that meeting he mentioned the Remuneration Group, a group of remuneration professionals at FTSE 100 companies who met regularly to discuss what was happening in their field. I realised that contact with such a group could solve my access problems.

The HR director was not prepared to allow me direct access to members of the Remuneration Group, but was prepared to distribute a letter to them. The text of that letter is set out at Appendix 6.

In writing to the Remuneration Group, I was conscious that this meant two changes to the research design. The original design had involved companies in the utilities and finance sectors; this would broaden the sample to include companies in other sectors. Furthermore, the original design was to interview five people at each company; it will be seen from Appendix 6 that the invitation to the Remuneration Group offered the chance for just the HR professional to be interviewed instead.

Much consideration was given to these changes to the research design. The first change was the simpler. Having interviewed people at three utilities and one finance company, and within that having discussed remuneration with two consultants who had wide experience, I realised that utilities were different, not just from finance companies but from all other companies. Utilities form a unique subset both due to their history as privatised companies and due to the regulator's influence on profits. Accordingly, they are of interest as case studies for a particular context. However, finance companies are no different from other companies as regards the influences on their remuneration-setting processes; once this was understood there was no need to limit the sample base. A second reason for broadening the sample base was that access to the Remuneration Group was a one-off chance, and it seemed appropriate to take advantage of the opportunity that had presented itself. This opportunistic practice is accepted in the research literature when access is difficult (for example Silverman, 2001: 249; Bryman, 1989: 162; Blaxter, Hughes and Tight, 2001: 163; Miles and Huberman, 1994: 28).

As for allowing the Remuneration Group to participate selectively in the research, with just the HR professionals taking part, the reason was different. Many of the companies that had rejected the research had done so because although the HR professional was interested, he or she had stated that there was no way they could persuade the CEO or non-executives to participate. In the event that the research question and design might have to be changed to reflect lack of access to higher echelons, it was felt that allowing selective participation gave more flexibility.

By continuing with the original contacts, and using the Remuneration Group, the final research sample for company interviews is set out in Table 4-4.

Table 4-4 Company interviewees by job category

Co	HR professional	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

Of the 12 companies, four were utilities and eight were from other industry sectors; nine were in the FTSE 100 index and three from the FTSE 250.

Given that the original design was five individuals in each of eight companies, it is worthwhile drawing attention to several issues in relation to this sample.

- In company 5 the company chairman played a significant role in the process, and so was an appropriate person to interview. I could not interview the committee chairman in this company: over a 12 month period several diary dates were made and then cancelled. The committee chairman has since (amicably) left that company.

- I originally had agreement for a full range of interviews at company 6. However, for nearly three months after the original interviews they failed to return my calls and emails, so the company was dropped.

- For company 7 there were seven interviewees. The directors of this company were very interested in corporate governance, and asked that I interview more people there.

- For company 8 I originally had agreement to interview the full range of protagonists. However, after I started the research the company entered into a significant M&A transaction, and the directors had no time for the research.

- Companies 3, 9, 10, 11 and 12 only ever agreed to one interviewee participating.

- The interviewees at companies 11 and 12 were approached after expressing interest in my research, following a paper I presented at a conference setting out the results of my pilot studies (Bender, 2003).

- In some instances the interview was conducted with more than one interviewee at the same time. Where the individuals had very similar backgrounds and views, this was treated as being one interview; where they differed they were counted as individual interviewees. For example, in Company 10 the interview was actually with three people, but the two more junior deferred to the senior; the two interviewees in Company 6 were part of the same interview.

Given my philosophical approach, that the individuals' experiences are socially constructed, and that the interview process itself forms a unique context, how can I be certain that the research results are valid in those companies for which I had only one or two participants? The answer, of course, is that I cannot. However, in the companies where I had several participants, their accounts differed in matters of nuance (and in some cases, in detail), but not in their fundamental thrust. Likewise, the narratives of all of the interviewees were similar in their accounts of how remuneration was set. From this I can infer that further interviews in these companies were likely to provide similar accounts, although a larger number, with more narrative strands, would have been preferable.

I also had to consider whether the number of companies participating in the research was sufficient. For qualitative research where there is no intention to generalise into a population, 'sufficient' is not a clear concept. Miles and Huberman (1994: 30) ask the question: "How many cases should a multiple-case study have?". They argue that there is no statistical justification for an answer to this question, and suggest that there need to be enough to give confidence in the results, but not so many as to be unwieldy. Pettigrew (1992a: 11) suggests between six and 10 studies is sufficient; Eisenhardt (1989b: 545) states that a number between four and 10 usually works well.

As regards this research, I noted in my research diary in October 2003: "Yesterday I interviewed at [Companies 4 and 9]. I couldn't help feeling 'heard most of this before". With the same issues arising at each company, and much the same types of explanation being given, I became confident that I had reached saturation, and that although interviewing at more companies would continue to be fascinating, it would not greatly advance my understanding[30].

4.4.8 Review of documentation

The original research design included a document review. The published remuneration reports for all the companies were reviewed, for the current and previous year, as was any press comment on their remuneration arrangements in the past year. Biographical details of the interviewees were checked before each meeting. However, access to internal documentation proved very difficult. Surprisingly, although companies were prepared to make individuals available for interview, they were reluctant to let me review documentation, even on their premises. Those individuals who explained their reasons for this suggested that it was because minutes contained sensitive information[31]: I have no way of knowing if this was the only reason, or if there was any difference between the companies that agreed to a review and those that did not.

Ultimately, internal documentation was reviewed as follows:

[30] In using the term 'saturation' I refer to the raw data, not to the analysis thereof as discussed by Strauss and Corbin (1998: 136).
[31] For example, about individuals, often below board level.

Table 4-5 Documentation reviewed

Company 1	Scheme legal documentation was made available to take away. One set of remuneration committee minutes and supporting documentation (including a consultants' report) was inspected at the company's premises, with the compensation and benefits manager present to explain the background to the discussions. A copy of the appendix to a consultants' report was made available to take away.
Company 2	Scheme legal documentation was made available to take away, as was the CEO's service agreement and two consultants' reports (same consultants, at different dates). One set of minutes was emailed to me as an example of how they looked.
Company 5	Minutes for two years were reviewed at the company's premises, with supporting documentation where attached, as were two internal reports on remuneration and one consultants' report and the slides from one consultants' presentation. The company secretary was present whilst I reviewed the documentation, and checked my written notes at the end of the meeting, to see that I was taking away no information that was confidential to individuals.
Company 7	Minutes for over a year were reviewed at the company's premises, together full supporting documentation, consultants' reports, details of institutional shareholders' and professional bodies' views, and legal scheme documentation. I was allowed access to these documents without supervision; the main constraint was that less than two hours was available to review all of the documentation, so I had to be selective.
Company 8	One brief internal HR report to the remuneration committee was emailed to me as an example of the documentation.

The scheme details for directors' remuneration policies are of course public documents, available on request to the company secretary. Had it been felt to be necessary, the formal documentation for all of the companies could have been obtained through this route. However, having examined carefully the scheme details for companies 1 and 2, I concluded that in terms of answering the research question there was little to be obtained from these legal documents. This was confirmed in the later review of documentation for company 7.

Additional documentation reviewed included the remuneration reports in the annual accounts published after my fieldwork. Thus for most companies I reviewed two sets of reports leading up to the fieldwork, and one subsequent. The advantage of reviewing the subsequent reports was that these were published after the Directors' Remuneration Report Regulations (2002) came into force. Thus they contained a great deal of information, which I could check against what I had been told. (In most cases the published reports confirmed what had been discussed in interviews.)[32]

The latest remuneration reports were also scrutinised to extract details of schemes, and of levels of potential and paid bonus, as well as information about directors' shareholdings.

4.4.9 Additional interviews

The Remuneration Group

Having obtained access to the Remuneration Group, they asked if I would present my preliminary findings at one of their meetings. This I did in March 2003. There were about 26 members of the Group at the meeting, including HR professionals, corporate communications directors and company secretaries. I used the meeting to obtain feedback on my initial ideas about the remuneration-setting process and about pay-for-performance. It provided clarification of some of the issues raised during the company interviews.

[32] One area of difference was in the number of remuneration committee meetings: not only did many of the interviewees recollect different numbers of meetings in a year, but generally these recollections differed from the published figure. Although at first this concerned me, I quickly realised that I could not actually recall the number of meetings I had attended on my own

Institutional professional bodies

Although the main focus of the research was the companies themselves, it was always the intention to conduct some interviews with others involved in the process. In particular, shareholding institutions were seen as very important to the process (Holland, 1996; 1998). Accordingly, once the bulk of the interviews had been concluded, an interview was arranged with an institutional professional body. This interview was conducted in the same way as those with companies, but with the emphasis of the questions being on the institutions' role and that of the professional bodies.

Headhunters

Following a presentation I made at a corporate governance conference, a partner in a major executive search firm contacted me about the research. This led to my interviewing two partners in that firm. The focus of this work was primarily on the headhunter role, and on how companies tailored packages to incoming executives. This added greatly to an understanding of the process.

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remuneration committee (for the local Council), and this detail did not affect the interpretation of the data.

4.4.10 Respondent validation using a focus group

Following the data analysis, I contacted selected members of the Remuneration Group to ask if they would attend a feedback session at which I would present my research findings. The purpose of this group session was to validate the research data once the theories had been developed (Flick, 1998: 116).

The focus group session was run in February 2004 with three members of the Remuneration Group, who had considerable experience as remuneration managers and advisors. One of the participants had been an interviewee in the original research. A discussion lasting about 90 minutes covered all aspects of the research, and the participants were asked to explain areas for which I needed explanation, and encouraged to contest research findings that jarred with their own experience. This proved a valuable supplement to the research.

4.5 Analysing the data

In addition to detailed notes taken during the interviews, all but three of the interviews were taped, using both a cassette recorder and a digital recorder to ensure that a full record of the meeting would be available[33]. I transcribed the majority of the interviews myself, to protect the confidentiality of the participants. Transcripts were sent to the interviewees for confirmation, and errors corrected where requested.

[33] One of the interviewees was not prepared to be taped, and one of the interviews happened 'spontaneously' whilst reviewing documentation. For one interview, both forms of recording failed. In all cases, full notes were taken of interviews.

Immediately after each interview a brief write-up was done, from the narrative notes, that set out the key points of the meeting and my impressions of how it had gone. This served to capture initial impressions, and as a useful aide memoire during the course of the fieldwork and analysis.

The transcripts, together with other research documentation (such as summaries of minutes), were analysed using NVivo to manage the data. An initial coding structure was drawn up (Miles and Huberman, 1994: 58), based on knowledge of the literature and the tentative theories held at the start of the process. The initial categories were Inputs (to the process); Theories (put forward by previous researchers, which included the components of L-C theory); Processes (of determining pay, including the roles of the different parties); and Policies and Packages (relating to the remuneration itself). This structure was extended significantly during the coding process, as new categories emerged. The final coding structure is set out at Appendix 7.

Coding of transcripts was initially done manually. The transcripts were printed leaving a three inch margin to the right of the text, and then the documents were scrutinised word-by-word, line-by-line in order to determine relevant codes. These codes were written on the transcript. When the transcript had been fully coded, the data were transferred to NVivo, where the new codes were added to the original structure. This manual process was carried out for the first three transcripts, until I became more familiar both with the process of coding and with the use of NVivo. After that, the hand-written stage was omitted, and coding was done directly on screen.

In the early stages of coding, as each document was coded I revisited its predecessors to determine whether the new transcript had added any ideas that were relevant to the previous ones. This activity became less relevant as coding progressed, as the number of new codes became fewer and my experience grew.

The process was changed as coding progressed, in that I found that it helped my thought patterns to code 'chunks' of narrative – sentences and paragraphs – rather than individual words and phrases (Miles and Huberman, 1994: 56). I later went back and re-coded the earlier documents in this matter, to maintain consistency between the documents.

Coding the transcripts and other documentation led to new ideas being developed. These were recorded in a Word document that I used as a research diary, in which were recorded the thoughts and issues developed over the process from the start of the fieldwork. This resource was my equivalent of the memoing technique suggested by, for example, Strauss and Corbin (1998: 218) or Miles and Huberman (1994: 72).

In March 2003 I prepared a meta matrix (what Miles and Huberman (1994: 178) refer to as a "monster dog") to display all of the results so far. This matrix assembled descriptive data for each of the cases. In small print this ran to 28 pages, using seven colours and two fonts. This schedule was used to gain an overview of the work. It was not updated for subsequent interviews, as the NVivo analysis was used for that work.

Once all of the documents had been coded, and the list of codes refined, I examined the content of each node (the NVivo term for a code). This was done by printing off the contents of each node and reading them through, to find the 'story' behind the words (similar to the process discussed by Strauss and Corbin (1998: 148)). Narrative notes were made in the margins of these new documents, highlighting related themes, and differences. I then prepared a summary for each node of the themes occurring in it, and the ideas it suggested. I did not subsequently re-code passages to reflect these themes, as suggested by Strauss and Corbin, as I found that chopping up and rebuilding the data did not suit my way of thinking. Thus, although I used some of the techniques of grounded theory suggested by Strauss and Corbin, I did not fully adopt their approach.

Analysis was facilitated by the use of cross-case displays (Miles and Huberman, 1994: 174). After the two pilot studies were done, the similarities and differences between the cases were tabulated, and used to inform the later research. Additional displays were prepared after the fieldwork was done, to establish patterns (or otherwise) in the data.

In analysing the data, I followed the seven-stage approach suggested by Easterby-Smith et al. (1991: 108), as set out in Table 4-6.

Table 4-6 Approach to data analysis

Stage	Work done	Research diary
1. Familiarisation	In transcribing almost all of the transcripts myself, I became very familiar with them both as aural narratives and as text.	Rather than adopt a formal 'memoing' technique (Lofland and Lofland, 1995: 193; Miles and Huberman, 1994: 72) I found that the best way for me to explain and understand the data and manage the relationships was in the form of a narrative Research Diary maintained as a Word document. All ideas about the research (including draft models of relationships between variables) were captured in this diary in chronological order. The diary was regularly reviewed throughout the process, guiding interviews and analysis.
2. Reflection	The coding structure drawn up during the literature review provided an initial platform for reflecting on the meaning of the data.	
3 - 5. Conceptualisation, cataloguing and re-coding	Coding was facilitated using NVivo, and the range of codes changed considerably over the period of analysis as new concepts were unearthed and previously-coded documents revisited. Unless it was very obvious, each of the nodes set up on NVivo was given a description of what was – and what was not – included in the category. This helped ensure consistency in coding over the period of analysis. Consistency was also aided by re-visiting previously-coded documents at several stages, to check that the meaning had not drifted.	
6. Linking	Using a multi-theoretic approach, many different links to theory were found and pursued to determine which were supported in the data and which were not.	
7. Re-evaluation	The research findings were evaluated in the light of comments from other academics and from practitioners.	

4.6 Validity, reliability and generalisability

It is important for any research project to be able to stand up to scrutiny. In undertaking qualitative research, the criteria for such scrutiny differ from those in the scientific, positivist paradigm. Easterby-Smith et al. (1991: 41) explain the three main questions as they relate to a phenomenological (interpretivist) viewpoint. Their meanings are set out in Table 4-7, together with the means used in this study.

Table 4-7 Credibility and rigour

Easterby-Smith	Work done
Validity Has the researcher gained full access to the knowledge and meaning of informants?	Respondent validation via a focus group interview to gain feedback (Silverman, 2001: 236; Bryman, 1989: 164; Miles and Huberman 1994: 275) and with an academic audience. Also, participants were given a report containing the draft findings, on which they were able to comment (although none did). Triangulation using multiple data sources by having different interviewees in companies, and through documentation. (Given the research philosophy, the triangulation was not used to adjudicate between different versions (Silverman, 2001: 234), other than it being assumed that the audited remuneration report was more likely to be correct than an informant's memory.)
Reliability Will similar observations be made by different researchers on different occasions?	Interviews were recorded verbatim rather than interpreted. They were transcribed by the author. Field notes were systematically recorded. It is possible that different researchers would make different observations. As discussed earlier, the interview is a social interaction, influenced by the characteristics of both parties (Silverman, 2001: 225). Furthermore, in this ever-changing subject (see timeline in Appendix 3) it is likely that respondent's views could change over time.
Generalisability How likely is it that ideas and theories generated in one setting will also apply in other settings?	The ideas have been discussed with individuals (including some of the focus group) who were not part of the original sample. They have also been tested with institutional professional bodies, for reasonableness.

4.7 Summary of chapter

In this chapter I have set out the philosophical underpinnings of the research and explained the methodology and methods adopted. This interview-based research, using the company as the unit of analysis, is generalisable into theory rather than to other companies and contexts.

5. HOW COMPANIES DETERMINE PAY

5.1 Introduction

The research question introduced in chapter 1 asks how companies determine the remuneration of their executive directors. It considers two aspects of this: the level of pay, and its structure. In this chapter I present data showing how, in practice, these issues are addressed.

According to the Combined Code (2003), the determination of executive pay is a matter for the remuneration committee. Therefore, much of this chapter, and the discussions set out in the following chapters, is set in the context of the committee's decision process. The committee has to decide, or to make a recommendation to the board, what level of pay will be, to paraphrase the Code, 'sufficient but not excessive'. It also has to determine an appropriate structure, using a substantial element of performance-related pay, that will drive appropriate performance in the company.

What became clear from the research data was that, for any company, there is no objective right answer to these questions. This is not the nature of the game. Nonetheless, to end that game an answer must be found, and a remuneration scheme chosen that can, it is felt, be justified, both to the executives and to the outside world. Much of the data set out in this chapter is the story of that justification process, and the different paths taken by the case companies in arriving at their decisions. It shows how the committees actively construct their remuneration decisions, using data which are justified as relating to a 'market', albeit a market defined by the companies themselves. The decision is given legitimacy by using these external data, and also by the use of remuneration consultants both to provide data and to advise on appropriate schemes.

The structure of this chapter is as follows. First, I examine the roles played by the various protagonists in the remuneration-setting decision, putting the rest of this discussion in context. Following this I discuss how companies determine the level of their executive directors' pay, then consider how they define its structure. A finding of the empirical work was that all of the case companies had changed their remuneration policies over the last few years, often making several changes. Accordingly, I end with a review of the issues that lead to changes in remuneration schemes.

Given the necessary length of this chapter, it is useful here to summarise the key findings. This is done in Figure 5-1.

Figure 5-1 Key findings in chapter 5

The roles of the protagonists	Each of the case companies could 'tick the boxes' as complying with good governance practices. However, the relationship of the protagonists differed in each company. The remuneration-setting process appeared to be controlled by the non-executives in some companies, with much more influence by the executives in others.
The level of pay	The level of pay is set based on 'the market'. This 'market' is a social construction, being determined by using selected comparators based on company size, industry and/or geography. Each company may have a different view of appropriate market comparators.
The structure of pay	Pay structures are designed to reflect the company's strategic characteristics but also to be in line with schemes adopted by other companies which have gained shareholder acceptance. This shareholder acceptance is important, legitimising the remuneration decisions.
Why companies change their schemes	Changes are made for a variety of reasons, chiefly: pay levels being below market; schemes not paying out; changes in company strategy, culture or personnel.

In chapters 6 and 7 I will return to these issues, analysing the data against a theoretical background.

5.2 The roles of the protagonists

The original research design, based on informal discussions and interviews, was to interview people in the following roles:

- committee chairman
- another NED
- CEO
- HR professional
- consultant.

In practice, interviewees included representatives from all of these roles, plus company secretaries, a company chairman, headhunters and institutional representatives.

Although by and large each of the companies had an individual with the relevant job title, the nature of the relationships between the individuals varied considerably between companies. For example, in some companies the remuneration-setting process appeared to be dominated by the remuneration committee:

> This remuneration committee is quite particular about not involving the executives in the design and development of the incentive arrangements. I think they've drawn a line and said "we will not ask the monkeys to tell us what kind of nuts they want".
>
> HR Director

Indeed, in one company the HR director had practically no input into the remuneration committee; the work of servicing that committee was done by the company secretary with support from the company chairman, and the main role of the HR director was to provide market information.

In other companies, the balance of power appeared to be with the executives rather than the non-executives. This was evidenced, for example, in statements discussing who was involved in the setting of the remuneration committee agenda. It was also seen in discussions of how the remuneration consultants were employed, and the input the committee and its chairman had into that decision.

The following extracts illustrate the variety of practices encountered, both committee- and executive-driven.

Regarding setting the agenda for committee meetings:

> Q: Who is involved in drafting the agenda?
>
> A: Who would be involved would be [HR Director], the chief executive, and myself. The reason for that is that there's no point in the non-executives or the board having a view.
>
> Committee chairman

> The agendas are basically largely compiled by myself and the chief legal officer, company secretary. But obviously sometimes issues will be raised by other people, and they'll want something on the agenda. And that could be anybody from the chairman of the company to the chief executive...
>
> HR director

> Q: Who sets the agenda?
>
> A: Group HR. In a sense. When I say that we set the agenda, obviously we take a huge amount of notice of what the chief executive wants and if he's got issues.
>
> HR manager

In that last company, no indication was given that the chairman of the remuneration committee had any input into the agenda.

Regarding the employment of remuneration consultants:

> And the committee's just changed its external advisers. They did that really without our help. We set up the beauty contest and the process, but they made those decisions on their own. Paradoxically they asked at the last minute if we were going to be involved. We said that we never envisaged that we would be responsible for selecting your external advisers.
>
> HR director

> The remuneration committee chose [the consultants]. Against a shortlist of, I think it was two, it could possibly have been three, that [HR director] came up with. We interviewed all three, and decided on [consultant name]
>
> Company chairman (who sat in on those interviews)

> I think I had a meeting with [HR director and HR manager], in which I got from them an understanding of what the business issues were, why they were undertaking a review, why they decided to change advisers, the particular business issues that they were facing, because you always try to put the remuneration review in context.
>
> Consultant, discussing how and by whom he was briefed.

In this last company, the consultant did have a relationship with the committee chairman, through the chairman's other company, although there was little indication of his involvement here.

> Q: I assume from everything you said, that you decided you were employing [consultant], rather than....
>
> A: Yes, the remuneration committee aren't the remotest bit interested in the views.
>
> HR director

The general tenor of discussions indicated that in some companies the views of the non-executives were treated with greater respect than in others. This is demonstrated again later in this chapter, in a discussion of the role of the committee in determining base pay.

5.3 How companies determine the level of their directors' remuneration

5.3.1 Defining the level of remuneration

An executive remuneration package generally comprises several parts: base salary, annual bonus, a long-term incentive, perks and pension. It was agreed by most interviewees that the package should be looked at 'in the round', considering the combination of all of the elements rather than examining each individually. If each element were taken individually, the overall package could end up excessive, or unbalanced.

> I personally am very reluctant to discuss bits of the package outside the context of the whole package.
>
> NED

> At the moment, we're not changing the scheme at all. ... And, I mean basically what [consultant] said was that in the round our package was comparable with market practice in [index], all that sort of thing. They said that we were light on the bonuses side in that the bonuses that we were paying were up to a maximum of 50% of salary, and they said that 100% would be more common. On the other hand, our salaries they thought were up with the game, and our pensions were ahead of the game.
>
> Committee chairman

However, one interviewee did believe that each element of the package needed to be considered separately.

> ... confirmed the beliefs of the remuneration committee that you should have a reasonably market-competitive salary and bonus. In other words you have to look at each element of the package as being reasonably competitive. And if you give somebody a very low basic but everything else is at risk that might be fine in good times, but if the market turns sour then there's not a great deal you can do about it. [Salary should always be competitive by itself, as it drives other elements of remuneration such as pension and bonus.][34]
>
> HR director

Given that there are various elements to the remuneration package, companies tend to benchmark an expected level of total remuneration that would be achieved if target performance were achieved[35]. Thus by 'level' I follow standard practice in referring to this expected level of remuneration, comprising base salary and anticipated incentive awards. However, because it is common practice for the level of incentives awarded to be a multiple of base salary, that salary is the focus of this section.

[34] This HR director requested that I seek approval for individual quotes used in the thesis. In granting approval for this quote, he added the wording in square brackets.

[35] For example, Vodafone Group plc, in its 2001 remuneration report (page 57), stated that its remuneration committee must benchmark "the expected value of remuneration" against the relevant market. It went on to illustrate that for expected performance, base pay would comprise circa 20% of total remuneration, and incentive payments circa 80%.

5.3.2 Sources of market information

In later paragraphs, it will be seen that levels of pay are benchmarked on market data. It is thus appropriate to consider where the remuneration committee obtains those data.

In practice, it is likely that the committee will see comparative data from several sources. These could include:

i. Bespoke reports prepared by consultants for this specific purpose.

ii. General reports prepared by consultants showing market data. It is customary for data from more than one consultant to be obtained.

iii. Data gathered by the HR professionals from various sources, including published surveys and other companies' annual reports.

iv. Data gathered informally by the committee members and others. This could be based on other directorships they hold, or on conversations with directors of other companies.

Survey data (both bespoke and general) are used extensively. The advantage of using surveys is that they do represent an external view, and can be used to justify the company's salaries:

> Our job is to act as the protectors of the non-executive directors' reputations. So they have to have adequate data on which to base their decisions, and they have to know that it is not adopting something indefensible. So providing the number chosen is within reasonably close touch of [numbers suggested by market surveys] ...
>
> HR manager

> The shareholders have got to have that degree of comfort, that they aren't just getting information from the likes of me who, it could be alleged, has an angle to grind here.
>
> HR director

However, many of the individuals interviewed expressed a level of unease about the use of survey data, particularly in the way that it was believed to cause executive pay to ratchet up year after year.

> You get these reports from the consultants saying 'look, the median salaries are now so much, and you are below it, and therefore you've got to go up to the median level or whatever you want to be'. And then of course you say 'yes, of course, everybody does that, it just goes on and up and up'. And so you need to look well below, I feel, and [Committee chairman] will agree with this, you always need to look at those sort of arguments very sceptically.
>
> NED

Several interviewees suggested that one reason for this ratcheting up is that many companies have a policy of setting remuneration at upper quartile levels. When that is done, each new survey shows a higher median than the previous one, and so pay levels have to rise accordingly.

> But I have an entirely different comment to make as well, which is 'me too' is such an important part of it, and this is what worries me about this kind of process. I'm not objecting in personal terms, but this business of 'the market's doing this so we better do this', there is this sense of ratcheting the stakes up. We do quite a lot of this because if we didn't, people would leave us for companies that did or we'd find it difficult to recruit people.
>
> HR director

> The way one every year is presented with statistics, which no doubt are genuine, and, you know, are produced by the high-priced help, demonstrating that this year there will be X or Y percent increase in executive remuneration, inevitably, you know, gives one some qualms. Because it's easy to see how there can be perpetual leapfrogging.
>
> Committee chairman

In one of the case companies, the CEO had effectively overruled the survey data presented to the remuneration committee, showing high pay increases, because he did not believe it.

> I have grown very suspicious of surveys for remuneration. I have yet to work for a company where I was shown a survey that showed that we were meeting the standards that we had set.... Systematically, whenever there is a survey coming we say well our aim is to be say midmarket or third quartile; systematically, for whatever reason, we are always below what the market says we should be. ... So I've grown very suspicious, and usually will want to double check with a couple of specific companies who I would consider to be good indicators as to what their policy is. Now I am lucky enough to have good friends, chief executive officers or chairmen of many companies, so I have direct access to some of them and some of the things I would do is to say 'who is it out there who is inflating these numbers?'. ... why I wasn't jumping immediately to the conclusion that everybody should be going up by that amount.
>
> CEO

In the subsequent discussion I passed on to that CEO the explanation for this phenomenon that had been given to me by an HR director; this explanation he found totally plausible.

> 'I think this is one of the reasons why main board pay does tend to go up rather more rapidly than overall averages. One, you've got small samples. Secondly, often people come in, particularly if they're an internal promotion, there's a bit of a wait-and-see approach. And if they go in at below the market median, it's quite easy for people to say gosh there's still 20 or 25% to go, and they are paying 4 or 5% catch up each time. Now, I'm not saying that that is right or wrong, but that's what happens.
>
> HR director

A further reason suggested was that individuals joining companies from outside are often offered above-market packages to attract them, and this too distorts the statistics.

> I mean a company that's had to bring in a lot of people from the outside will see a naturally higher-than-inflation movement. They are basically paying to attract people to a new, riskier environment.
>
> NED

Nevertheless, survey data are universally used as a means to establish pay levels. The following sections discuss how they are used, examining how benchmark markets are determined, and considering how companies set their pay levels based on the surveys.

5.3.3 Determining the level of base salary

If survey data are used to determine base salaries, remuneration committees need to address two questions:

> Against what should pay be benchmarked? and
>
> Where should our pay be set in relation to the range in the survey?

This was summarised by one of the consultants interviewed for the research.

> Firstly let us identify what we mean by market practice. We use the phrase too carefully. We assume that there is one market position, let's take job X, that there is a market position for base salary, there's a market position for bonus opportunity, and there's a market position for either option grants or real share award scheme awards. There isn't. Typically, around the middle of a market, between the quartiles, there'll be something like plus or minus 20 or 25. And you've only looked at a 50 percent distribution, You haven't gone from the minimum to the maximum, which is huge.

And

> In determining market position the first argument is what is the market, or what are the markets? Because if you would select your CEO from the utilities sector and your FD from a much wider sector, and you've actually defined two markets. You might have more jobs or you might have more markets.
>
> Consultant

In every company, a question about how the level of base salary was determined elicited an answer that discussed benchmarking against 'the market'. With no way of determining in an absolute sense what an executive is worth, some form of comparator is needed[36]. However, the choice of that comparator can have a significant impact on the level of pay in a company.

[36] Economists would argue that executive pay should reflect the marginal productivity of the executive; alas, this is not easily determined.

Generally, the market comparators for salary reflect the size of the company, and often its industry. In neither case is the decision about comparators obvious. These issues are addressed in the following sections.

Defining the market by size

For remuneration purposes, the most common determinants of a company's size are its turnover or its market capitalisation. Of the companies participating in the research, some used turnover as the sole measure, some used market capitalisation as the sole measure, and some used a combination of these, occasionally adding another measure such as number of employees. In discussions with the participants, sometimes an argument was given to explain why a particular size measure had been used, but at times it appeared that this had not been considered deeply.

> It is the view of the consultants that the salary guidelines based on [company's] market capitalisation of [£Xm] provide a more appropriate guide to relevant market practice than those based on turnover. It is the guidelines based on market capitalisation which better reflect [company's] position in the FTSE [index].
>
> Extract from Consultants' report which benchmarked one aspect of the company's business against turnover and another against market capitalisation

> Well you can look at it a number of ways, as you know from your work in this area - employees, turnover, market cap, you name it. As I understand it, and it's going back a long time, turnover's a reasonably stable kind of measure, market cap can vary considerably - we mentioned dot.coms - and there is some kind of perceived relationship between turnover and pay. There appears to be some kind of relationship, as I understand it. Now you're going to tell me I'm wrong!
>
> HR director

However, in one company, the HR director had clearly given the matter some considerable thought.

> The reports I had, they covered market cap, turnover, profit and number of people. The reason that I think the number of people is important is because the challenge is the more people you manage, the harder it gets. Yes? If you've only got five people to manage, it's a helluva different task than 500. [It is much harder to manage 500 people than 5 because of the need to align, motivate and direct layers of management.][37] So therefore, what I did within that was to say in comparing us against other companies, I did a comparison by all four entities, and whether we were upper quartile, median, or lower quartile. And therefore the reports I provided for the remuneration committee showed these explicitly. So in other words, I didn't try to hide anything. I kept it very clear. So that if market cap was way out of line with everything else it was dangerous to align it to market cap.
>
> HR director

It should be self-evident that benchmarking a company's salaries based on its turnover could give very different answers to a benchmark based on its market capitalisation. Thus the choice of 'market' has a big impact on base salaries. Discussions with the participants indicated that this choice of benchmark is often left to the HR support, or to the consultants[38].

Before leaving the subject of company size as an input into the pay decision, it is worthwhile considering what happens to pay when there is a step-change in the size of the company, through acquisitions or divestments. In the recent past, one of the case companies had undertaken a major acquisition: this had led to an upward rebasing of the executives' salaries. The director of another of the companies was involved in a similar merger, in one of the other companies for which he sat on the board. At the time of our meeting he commented[39]:

[37] This HR director requested that I seek approval for individual quotes used in the thesis. In granting approval for this quote, he added the wording in square brackets.

[38] One HR director, when asked why the consultants had chosen a particular benchmark, suggested that it was because they already had these data available, rather than for any reason particularly related to his company.

[39] In order to ensure the anonymity of the interviewees, occasionally no job description is given to support a quotation.

> Just as an aside, we're putting these two big companies together now. And we end up with a much bigger company, obviously. ... And the remuneration committee then have got to sit down and say well we are a much bigger company, what should we do about pay and all the rest of it? Should we increase the directors' salaries, or shouldn't we? Some of the directors will be doing roughly the same jobs that they were doing before. The chief executive, certainly, has got a bigger responsibility. What should we do? And I honestly don't know what the answer is.

A review of the remuneration report for that company, published several months after this interview, indicated that the CEO's salary went up substantially.

Defining the market by industry

It is common knowledge that the general level of pay in some industries greatly exceeds that in others. Indeed, the original design for this research study was based on utilities and finance companies, partly for that very reason. Hence, in benchmarking salaries it seems reasonable to use peer companies in an industry as an appropriate comparator.

Several difficulties arise with this. Firstly, it can be problematic to define a company's industry. This is particularly true for multi-business companies, for example the regulated utilities in the UK, whose strategies often involve developing a substantial non-regulated business. Whereas executive directors responsible for the utility or the 'other' business may have a clear comparator group, deciding the appropriate base for the CEO or the finance director (FD), responsible for both of these, is more difficult.

As an illustration, consultants for one of the case utilities prepared a report giving comparative information for two sets of comparators: other utilities, and companies in the related sector whose turnover was comparable with the utility's non-regulated business. Consultants for another utility used three comparator groups:

> ... we discussed with [HR director] the sort of companies we should look at: both utilities and companies with a similar market capitalisation. And then companies who are in the kind of areas that they are moving into.

And

> [Three peer groups] ...in the sense that we were comparing their remuneration with other [utility] companies, with [FTSE index] companies generally, and with other businesses of the similar nature to their non-regulated business. ... So we came up essentially with three different set of figures, I think we called them comparator group A, B and C. A, we said that 'well the finance director's at median or below median, B is median and C is below median'. That was how we presented it.
>
> Consultant

The second difficulty that arises in using industry comparators is that some individuals are mobile between industries. If one aim of using market-based salaries is to 'attract, retain and motivate' the individuals, then the remuneration committee has to be sensitive to the different areas from which and to which they might move.

> That's an interesting question. In functional roles, you don't necessarily look at [our sector]. [Name] went off to [company in different sector], and other people in functional roles join us from other industries and move off to other industries. Albeit we would always try to look at [our sector]. Sometimes there isn't enough data to look at significant [companies in our sector] alone.
>
> HR director

Defining the market by geography

In addition to considerations of size and industry, some companies adjust the benchmarks they use to accommodate geographical issues. The most commonly known of these is the reported need for companies to pay globally competitive packages, to reflect the fact that their executives are 'globally mobile', as illustrated by the following quotations from published sources.

> *We should also remember that major firms fish for talent in a global pool. If UK terms and conditions are less favourable, management talent will go elsewhere.*
>
> *Digby Jones, Director-General of the CBI (2003)*

> *In his letter to shareholders, Sir Christopher Hogg, GSK's chairman, warned that global companies must remain competitive in the remuneration they offer to top executives. The application of UK "cultural attitudes" in companies that are big in the US could leave them vulnerable in a country where traditionally pay has been higher than in Europe.*
>
> *Dyer (2003)*

However, there are many who believe that this argument is overstated, that the number of truly global individuals is relatively few, and that comparisons with US pay (the benchmark for 'global') are unmerited and serve merely to inflate remuneration packages in the UK. Alastair Ross Goobey, introducing a report for the International Centre for Corporate Governance, described the argument as "so much hooey" (Targett and Tassell, 2002). A couple of months later, a European compensation consultant was quoted as follows:

> *Mr Booker believes international comparisons are becoming "a flimsy defence" for high pay. "There is some justified cynicism about the idea that just because American pay is higher, pay elsewhere should rise. It is not uncommon to find chief executives paid less than the leaders of US subsidiaries - in investment banks, CEOs are not even in the 30 top earners. The national and industrial comparisons are the important ones."*
>
> *Overell (2002)*

These comments were reflected by some of the interviewees.

> And the argument that we live in a global world and pay global salaries doesn't strike me as very valid.
>
> NED

> It is wrong. And there's the American thing which is I think for most companies a total red herring, just an excuse for paying more. It's the difficulty. The whole sort of global company thing. There's hardly any companies which are really global to the extent that their executives are really interchangeable, which is the only time it should come into remuneration.
>
> HR manager

Of the companies studied in this research, one was clearly global, earning more than half its profits in the US, and having operations throughout the world. For this company, with several Americans in senior management positions, it was appropriate to consider US remuneration as a benchmark. Indeed, the HR director commented that by adopting UK-type policies the company had fallen behind its market, and had been obliged to increase its packages. At the time of the interview he opined that there was more work to be done in this area:

> No, I think really in [date] we sort of took a bit of adjustment for North Americans below the board, really. It wasn't really until [3 years later] that we began to improve North American packages generally at the executive level - not just at the board - in order to get closer. But I've got to say this, when we went to that route, [consultant name], who are our advisors, had said '[name], you're not really mid-Atlantic, you're more north of Ireland!'.
>
> HR director

Other companies in the research sample had less of an American influence, although several did business extensively in continental Europe, and stated that they needed to keep policies and packages competitive for their European executives.

At the other end of the geographic scale, one company was based solely in the UK, and mainly in a region in which pay levels are generally low. It was stated by the directors and by their consultants that pay levels in this company had been tailored to reflect the regional rates, being slightly lower than would have been earned in, say, London. This example, albeit an unusual one, indicates that geography can influence the pay market on the downside as well as the upside.

Setting pay at 'median'

Having determined an appropriate market against which to benchmark, the remuneration committee then has to decide the level at which it wants to set its pay. For example, many companies aim to be at the median level based on their comparators; some state that they aim for an upper quartile rating.

Of the case companies, all but two stated their policy was for salaries to be at median. One company related salary levels to individual performance, with a policy of paying upper quartile salaries for "superior" performance. One other stated in its published remuneration report that salaries were "competitive" – the interviewee explained to me that this meant upper quartile. The two paying upper quartile salaries did not state explicitly why this policy had been chosen. However, in one case it seemed likely that this reflected the company's international bias. Of the companies whose policy was to pay median salaries, most interviewees stated that they took median salaries so that they could weight incentives towards an upper quartile package for good performance. One HR manager in a major company explained why it was appropriate for that company:

> [In answer to the question: Why midmarket?]
>
> Why not? To say that we're going to pay under the market would be silly. We're a long established company, and to be other than midmarket I tend to think that you would have to be in different point in your cycle.
>
> HR manager

Even if a company has a policy of 'median' pay, median may not be seen as an exact number, but as a range of values. One HR manager interviewed in this research gave his opinion that 'median' was a range of +/- 10% around the mathematical median of the survey, but went on to point out that his remuneration committee used a range of 15% to 20% above or below. However the respondent focus group took the view that median should be the arithmetic median itself.

In addition, the point at which the actual pay is set may depend on several factors, as illustrated below.

The competencies and experience of the particular manager.

> As I say, we look at the performance of the people. And you look at where they're at as well; you look at where are they at the moment - that has to be a significant factor. ... What we've done last year, at least, is look at the individuals as well, where they are in their roles.
>
> HR director

The salary paid in the previous year.

> Also remember that once a salary has been established, then they tend not to go down.
>
> HR manager

The committee's view of appropriate pay rises.

> Generally, the committee chose to award a pay increase that left the executive at less than the suggested salary, less than median. [HR manager] reckons that the main reason for this is that they didn't want to have to justify high % increases in the remuneration report. (The [non-board] salaries went through pretty quickly, with little changes from recommended.)
>
> From file note of untaped conversation with HR manager

It is also worth noting that in two of the case companies, different individuals offered different opinions as to where the company was in terms of its salaries – ranging from just below median to upper quartile! I was unable to establish either the 'true' position (having no access to the underlying data) or why they held these views. It is possible that non-executives are not as close to the underlying data as are, for example, HR directors.

Mediating factors

Accommodating individual characteristics

When asked how remuneration levels were set, some interviewees replied that pay related to the job description.

> Well, it's tailored to the post first and foremost. Then to the individual.
>
> HR director

That is also the inference to be made from the reliance on market surveys, benchmarking CEO, FD or other executive directors against similar roles. However, although this is apparently seen as standard practice, many instances were cited where the package had obviously been tailored in order to attract a particular individual to the company.

> I would say to them: if we believe this is the right thing to do and you're saying to me we need this set of skills, and we believe as a board we need that set of skills, this is what we're going to have to do, and this is what it is going to cost.
>
> Committee chairman

> We clearly in this particular case went beyond what we had established as at that level of the organisation. But given the strategic importance of the project he was going to lead, the value that he brought to the company over and above what the job specified, we said well there is clearly a premium in there and we want the man, so what is he worth?
>
> Company chairman

The experience and talents of these particular executives were seen as such that they outweighed the influence of the company's existing remuneration arrangements. Given that absolute pay seems to be less important than relative pay, I asked if bringing in an individual at a scale above that of existing executives would distort the level of pay for the board as a whole. Two individuals (in the same company) stated that it would have no influence. A third individual, in a different company, opined that inevitably it meant that salaries would rise over a period. (There is of course no way of knowing whether the directors in the first company were being realistic in their views.)

In an interview with two headhunters, conducted several months after the bulk of the fieldwork, I obtained their views on this subject. Perhaps unsurprisingly, they strongly believed that the package was tailored to the individual rather than the role.

> ... coming back to your question about if you've got two candidates on the final straight - what you might very well be saying to your client is that if you're going to have Candidate A, then you're going to have to be paying this, while Candidate B you will be paying a different sort of thing. You must make up your mind as to which you feel is going to be appropriate, and how that balance is going to be.
>
> Headhunter

They also stated that companies have different attitudes as to whether incoming executives will be on a similar package to existing employees. In some companies, their client will advise that the package of the incomer has to fit in with the existing structure; others see this as less important. To some extent this is dependent on the client's needs.

> A high-profile company, particularly one facing quite significant challenges ahead, will only entice a high-profile, effective chief executive with an impeccable track record if they are able to satisfy that individual that they can compensate them for any potential loss of reputation for moving into a high risk job, where their untarnished record - with the best will in the world - might be in jeopardy. So that individual may well have fairly forceful views about the package which would entice them to move. By contrast, a role in a company which is in a less turbulent state, a strong position, may feel able to resist the pressure from a particular candidate over their package.
>
> Headhunter

Views of the NEDs

Despite all of the data that can be brought to bear on the remuneration-setting decision, it is not a mathematical exercise, and involves considerable judgement Several of the interviewees made this point, some quite strongly.

> ... you make it sound very black and white. But a lot of this is actually quite grey.
>
> NED

> ... it's not a science, so you're still going to bring that knowledge along and say 'well, I feel comfortable' ... I think you're going to use your experience and make a judgement, but I don't think it's particularly scientific, it's a 'feel' thing. All you're getting in a remn committee report, somebody gives you is a few figures: upper quartile, lower quartile, median. You just pick out where you feel happy.
>
> Consultant

> So there's no kind of god-given objectivity to that kind of stuff.
>
> HR director

> I mean, I think that like all information it's there [but] you don't just use it, you've got to apply judgement to it.
>
> HR manager

> I think one has to remember that this is, at least in part, an art; it's not purely a science.
>
> HR manager

> It's probably not nearly as statistical and scientific as people would imagine. It's a lot more human and a lot more partly market-driven, but other factors come into play.
>
> CEO

It seems inevitable that if judgement is being applied to the data in order to arrive at the final numbers, that judgement must be swayed by the prior experience of the individuals. To some extent, this was acknowledged to be true. Two of the interviewees had a non-corporate background and they discussed the difficulties of accepting the large corporate packages. The following quote illustrates:

> ... so I started from a rather different background from my other colleagues and they had to work quite hard to persuade me that these levels of remuneration which we now give to executive directors were actually necessary in order to retain and acquire the people we wanted.

At the other extreme, one HR manager pointed out the difficulty of having NEDs on the board who come from a high-level financial services background:

> Well there is one who has some sort of merchant banking background, and I don't think he really understands anybody being paid less than about £50,000 a year. Which is always a problem, incidentally, for people at that level. I think that for almost anybody at the level of NED the thought that somebody is paid less than £10,000, they can't imagine[40].
>
> HR manager

So individuals do bring their own 'baggage' to this decision. Often this is seen as very useful - one chairman pointed out the advantages of using this knowledge of other companies in mentally benchmarking the packages on offer:

> And I think that's important. And most people's contribution to discussions is a kind of mental comparison with things. And people often say 'well in another company I'm involved in we're doing X, Y and Z'. So that is very useful, to have at least some other thing.
>
> Committee chairman

Having said this, it would be very difficult to determine whether or how any particular individual's personal comparisons affected the level of pay of executives. A board is made up of many people, often with widely different backgrounds. Each of these will have different referents, different experiences. It would thus be a challenge to say that a particular remuneration package arose from one individual's personal benchmarks. This point was emphasised by several interviewees in discussing this issue. For example:

> We draw our non-executive from [five industries mentioned]. So we've got a pretty wide spectrum of interests represented in the non-executives. I just about find it inconceivable that they would see anything. The opposite is

[40] Needless to say, the salary of £10,000 did not relate to any of the board executives in the company!

> probably true. I mean, we've got [name] who is well used to signing off whacking great packages for people in [financial services]. But he is as stern a critic of excessive rewards in [company] as anyone. Unless people could convince me that there were these links and the evidence did exist, I tend to dismiss that kind of debate as pretty hollow.
>
> HR director

5.3.4 The role of the committee in determining base salary

It is useful to consider the role of the committee in determining base salary – how the ultimate decision is actually made. There were some characteristics common to each of the case companies:

- Base salaries were determined formally at a meeting of the remuneration committee.
- Survey data (or summaries thereof prepared by the HR support) were available to the committee to assist in the decision.
- The CEO had input into the decision, in particular as regards the performance level of his direct reports[41]. In some companies he also gave a view as to the level of satisfaction of his executives with their pay, and the likelihood of their being poached by competitors.

However, it was clear from the way that people discussed the meetings that in some companies they were seen much more as a formality than as a decision forum.

[41] In all cases I was informed that the CEO left the room when his own pay was being discussed; this appears to be standard practice. The company chairman, as the CEO's line manager, would provide input as to his level of performance.

> There's normally a quick [committee meeting] in December, which will deal with things like annual salary increases so that, to focus on practicalities, any changes can be put into the payroll for January. ... The meeting itself is deliberately organised as a set piece. Although one will genuinely not know exactly how the non-executives will feel about a particular item. But the margin for decision is not all that great.
>
> HR manager

In other companies the issue was debated fully.

> Some of the key [meetings] that made decisions about this were quite protracted. The longest ones tend to be around annual review time for the executives. In the early days when everybody was getting inflation, that was a rubber stamp job. In later years, where we were really trying to correct some of the anomalies which were caused by that, the meetings were pretty extended. The pay settlement last year was three and half hours plus.
>
> HR director

In this latter company, the HR director had presented a paper to the committee setting out a summary of all of the survey data, including his own views of where pay should be set to be at median. This recommendation was rejected by the committee as being bad governance practice; they believed that it was their job to assess the data and surface recommendations. In one other company the HR director took the view that his role was to give the data to the committee and to let them make judgements. In other companies either the HR personnel made suggestions, or the HR personnel in conjunction with the remuneration committee chairman presented suggestions to the committee for its consideration.

5.3.5 Input factors to the decision on pay levels

In chapter 4 I discussed a questionnaire soliciting participants' views on factors affecting remuneration. Table 5-1 below sets out the factors affecting pay levels, ranked in order of their average score.

Table 5-1 Factors affecting the level of pay

	Score (max 5)
Company size	4.43
Shareholder returns	4.38
Company profitability	4.29
Individual directors' experience and qualifications	3.57
Investors' views	3.55
Company strategy/industry	3.38
Cash flow	2.57
Financial accounting considerations	2.10
Tax (for the company)	2.10
Tax (for the individual)	1.71

From the questionnaire, company size has the most influence on pay: this was borne out in the interviews. It is notable that shareholder returns and performance were said to play an important part in the decision, as these did not feature significantly in the discussion. In the focus group discussion conducted to validate the research findings, the participants confirmed the questionnaire results. They stated that if a company is not making good returns it cannot afford to make high payments to executives. Furthermore, a poorly-performing company would be very conscious of the impact with external stakeholders of being seen to make high payments.

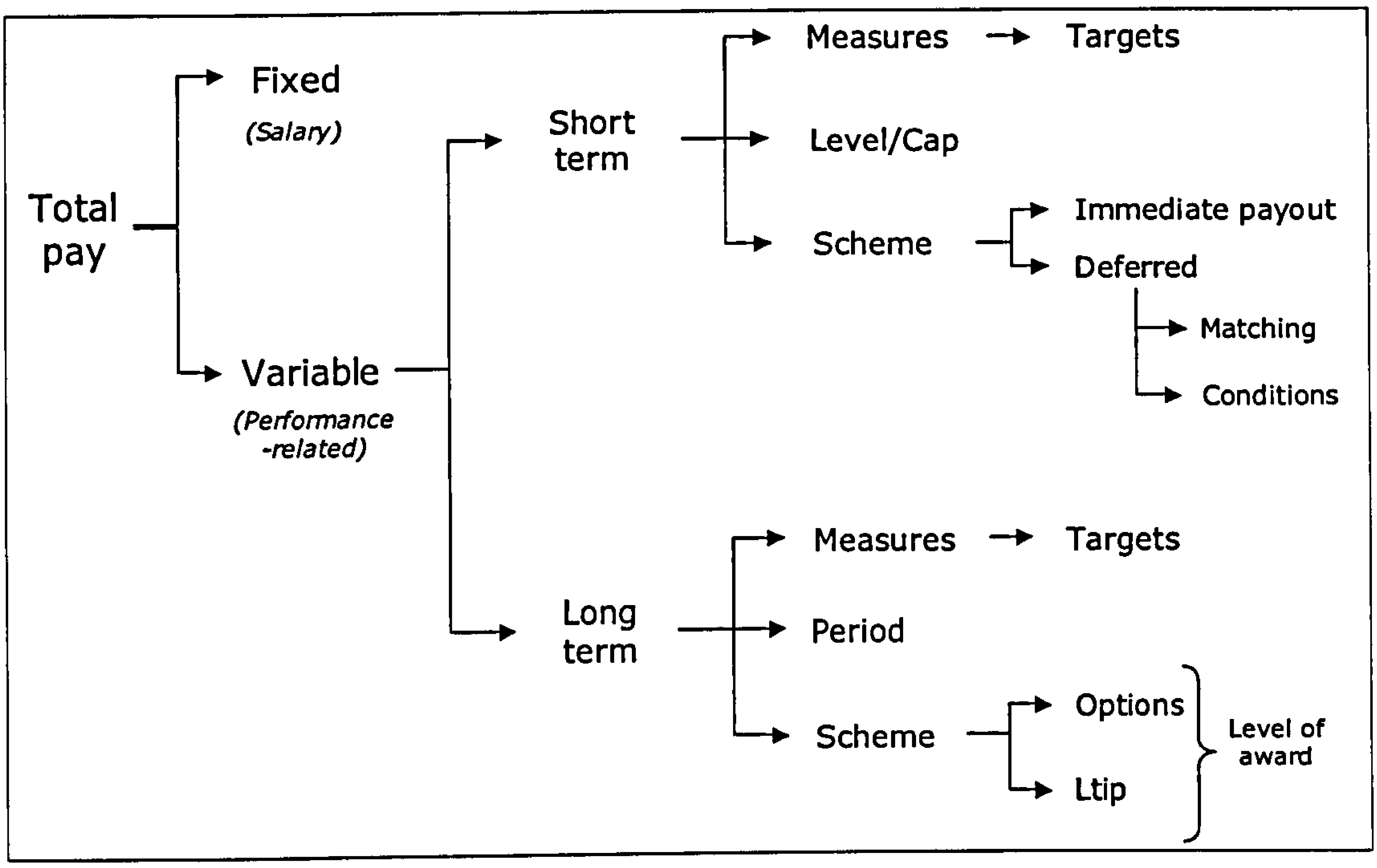
5.3.6 How companies determine the level of remuneration: summary of section

It is appropriate to conclude this part of the chapter with a summary of how companies determine the level of their executive pay. In simple terms, pay is based on 'the market'. However, the determination of that market is particularly complex, being based on the company's size (however measured), the relevant industry(ies), and its geographical situation. Having established appropriate benchmarks, the remuneration committee then has to determine whether it wishes to set its pay at median, or above or below that level, and how that is calculated.

Finally, committees differ in their approach to setting base pay, with some being more proactive and others leaving much of the work to the supporting HR staff.

5.4 How companies determine the structure of their directors' remuneration

Figure 5-2 Decisions relating to the structure and form of pay



Source: author

Figure 5-2 sets out the decisions that a company needs to make regarding the structure of its executive pay[42]. These are:

1. The level of gearing of the package, i.e. the balance between fixed and variable (performance-related) pay.
2. The balance of the variable elements between short-term and long-term incentives.

[42] In practice there are more decisions than this. Total reward has both extrinsic and intrinsic elements (American Compensation Association, 1999) and could also include a large pension and benefit-in-kind element. However, these fall outside the design of this research project and are not considered here.

3. For short-term schemes (annual bonus)
    a. the level of bonus for target and maximum performance
    b. the type of scheme to be used (e.g. whether there is immediate cash payout, or a deferred element)
    c. the performance measures and targets to be used.
4. For long-term schemes
    a. the scheme design – for example, a share option scheme or another form of ltip
    b. the performance measures and targets to be used
    c. the period to be covered by the scheme
    d. the amount of options/shares to be awarded.

In this section each of these decisions is discussed, in terms of the aims of the remuneration committee and the way in which they make their choices[43]. Appendix 8 puts this discussion into context, setting out the range of schemes and measures used in the companies.

5.4.1 Why use performance-related pay?

Every company in this research study used a significant element of variable pay, adopting both short-term and long-term schemes. Of those companies that disclosed a pay structure in their published remuneration reports, the level of fixed pay varied between 35% and 50% of the total pay for on-target performance. This reflects survey data presented by consultants, for example New Bridge Street (2003a) showed that almost all companies in the FTSE 350 use performance-related pay (PRP). One of the main issues researched in this study was to determine why companies do this.[44]

The responses to this line of questioning could be categorised into two broad areas: PRP is used for strategic HR purposes, and it is used to confer legitimacy. These are discussed below.

HR reasons for using performance-related pay

<u>Pay as a motivator</u>

> *I'm not motivated by money. The bonuses are a large amount of money, but the [Skandia] board put the schemes in place to incentivise people.*
>
> *Alan Wilson, chief executive of Skandia UK, (Orr, 2003)*

The first issue discussed by the participants was the use of PRP to motivate executives. It is a basic assumption of agency theory that paying individuals to achieve results will encourage them to work harder and result in better outcomes for the organisation. However, when this point was put to the interviewees, their responses were mixed. Several took the view that pay did indeed motivate performance; others argued that it did not. Some, reflecting the quotation that started this section, appeared to argue both views at the same time – that pay does not 'motivate' but is used to 'incentivise'[45]. Although some of the HR professionals referred to research on the motivational impact of performance-related pay, many of the arguments made seemed to come from the interviewees' experience and belief. The points raised reflected issues such as whether pay ever

[43] Remuneration committees will not necessarily take these decisions in the chronological order in which they are set out here, but this is a convenient way to approach them.

motivated, or whether it motivated at the executive level under consideration in this research.

Some took the view that performance-related pay was a motivating factor, and that it did incentivise people to perform, inasmuch as people needed an incentive to outperform.

> Why should people take risks - because there is some reward.
>
> NED

> There's a risk [if pay were at a flat rate] that they may not be focused on extending the business as far as they could, in the knowledge that the fee was achievable irrespective of performance. There's a possibility that psychologically they could under-perform and not stretch themselves. There's a risk I think from the individual perspective that potential for improvement through salary would be lost. A lot of our people at the top of the organisation are quite driven by the prospect of personal wealth, and flat fees, and the level of them, seem to us to remove one of the carrots, incentives to get people to do more. For some people there's a tendency to slide back into average behaviour if they know that their pay outcomes are not rewarding extra effort and extra success.
>
> HR director

> ...we unashamedly believe that people are motivated by pride and by money.
>
> Committee chairman

> Paying everybody the same base salary with no additional rewards, you will do what you've always done and get what you've always got.
>
> HR director

However, other interviewees did not believe that pay influenced effort at a senior level of the business.

> I'm not sure that anyone believes in practice that it makes very much difference. Especially at the very senior level of the organisation. Senior managers are motivated by something other than pure salary.
>
> Company secretary

---

[44] Much of the discussion in this section was published in Bender (2004).

> I'm highly sceptical myself as to how much extra people really put in. It has an impact, it does have an impact. But I think... it depends on the market you're in, but I think it can be overplayed.

And

> Q: If they were on flat salaries would they work the same?
>
> A: I think it is very marginal, particularly for people right at the top of the organisation. Because they are just highly motivated people who wouldn't be there otherwise.
>
> CEO

And

> I wouldn't want to feel exploited. ... But I don't come to work every day and think 'if I work even harder do I get paid even more?'. It just doesn't work like that.
>
> CEO

And one participant summed up both sides of the argument:

> And obviously there is always a moment in time where probably you put in that little extra effort because you might get additional reward. But I very seldom see people, say, work longer hours or work differently or become suddenly more intelligent because they are performance-related.
>
> CEO

Outside of the simplicity of the argument that says 'pay does motivate' or 'it does not', some comments were made which indicated that the influence of performance-related pay was more subtle, and context-dependent. Some argued that it would influence some individuals more than others.

> So we have an aggressive bonus, which is only ever paid on a profit-sharing scheme. So this of course attracts a certain sort of person.
>
> NED

> We have some people whom I have heard being described as "coin operated". They're here for the money, and that's it. You get those sort of people in marketing. Given a big bonus to go for and bam! But you get other people, for example - I'm generalising now - and this is below executive level, guys who work in [business area]. Yes, you've got to get the hygiene factors right, but they don't particularly want to earn socking great

[45] The difference between these concepts is not necessarily clear.

> amounts of money. These are people who have very strong vocational interests, and as long as they are earning a reasonable amount, that's it.
>
> CEO

A consultant suggested that interview responses would suggest that performance-related pay did inspire effort – but not for the individual himself.

> If you ask most people on the impact of performance linked pay you get a very typical answer. I suspect you get it from all of us. "No, it doesn't influence me. I am a professional manager with a very, very high level of commitment, and I'm not going to be influenced by anything as lowly as material gain. However, in managing the part of the business that I manage I find that incentive pay to the people within that business really has an impact." (Laughs) And you can go down through an organisation and you get broadly similar comments.
>
> Consultant

In this he was correct: none of the individuals interviewed stated outright that he personally worked harder because of the incentives he was offered.

It can be seen that the interviewees were divided as to whether money was indeed a motivator. But, as will be seen later in this chapter, in the discussion of changes to schemes, they were clear that the *lack* of money was a *de*-motivator. That being so, it was apparent that the pay represented something beyond its cash value, and the symbolic value of pay is now considered.

Pay as a symbol of worth

> Teachers in schools do it with gold stars; in business you do it with money.
>
> CEO

This comment illustrates the power of money as a symbol of success. One of the other interviewees, a remuneration consultant, suggested that once a director reaches the top of the company there is less formal appraisal and feedback, and so the amount of money earned is the main indicator he has of his value[46]. This is a symbol to him, to the rest of the company, and also to his peers. It is a clear way by which he can benchmark himself against his peers and rivals – a measure of success.

> ... the majority of directors that I know are egotistical and have a personal pride in success. They are peer-conscious. They want to be seen to be doing better than the others.
>
> NED

The amount earned – which, of course, is publicly disclosed – thus becomes a matter of ego for the executives. This can be seen in following extracts, discussing this aspect of the use of PRP.

> And the ego of the senior corporate man is a well-known fact of life, and it's a very good way of using that to get very focused achievement. And that's perhaps the most effective way in which you align an executive's performance with the chosen strategy of the company.
>
> HR manager

> And there's absolutely no doubt that some of this pressure, particularly at the top, the very large rewards, comes from a tendency of businessmen to compare themselves with other people. And I would describe it as a sort of macho desire to be seen publicly to be a success. And part of being a success is not only the job you hold, it's the effectiveness with which you have negotiated your reward.
>
> Committee chairman

> At senior level, it's not the £50,000 plus or minus that counts, it's the fact that it's a communication of performance.
>
> Consultant

Thus the level of pay, and particularly the performance-related award, serve a symbolic purpose over and above their monetary worth. By the same token, should an executive receive an award substantially less than his peers, the damage to his self-esteem may outweigh the monetary disadvantage.

[46] Board and director appraisal is now a requirement of the Combined Code (2003: A6).

> ... if you get it wrong, if there is a problem or crisis and you don't handle it properly, you will find, and you'll see it in the end, that you're earning far less in that year in incentive terms than your peer group. And that is a humiliation, not just a loss of money. It gives you a bad feeling. And it's meant to.
>
> Committee chairman

Focus

A standard agency theory explanation for using PRP is that it makes the agent work harder, preventing 'shirking'. That explanation was not accepted by any of the interviewees.

> Q: What I'm curious to understand, as everybody seems to take it for granted, is do people work harder for performance related pay? Or better? What's the advantage of it?
>
> A: I don't know that people work harder. I can't actually prove that they work better. I think what it does do, because performance has to be related to measurement, is it does enable you to provide very clear, measurable targets/objectives against which people get rewarded.
>
> Committee chairman

As illustrated above, the most common explanation given by interviewees for why companies use PRP was that it provides a focus to executives for their work efforts. They pointed out that the performance measures were a signal of what the organisation saw as important, and what they should be concentrating on in the short-term. The word 'focus' was used a lot in discussing these issues.

> It's certainly going to focus you on the things which are seen by the company to be important.
>
> Consultant

> I think that they focus minds if they are well-designed.
>
> NED

> So I don't doubt the fact that they work hard. I actually think that if the board and the management get it right then it delivers a focus to what they should be doing; i.e. they don't have flights of fancy in terms of extra-core acquisitions and things. It actually applies a focus to the way in which they do their business. I think that that is what it gives, rather than working any harder.
>
> NED

> So it's a tool to assist the chief executive in getting very focused performance out of his reports.
>
> HR manager

Other points raised along the same lines related to the need to provide a clear message to the executives and throughout the firm, using the variable pay (and particularly the annual bonus) to communicate a message throughout the organisation. It sends a clear message to the CEO about what the board thinks is important, and to the rest of the company about what the CEO believes to be important. Indeed, it was suggested by one HR manager that there was little point in setting objectives in the organisation if the reward system did not recognise them – they would not be seen as serious. In this respect, the variable pay is a way of communicating strategy.

Fairness

Many of the interviewees referred to the need for fairness as a reason for awarding performance-related pay. However, meanings of 'fair' differed. One aspect of fairness was fairness between employees in the same company, so that higher-performing workers received higher rewards.

> I think performance measures that fairly incentivise people - and being fair is the key - ... incentives that are fair and recognise the exceptional performer for going the extra mile is entirely appropriate in the business.
>
> HR manager

> We want rewards to encourage people to do better, to do as well as they can. And we wish in some way to distinguish between those who are performing and those who aren't.
>
> Committee chairman

Another aspect of fairness was fairness between the director and his peers in other companies. The argument was put that directors had to have the same opportunity to earn large sums as did their peers. This was considered necessary in order to attract good people to the company, and to retain their services.

> What [CEO] wants and expects is to be paid fairly. He would regard being paid fairly in two ways. One, that the basic amount he gets is reasonably comparable with those that he regards as his peers outside. And the second thing he'd expect is that if he and the company perform better, he gets paid more. Now that is what he would regard as being treated fairly. So if he didn't get that he would regard himself as being treated unfairly. Whether that would have the effect of him working less hard, I don't think it is that simple. Because I think he'd probably still work as hard, but if somebody is less happy, less content with life, their performance would tend to go down. And he might also look for somewhere else, or have looked somewhere else. Because the other thing is you want to retain someone. And if they are unsettled... . Most of pay, in my view, is hygiene. And that includes performance, it's not just the base. But it's very easy to lose it. You're most certainly not perfect, so it's how little imperfect you can be.
>
> HR manager

> What I think is probably more important than absolute reward is relative reward. And I think that people are conscious of what's going on out there, and that they don't want to feel undervalued if they think that they are a good, if not an outstanding, performer. So I think that that again has had some impact on what people now expect at senior level.
>
> HR manager

This comment about relative reward, reflecting back to the symbolic value of the PRP, was echoed again in comments on fairness:

> Q: If I can turn it around, forgive the impertinence, do you work harder because you get more money?
>
> A: No. I don't. But it comes back to a very different element, which is the value you consider yourself to be worth for a job well-performed.
>
> CEO

One final aspect of this discussion was fairness to shareholders – not paying large amounts to executives when shareholders had suffered a loss in the year. This was commented upon by participants discussing alignment of executives and shareholders (for example through long-term schemes or share ownership). It was also mentioned in the context of PRP:

> Because generally I think people do feel that they should not be paying the highest level of salaries or total income without there being some relationship to delivery to shareholders. I think those are the key reasons. It's not about motivation. Yes, there will be the weasel words in their proposals to shareholders, but it is not about motivation. The people that they are directing these plans at are self-motivated; it's not going to come from the opportunities of big payouts.
>
> Consultant

Performance-related pay and legitimacy

The reasons discussed above suggest that performance-related pay is used in order to motivate certain behaviour from the directors. This is a matter internal to the company with, as one committee chairman stated, remuneration being "the principal link between the individuals and the company". However, the results of the research indicated that external factors also came into play when companies were deciding whether to implement a performance-related reward scheme. The two main such reasons, which are inter-connected, were market practices and the need for legitimacy.

Many of the interviewees mentioned that they had a PRP scheme because it was market practice so to do. The explanations for this were two-fold. One, related to fairness, came back to the idea that the directors have to perceive pay structures as being fair between themselves and their peers in other companies, giving them the same earnings opportunities, and being a structure to which they were accustomed.

> I think most of our senior executives would never have worked anywhere where a flat fee reward structure would be the norm for them. So it would be kind of out of left field really for them. I don't think any of the current top team would have worked anywhere where that was the reward regime.
>
> HR director

A second matter raised in this area by many participants related to the perceived need to be in line with other companies because that was 'best practice' and good corporate governance.

> I think because corporate governance says is that an element of salaries should relate to performance. I'm highly sceptical myself as to how much extra people really put in.
>
> CEO

> It's seen to be a good thing. That's the cynical answer.
>
> Consultant

> But you need a bonus structure, because everybody else has a bonus structure, and it's conventional wisdom that's the best way to pay people.
>
> NED

> Because they're directed that way by corporate governance standards; because they think it's the right thing to do.
>
> Consultant

> ... because a third of the total remuneration is 'performance related'. So you can write that down in the report and accounts, and when anybody questions you, you say 'we're complying with best corporate governance of the moment, and we have a substantial part of pay which is variable and subject to performance, etc etc'.
>
> Consultant

Other respondents also mentioned that PRP was used because 'the government likes it'. Certainly, this is the case: both the DTI (1999, 2001) and the Combined Code (2003: B1) have emphasised the importance of a link between directors' particularly with equity-based schemes. One further issue is that it is notable that the PRP element of the remuneration is expected by the executives. Indeed, later in this chapter I show that if the variable payout is not awarded, the scheme is often changed. One of the interviewees summed this up:

> It's not linked to performance. It's all 'pay'. It's just different ways.... I mean, there is a question about whether there is such a thing as pay for performance, and what performance is, as opposed to profit sharing.
>
> Consultant

Such comments reflect a debate in the academic literature. For example, Fernie and Metcalf (1995: 383) set out the ways in which PRP is meant to lead to better performance, and state that it reads "more like a wish list than a coherent theory of why performance might improve".

5.4.3 Level of gearing

Having established why companies use PRP, the remuneration committee still has to decide the level of PRP to adopt. As most schemes, both short-term and long-term, base the potential variable award on a multiple of salary, the gearing decision is about selecting appropriate multiples for the annual bonus scheme (in terms of on-target performance and the bonus cap) and the long-term scheme (in terms of the numbers of options or shares potentially made available). Yet again, this decision tends to reflect 'the market'. For example, one consultant commented that the 40% bonus cap on a particular scheme was "not generous". In explaining why he took this view he commented:

> You can only measure these things relative to other companies. [Pause] It's a very difficult question to answer.
>
> Consultant

His comment about the difficulty of setting bonus levels signals how people recognise that there is no 'correct' answer. As another consultant said, "It's just convention", and as market practices change, the level of acceptable bonus changes. Over time, the level of bonus cap, and bonuses paid out, has risen (New Bridge Street, 2003a). This was explained as being because companies have followed the market up: in the same way that base salaries have ratcheted up, so have bonus levels.

> Well again, [the level of bonus is] driven more by market forces and looking at what seems to be competitive levels of annual incentive. And 60% we know is between the median and the upper quartile of the major [sector] companies in the UK.
>
> HR manager

Having made this point, different companies do take different stances on the level of gearing. One interviewee commented that his company, in a fast-moving business environment, had an aggressive scheme in order to attract a particular type of employee:

> ... need to hire combative people, who are aggressive, passionate, prepared to put in 60-70 hours a week, and who are certain types of personality. And you simply cannot attract those people without very significant performance upsides in their pay.
>
> Company secretary

A non-executive pointed out that in the utility that was the subject of our discussion there was a relatively low level of gearing, which was appropriate for that business. However, in another company of which he was a director there was a relatively low base salary and an "eat what you kill" culture of very high bonus potential. He stated that the cultures of the businesses were very different, as were the operating conditions, and the highly geared scheme would not work successfully in the utility.

A further issue concerning the level of gearing is how it links to a company's choice of base salary position. It was stated earlier that companies appear to set base pay at median or upper quartile, rarely below. This was explained by one HR manager as follows:

> ...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 manager

It is interesting to dissect this argument. The company is paying median, in order to be fair to its employees. It is introducing a highly incentivised package, giving plenty upside if performance is good. However there is an argument that employees are protected from bad performance, as they never fall below median. This can be related to the argument, expressed earlier, that the PRP payout has become expected. In most FTSE companies a high level of executive pay is expected.

5.4.4 Balance between short- and long-term elements

Having established that a certain proportion of pay should be performance-related, the remuneration committee has to determine the mix of short- and long-term elements. Both are important. Short-term bonus is useful to focus executives' attention on immediate operational issues, whilst the long-term element is seen to provide a balance, and alignment with the shareholders' interests.

> And again, going back to why we chose to introduce the ltip. So they have got three elements now of variable pay: their annual cash bonus scheme, that measures group profit; you've got our [share option] scheme which has earnings per share; and the [share matching scheme] which has total shareholder return. So it's the mix of those measures that helps ensure that the decisions aren't skewed in a particular direction. Because if you like, they can make a decision this year that would ensure that they got their annual cash bonus. However, it would probably mean that they might not get one of the other two bits. And therefore because of that balance it helps make that right decision.
>
> HR manager

> I think that if you were to try and cut [bonus] opportunity massively, that there could be an adverse impact on the performance of companies. I think maybe not because people would work less hard, but actually what may happen is that that they may actually stop focusing on the short-term, but actually allow results to be less positive in the short-term, on the basis of 'we're going to produce in the future'. But if people say 'ah yes, but I don't believe that' and prices get marked down because they are not delivering today. There's this whole thing that the City only think as far as the next quarter, and yet managers are trying to think longer term, so in the end we all end up thinking short-term.
>
> HR manager

Generally, the interviewees saw the short-term bonus performance targets as influencing behaviour more than the long-term ones. Although useful for aligning executives with shareholders, the long-term incentives were affected more by external forces ('luck') than the bonus. This characteristic has been recognised in the academic literature: March (1984: 56) referred to such incentive schemes as "partial lotteries", as the performance criteria created unreliable distinctions between employees.

5.4.5 Issues relating to annual bonus schemes

In setting up an annual bonus scheme, the remuneration committee will have regard to the short-term and strategic objectives of the company.

> [CEO's measures and targets] are set in conjunction with the remn committee, so they're signed off by the remn committee through our operating plan process and strategic process.
>
> HR manager

Decisions to be made include those relating to the level of bonus available, the type of scheme to be used, and the selection of performance measures and targets. Key points relating to these will be discussed in turn.

Level of bonus

There are two bonus levels that the committee needs to decide: how much will be paid for on-target performance, and how much will be paid for 'superior' performance. Similar factors affect each decision, and it is common practice for each of these levels to be set as a multiple of base pay.

As stated earlier, bonus levels are dependent on 'the market', i.e. on the levels paid by comparable companies. In this instance, 'comparable' is often taken to be companies in the same FTSE index rather than in the same industrial sector. Market pressures are ratcheting up the level of bonus, which is tending to increase each year. Companies choosing highly geared schemes will set their bonus levels higher than others, where incentives are seen as less crucial to performance.

> Because it's got to be important enough so that you feel as if there is enough differentiation. If I put it at 20%, let's take it to extremes, probably it wouldn't enable me to make enough differentiation between an excellent and an average performer, if it was only 20% of base pay. But there is no science that tells you why it should be 50. I mean, to be honest I think you go by most commonly accepted practices.
>
> CEO

In examining a remuneration scheme it is insufficient merely to consider the levels of bonus available, one must also examine the levels historically paid. As one consultant pointed out, a scheme with a potential payout of 80% that historically has only paid about 30% is not nearly as attractive to executives as one with potential for 40% that pays out fully. This is illustrated in the following extract.

> 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 mindset of the executive, they wanted 100% every year. And they hadn't really appreciated that our design was designed for an average payout of 50%.
>
> Q: So they were feeling cheated and underpaid?
>
> A: They thought that if they got less than 100%, something was wrong. Whereas we think if they get more than 50% on average, something is wrong!
>
> Committee chairman

This mismatch of expectations and payout is discussed again in the section on why schemes change.

Type of scheme

It will be seen from Appendix 8 that the case companies used cash bonuses, and a variety of devices to provide a share-based element to those bonuses. One aim of this share-based element was to provide longer term alignment with shareholders. Another was to act as a retention device for valuable executives.

There is no right answer as to which scheme is best, and there is a wide variety of bonus schemes, albeit all sharing the same broad characteristics. One question asked of all the participants was whether, if they came up with a scheme that was totally original but ideally suited to the company's circumstances and strategy, they would implement such a scheme. Responses to this were mixed. Several interviewees (particularly in utilities) stated that they would not wish to do this, as it could draw adverse attention from the shareholders and the media. Some HR support staff indicated that they would be reluctant to put an unconventional scheme forward to the remuneration committee for this same reason.

> And the nature of our business, utilities, is not that it's leading-edge in terms of innovative approaches to rewards. So we would think very carefully about being first in the queue to be imaginative about reward for executives. There's a caution and conservatism about utilities in general, I think. And in our particular case, driven by some of our not-so-recent history, there is a conservatism about fat cattery and not making the mistakes of the past again and doing something idiosyncratic and a bit off the wall would likely draw attention to us in a way that we don't want. So, yes, I think that the psyche of picking relatively dependable, conservative, predictable reward strategies is partly a response to where we were in the past.
>
> HR director

> No, I would go for it. But the issues that you would face with the remn committee would be partly 'do we dare to be different?'. Because I think there is a reluctance amongst non-executive directors to be different. Because you can be blamed for it. They've got a higher profile. And they're still...the non-execs are still a bit of a nervous bunch, I'd say, at the moment, because of history.
>
> Company secretary

> And the [utility] remuneration committee is actually quite strong-willed in not wanting to be leading-edge.
>
> Consultant

> But I would have thought that there's a lot of companies out there, and if there were these sort of novel things around, people would have thought of them by now.
>
> Company chairman

Interestingly, relating to this last extract, the secretary of that company, in a separate interview, mirrored this wording exactly, which might indicate that the matter had been discussed at some time.

Surprisingly, some non-executives seemed more prepared to consider an original scheme than their advisors might have imagined. They indicated that most remuneration schemes look similar, and they would have liked their consultants to suggest something more unusual. However, all agreed that the big issue would be persuading the institutions to agree the proposals. I discussed this with an institutional representative, who pointed out that although in principle they and their members have nothing against innovative schemes, there is "an instinctive tendency to mistrust new measures" as often they are too easily manipulated and can lead to schemes being too rich.

Before leaving this section, one quotation from an HR manager both explains their attitude to this issue, and illustrates where the power lies in the company:

> In some ways it's unlikely [that they would adopt a novel scheme] I've got to say. Because we have the strategy of linking with the market. But it depends what it was. The NEDs might struggle with it in the first place. The real person we'd have to convince is [CEO]. He does run the company. We're less worried about the outside world than you might think. [CEO's] view, and therefore our view, is that if we believe it is the right thing to do we should do it. He would be quite prepared to fight the ABI. He would be prepared to break the ABI guidelines if he felt it was the right thing to do for [company]. And we would expect to win the argument.
>
> HR manager

Performance measures and targets

Companies use the measures and targets in their short-term incentives as a means to focus executive attention on what is seen as important. The schemes can be adapted each year, the choice of performance measures and targets changing to reflect current business issues.

As set out in Appendix 8, in their desire to create focus on key objectives, companies had used different types of performance measures, to accommodate differences in their cultures and structures, and in their aims. Some implemented both financial and non-financial measures, others used just financial ones. Some rewarded individual targets, others tried to inculcate a group sense of shared responsibility by adopting solely group targets. It was accepted that the performance measures and targets needed to be appropriate to the business circumstances, linked to strategic plans.

> Some of them will be about the things that will back up delivery of the operating plan. Some of them will be about actually bringing about the cultural changes within the business. So how we are expecting him as our leader to operate and bring about some of those changes. So some of those are sort of the more subjective ones, obviously. They have to be.
>
> HR manager

In setting targets, companies often use their operating budget as a standard. Given that the budget is set by executives, and the remuneration packages are approved by NEDs with less detailed knowledge of the business, one question asked of the participants was how the non-executives knew whether the targets were reasonable in the context of anticipated performance. A couple of non-executives (both in the same company) argued that their business experience facilitated this.

> But take me for example. I've been the chief executive of [company]. I know all about setting budgets and what the key drivers of a budget are. I think I have enough experience to ask the right questions and make judgements. [NED], for example, was finance director of [company]. So he again is well equipped for experience to get inside the budget quite quickly.
>
> Committee chairman

> ... has been particularly difficult on this score, when we come to setting budgets, they tend to set soft budgets at [company].
>
> Q: How do you know that they set soft budgets?
>
> A: Because they found them so easy to achieve them.
>
> NED

However, most of the other non-executives admitted that this was an issue, and that they could not possibly know as much about the businesses as the executives.

Many of the participants stated that there needed to be an element of trust between the parties in order for the process to work[47].

> I think the overall integrity of senior management is such that you have to have a target that the remuneration committee can live with. This is where the remuneration committee can't have the same sort of feel; they have to trust what the target is that is given to them from the organisation. They can push it a bit, they can say... But at the end of the day they don't have the hands on executive contact that would allow them to say 'I think this is a fair profit target for the year', or 'I think you're making it too easy'.
>
> Company secretary

> Well the conclusion you come to is that that's a role for the non-executives, to prevent it setting easy targets. But, you know, it's not necessarily all that easy to do. ... So there is that problem, I agree. But there are many other problems in all this. For example, the bonuses, how do you prevent short term arrangements made to achieve certain profit levels in certain periods, and all that? ... The answer to that question is ultimately, I don't think you can. But as part of the sort of... this kind of vague thing that non-executives do, you have to try and monitor that. And it's all about... everything about being a non-executive is about trying to know your company, know your executive colleagues, try to get a feel for how they are behaving. If you have confidence in them, then you need to worry less about that; if you don't, then either you need to go, or change them, or something. But there's a lot of instinct and feel and such like.
>
> Committee chairman

> I think to a degree it's a question of having faith in the FD to start with. Because he or she is charged with making sure that the company is acting honestly, if you like. And the non-execs have to trust him or her. At the end of the day there's no shortcut, there's no way round that.
>
> HR director

One company secretary indicated his belief that budgets were set with half an eye on the performance targets they would entail:

[47] It must be noted that the nature of the research sample – all of the companies were volunteers for this study – implies that there might be more trust between executives and non-executives on remuneration matters in these companies than there is in the population generally.

> So when the operating plan is set, you will end with, in very loose terms, a profit target for the year end. And that profit target will be the one against which your achieved level of bonus will be, and then there will be a sliding scale up from that, in excess of that. So there is a disincentive to have too stretching a profit target, because it will very quickly be potentially demotivating if you know you've not hit it. But it does mean that if you just took away all thoughts of reward, if suddenly you could change somebody's mind and say I only want to operate for the good of the company and the shareholders, then I'm not sure you'd come up with exactly the same operating plan. I don't think it's been particularly harmful, but I think I'd come up with a different operating plan, where you'd put more stretch in it.
>
> Company secretary

5.4.6 Issues relating to long-term incentives

Underlying the use of a long-term incentive are issues of alignment of executives' interests with those of the company, and of retention of good executives. Committees also have a fundamental choice to make between options and ltips. That choice is the starting point for this section, which will then move on to consider the other issues.

Schemes, measures and targets

Figure 5-3 Characteristics of long-term schemes adopted by case companies

- Of the 12 companies, seven had option schemes and 10 had ltips (five had both).
- Of the options, two used TSR as a performance measure and five used eps growth. The targets for eps growth ranged upwards from RPI+2%.
- Of the ltips, two used eps growth as the performance measure and eight used TSR. Of those using TSR, four supplemented it with another financial measure.

In the section on annual bonuses, types of scheme were considered separately from the choice of measures and targets. In considering long-term incentive schemes this distinction is not appropriate, not because it is not a valid distinction, but because often the participants appear not to make the distinction themselves. Regularly in the interviews, a question about why a company had adopted an ltip/option was answered initially by stating why TSR/eps was an appropriate measure.

> There's been a big debate on ltips versus options. Ltips, I suppose for two reasons, none of us were particularly happy with. They were spawned in the time when options for utilities were being decried in the media. But the problem first of all is, what is an appropriate peer group to measure shareholder return against? ... And the second thing is, if the whole sector does well and you create value for the shareholders, but you happen to be No 5 out of 10, you don't get anything. You've created value because you performed well, but because the whole sector's performed well you finish up with nothing. Whereas a share option, at least if you've created value it's reflected in the share price so you benefit. The disadvantage of the option, it is said, is that you piggyback on the whole market going up without necessarily improving performance. So there are pros and cons. But I think it is fair to say that the members of the remuneration committee all favour options...
>
> CEO

> Q: You moved from an ltip to an option scheme. What happened?
>
> A: ... It is a matter of philosophy, isn't it. Both in terms of your view on what the most appropriate performance indicator is: is it total shareholder return or EPS? - and we could sit here for the next two days arguing about it and not come to a conclusion. So I think you have to start from that position. But it's my view that earnings per share is a measure which the executives can have a fair degree of influence over, and therefore it's fair and reasonable that they should get measured against it.
>
> Committee chairman

This chairman did then go on to discuss other reasons why an option was more appropriate than an ltip. However, because of this mingling of ideas, schemes, measures and targets are all considered together in this section.

Ltips and options

Long-term incentives will take the form either of an executive share option scheme or of a share-based long-term incentive plan, an ltip. Prior to the Myners and Greenbury reports in 1995, UK schemes were mostly options-based. This changed after 1995, and ltips became more popular. However, in recent years the market has seen a trend back to options, or to the use of both options and ltips. The following quotations illustrate this.

> Also, you've got to look a little bit back in history. Share options were the flavour of the month, certainly at privatisation. And we all had a share option scheme.
>
> Company chairman

> But clearly you're right to the extent that TSR-linked ltips were fashionable, I suppose, and not surprising given the output of the Myners committee, the Greenbury committee, and the published guidelines of some of the institutional representative bodies. We then saw a swing back towards options, that's true.
>
> Consultant

> [Regarding the use of both ltip and option.] Both Mid 250 companies generally and within their own sector it was either one or the other. It's becoming much more common among the FTSE 100 companies and we may see it in future drift down.
>
> Consultant

The arguments for and against options and ltips are set out in chapter 2; there is no clear advantage of one type of scheme over the other in all circumstances. Companies looking for a steer on this from their shareholders would be disappointed: institutional pressures have not been consistent as regards whether options or ltips have been preferred.

> *For instance, in the UK in the early 1990s, the Association of British Insurers and the National Association of Pension Funds could not agree on the favoured structure of long-term incentive plans. The ABI favoured share options with earnings per share hurdles, the NAPF favoured L-TIPs based on total shareholder returns against a suitable peer group. It is no wonder that companies threw their hands up and simply designed schemes that they believed would command enough support from both bodies to be carried through.*
>
> *International Corporate Governance Network (2002)*

This being the case, the decision to use an option or an ltip appears in some cases to have been somewhat arbitrary:

> I don't think there was a great deal of debate. I think there was a general feeling round the remuneration table that share options were not what people were going for at this point in time, that they were going more for things that demanded a long-term performance against some agreed hurdles, performance targets which needed to be achieved. And I suspect that you're going to tell me that even share options now can have hurdle rates.
>
> NED

Other participants did state a view as to why they chose one scheme or another, or indeed both. The chairman cited earlier went on to say:

> But why options as opposed to ltips? Especially for the senior people, in my view, they should share in the rewards of the company in terms of their medium-term to long-term incentive in the way that shareholders benefit. And therefore if there is growth in the value of the share price and our shareholders benefit, as they should, so should our executives.
>
> Committee chairman

Of course, although options are a more geared instrument than ltips the argument of benefiting executives by increases in share price applies to both types of scheme[48].

Other reasons given for choosing one scheme over another included[49]:

- Options are used extensively in the US.
- Options have a tax advantage over ltips in that under current Inland Revenue regulations the first £30,000 is not taxed.
- Options, under current rules, may not show as a charge against profits. (Few of the participants said that the forthcoming change in accounting regulations would lead to a change in their remuneration policies. One of the companies

[48] For the same cost to the company, more options can be issued to an executive than can shares under an ltip. Option values are more volatile to share price changes than are ltips, their value to executives falling dramatically when out-of-the-money.

[49] These reasons are deliberately not analysed between those in favour of options and those in favour of ltips. Because the balance of power in some companies is with the committee and in some is with the executives, it is difficult to state whether the interviewees saw some of these features as advantages or disadvantages!

has since changed its scheme away from options, citing accounting issues as one reason.)

- An ltip delivers value to executives even if the share price falls, so options are more aligned. (Some saw ltips as effectively options granted at a nil exercise price.)
- It is a powerful signal for executives to hold shares, and retain them, whereas shares are generally sold on exercise of options.
- Options carry the risk of being underwater.
- In a bull market, options give the executive more value, merely from the 'rising tide'.
- The timescales for options are longer than ltips.
- Ltips are more complex than options.

Very little intellectualising over this subject was noted, even when reading consultants' reports recommending one or the other scheme. However, one HR professional, whose company used either options or an ltip in any one year, explained clearly the advantages that he saw of each scheme under different circumstances:

> ... they actually do have a different sort of shape. One is more heavily geared on how the share price is doing. The other is more heavily geared on how well we are doing compared to other people.

And

> Because the other thing is that with share options you [the executive] get the best value, probably after ten years. Whereas the performance shares it's three years. That's another difference between them, which people have to balance.
>
> HR manager

Performance measures and targets

In the UK, it is common, although not universal, for share option schemes to use a performance measure based on growth in eps relative to an inflation index, and for ltips to use a performance measure based on TSR relative to a comparator index. As stated earlier, many of the participants appeared to make the assumption that if a particular type of measure was most appropriate for their needs, then they should adopt the relevant type of incentive.

Reasons given for using eps-based measures rather than TSR measures mostly revolved around the problems associated with TSR. Being measured against a comparator group, it is important that the group selected is appropriate in terms of size and composition. There is an immediate issue as regards the size of a comparator group, particularly with utilities, as there has been so much M&A activity in that sector in recent years. Each merger or takeover reduces the pool of comparators. Furthermore, a weak company may be taken over at a premium – which increases that company's TSR, unfairly distorting the comparator index. Several interviewees reflected on this issue.

> Let's say you start off with ten companies in a comparator group. Within six months a couple of them have been taken over. You then get down to three or four. Now, how do you measure median and upper decile with three or four comparators? It just becomes meaningless.
>
> Consultant

A related issue was the decision on whether to use a comparator group of similar companies, or an index, for example FTSE 100.

> The difficult area is the comparator group. Everybody's got a different idea, from 'it should only be utilities', to 'it should be the whole FTSE index', and anything between those two.
>
> Committee chairman

The advantage of using an index is that there are always enough companies in it for a realistic median to be taken, which addresses the points made earlier. However, if a particular sector is out of favour with the City, share prices in that sector will be depressed relative to the index, with the result that ltip payouts will be penalised.

For these reasons, many companies prefer an eps growth target. In adopting an eps measure, most of the companies used RPI as a performance benchmark, taking an RPI+X% formula. Decisions then had to be made as to the level of X, both for the minimum payout to be triggered, and for maximum payout. The majority of companies in the sample (and indeed, in the FTSE 350 – New Bridge Street, 2003b) took a base level of X at 2% or 3% per annum over three years. I pointed out to many of the participants that growing earnings at this level would not generate shareholder value, as it would not cover the cost of equity. This, however, was not seen as an issue. The general response was that the benchmark was set based on 'the market'.

However, in some companies the level of X required to achieve full payout was significant, with companies having considered their industry dynamic[50].

[50] Although many companies are now modelling expected payouts from their schemes at various levels of performance, there was no indication that the performance hurdles were closely linked to companies' costs of capital and price earnings ratios.

> ... and my view of RPI plus 3 is that if you don't get there you should be shot. You shouldn't be in business, you should put the money in the bank. The fact that that should be around is, I think, terrible. But it doesn't matter. What we very much wanted was something which was tiered. That said this is the threshold where you get something, I think 33% at RPI plus 3, and then you get the maximum at RPI plus [X] %. So it was a matter of setting a scale. So the first point was we didn't want something which the light switch was "on or off", we wanted something which was tiered, and we wanted something that rewarded them for well above average performance. Again, fitting into the philosophy that I talked about.
>
> Committee chairman

Several interviewees mentioned the problem of setting aggressive eps growth targets in technology-related companies which had appeared achievable a few years ago, and were impossible under recession conditions[51]. Another problem raised on the eps measure was the situation of regulated utilities, where the regulator has significantly reduced the companies' profits every five years. This has led to many schemes which are not paying out – as discussed later, in the section on changes in schemes.

One final comment in this section, made by many of the participants, was that TSR is a very complex measure and it is difficult to incentivise people on something they do not understand. With a share option scheme based on eps growth, executives can look at the Financial Times every day to see if their options are in-the-money, and have a good idea what the profits for the business are likely to be, to evaluate whether performance conditions are likely to be met. With TSR, a complex calculation has to be done to average out the company's share price and dividend return over a period, then do the same for each of a group of comparators, then determine the median and upper quartile positions. Even if a

[51] And one consultant asserted that what usually happens in such cases is that the company sacks its consultant and takes advice from another about a new scheme!

company is doing well, it is not intuitively obvious to the executives whether, or indeed why, their scheme will pay out.

> All this adds complexity. And I think most participants would say that it lacks in transparency. You don't particularly know on any day where you are. You really don't know where you are until you're past the goal posts. So on that basis it becomes a reward rather than an incentive.
>
> Consultant

<u>Alignment</u>

One of the main reasons given for using a long-term scheme is to align executives with shareholders. Alignment tends to come through the long-term scheme rather than the short-term bonus, if only because long-term incentives involve a form of equity-holding.

> And basically we felt that identification and primarily share ownership - not options really but share ownership - was probably the best way of getting alignment between shareholders and the company management.
>
> HR manager

> And the last one was to put in an arrangement which encouraged people, in fact required people to invest some of their bonus in the company's shares. And that gave them a better alignment with shareholders, but gave them an awful lot of upside if they did well with the business.
>
> Consultant

This requirement for executive shareholding was met in some companies by linking to the short- or long-term incentives, and in others by demanding that directors build up a shareholding equal to a multiple of their base salary. However, although it is seen as best practice to align executives through a shareholding, at least one interviewee took the view that this technique may not always achieve the desired results.

> Does it make people behave differently? I wish I could say yes. So yes they behave differently when it comes the time to move somewhere else, but does it make them make wiser management decisions? Individually, the unfortunate answer is no. Collectively though, you can. So when I will sit in front of, which is going to be in a couple of days from now, the 30 top managers, and when we make strategic decisions as to what we should or shouldn't be doing, then the alignment is much easier. And I don't have to remind everybody that they are all shareholders and potential shareholders. I think that it is probably easier to align them to the shareholder interest when in the back of their mind they know that they've got their own shares out there.
>
> CEO

Another interviewee pointed out the impact of 'downside alignment' as well as the upside:

> Now not only have your executives got no upside left in their [incentive scheme], they've also lost a significant amount of personal money in their matching contribution in the restricted share plans. And then you're reaching the stage where as a remuneration committee you have to do... well our remuneration committee basically takes the view that the object of the exercise is to align the interests of executives with shareholders, and they are now aligned. The executives have lost money, so have the shareholders.
>
> Company secretary

In the respondent validation focus group I asked if PRP aligned directors' interests with those of the shareholders. Following this question there was silence for 12 full seconds, before one of the participants answered "not necessarily". This, and the discussion that followed, indicates that the alignment may be more sought after than achieved.

<u>Retention</u>

Another reason given for using long-term incentives was the need to retain good executives in the company: if they have an equity payout due after, say, three years, they are less likely to leave.

> Because what shares do not do is create a retention possibility. And the reason why we give options is that you have to be there to get them. So it's a retention tool, whereas shares, like restricted shares in my case, basically align you immediately but they are mostly yours. And if you make them too restricted, then they become options to a certain extent.
>
> CEO

Two issues arise from this: one relates to 'jumping off points', and one to the practice of companies 'buying out' executives' contracts. The comment on jumping off points was raised by the secretary of a company that had made very substantial grants of options in one particular year; all of these options would vest at the same time.

> The issue of course that that can potentially bring is that as soon as you do something like that, in my view, you set at date by which someone knows they've got to stay until, but it gives them a leaving opportunity. And I think that's part of why you need to have a smooth retention plan in relation to people, because otherwise you get jumping off points.
>
> Company secretary

As regards buying out executives' contracts, options and restricted equity act as a 'handcuff' to the extent that the executive will lose financially if he leaves the company. If his new employer agrees to a 'golden hello' which gives him equivalent value to what he is foregoing, then there is no retention effect. Effectively, the handcuff is merely a transfer fee paid by the other company.

> I think to get to the same point with an earlier question you had - 'does it make people act differently?', which is the real question. Because it makes them probably... Before they move to another company, yes. There is a moment in time when they have to make an assessment 'are my options worth so much that I can't possibly afford to lose them?'. And today that is a true obstacle for moving to another company. Not if they are underwater of course, so we have a regular check on how much our managers have invested and vested in [company], so therefore how difficult is it for them to move away, or to be tempted to move away, on the basis of the capital they have invested in our company, and that they would lose if they move somewhere else. Then you judge as to, okay, but would any potential new employer, would they be capable to buy them out? And we bought out some people. But there's a pain level where you will probably not do it. So depending on the value of the individual, it has its limits. And I remember at least two people whom I said no thank you, because it's just simply too much, the cost is just absolutely astronomic. So that's one piece of it, the retention issue.
>
> CEO

It should be pointed out that the headhunters interviewed for this research argued that quite often the new company is not prepared to buy out the package, and so it does act as a retention device.

Choice of performance period

A particular challenge relating to longer term performance-related pay is that conditions when the award period ends may have changed considerably from those which pertained when the performance measures and targets were set. External conditions – perhaps simplistically described as 'luck' – could impact on performance positively or negatively, thus meaning that executives could claim unearned awards, or fail to achieve an award despite good performance. It is perhaps fair to state that none of the people interviewed appear to have taken issue with high awards being made for good luck, although several mentioned the negative impact of factors outside their control. This is in line with the findings of Garvey and Milbourn (2003) who suggested that companies are more concerned with the retention risk of losing executives who do not receive an award due to 'bad luck' than they are with the risk of overpaying executives for good luck.

> I think again the same is true of the long-term. The average employee can't affect the share price performance, whereas your top executive can. But the longer you go out, I think the less sharp an incentive it is. Particularly when it's share price, there are so many different factors that are going to influence what the share price does.
>
> Consultant

All of the companies in the sample, and indeed the majority of large listed companies (New Bridge Street, 2003b) use performance-related long-term rewards as part of their directors' remuneration packages. However, despite the diversity of the industries in which they operate, it is almost universal that 'long-term' is defined as three years. This in part reflects the sentiments discussed above, that the performance targets are difficult to judge over longer periods.

> ...no plan is going to work if it goes beyond the time horizon of an executive participant population. And in my view it's very difficult to see that beyond three years. ... I think you would also have to say that if we're talking about meaningful performance targets, and I don't believe that plans adopted for five or ten years should actually incorporate a defined performance measure along with targets...
>
> Consultant

There is another explanation for the ubiquity of the three year performance period. One of the consultants explained that a statement from the ABI in the early eighties had used a period of three years as its example of a longer term scheme, and that this had been universally adopted. Furthermore, the consultant suggested that the three years had been chosen as an example because it fitted in with Inland Revenue rules for share options at that time, so there was little business logic behind it. Since then, as more companies have adopted three year performance measurement terms it has become accepted practice. Furthermore, it might be disadvantageous to a company to use a longer performance period, as companies are in competition to attract and retain good executives, and a longer period could be seen as a negative by the executives.

Amount of award

Remuneration committees have to determine the amount of options to grant or ltip shares to award each year. One of the research questions was to ask the participants how this was determined. As with many of the research findings in this study, the answer came down to 'the market' – generally companies awarded about the same multiple of salary as they saw their comparators doing, and with much the same ratcheting effect. Awards were also made dependent on performance in the year – for example, the amount of options awarded would be a function of (a) salary and (b) the performance bonus.

5.4.7 Input factors to the decision on pay structure

In chapter 4 I discussed a questionnaire survey given to the participants, soliciting their views on factors affecting remuneration. Table 5-2 sets out the factors affecting pay structure, ranked in order of their average score.

Table 5-2 Factors affecting the structure of pay

	Score (max 5)
Investors' views	4.25
Shareholder returns	3.95
Company strategy/industry	3.86
Company profitability	3.71
Company size	3.38
Financial accounting considerations	2.86
Tax (for the company)	2.81
Cash flow	2.52
Individual directors' experience and qualifications	2.43
Tax (for the individual)	2.43

It was clear from the interviews that investors' views (and good governance practices generally) are an important influence, as are the company's strategy and industry. The issues of strategy and industry were discussed in chapter 2, and these findings support that literature, in that the choice of pay levels and schemes appears to reflect industry and lifecycle characteristics. The influence of institutional investors is worth considering further here.

The private disclosures made by UK companies to their institutional investors, and the influence of said investors, particularly during periods of corporate difficulty, have been well documented (for example Holland, 1996, 2002; Pye, 2001). It is interesting to note how the relationship has changed over the past decade. Holland and Doran (1998: 145) reported on interviews conducted in 1993/4 (before the Greenbury report) with fund managers and senior directors, and stated that:

> *The case FIs [financial institutions] also identified areas such as executive remuneration where they were careful and sometimes avoided influencing management.*

The argument made was that it is management's 'right to manage' and this is outside the FIs' area of competence. However, they then went on to state that:

> *Despite these FI comments, it may prove difficult in the political climate of the late 1990s for the case FIs to maintain their view that their corporate agents can determine the size and structure of their own remuneration. (1998: 145)*

This indeed proved to be the case, and institutions have become far more active in commenting on, and demanding changes to, executive remuneration policies and packages.

The majority of interviewees made reference to the way in which they interacted with the institutions in determining the pay of the directors. It is a regulatory requirement to seek shareholders' approval for long-term, share-based remuneration schemes (Combined Code, 2003: A). However, the interaction often goes further than this, with companies seeking institutional comment in advance of finalising a scheme, in order to ensure that the scheme will gain acceptance. This is considered very important, as illustrated by one NED reflecting on institutional liaison:

> And, you know, is it in accordance with best practice and good governance? Because the one thing you don't want is a row with the ABI and the Financial Times and Patience Wheatcroft and Niall Collins all in one season!
>
> NED

This point was also made by one of the consultants:

> We would liaise with the ABI. That is a very important part of the project, because different investors have different views and it's a question of knowing what the sensitivities are, where they are coming from, and trying to take some of the heat out of the process. Getting it done before the circular hits the press is obviously something we'd recommend. A lot of the problems come in this area because you leave too little time for that, and then the shareholders start doing their talking through the press, and that doesn't help anybody.
>
> Consultant

The participants referred to the liaison with institutions taking place in a variety of different ways. These included:

- letter sent in the name of the remuneration consultant;
- letter sent in the name of the chairman of the remuneration committee (often drafted by the consultant or the HR professional);
- telephone contact, with either the chairman of the committee, the HR support, the company secretary or the consultant;
- face-to-face meetings, with any of the above.

From the interviews, it seemed that the consultants preferred the dialogue to take place through them, and saw themselves as having the technical knowledge to be able to 'translate' between the parties.

> It's mostly us [who do the liaison]. But it is changing. There is a pressure from the institutions that they want to see the company, really, rather than us. Which in some ways I understand. But then you have the issue of how well-versed is the person who actually goes along, in terms of actually talking to them... That dynamic is changing. But I think it's in a bit of a development phase. I think it's a bit like the consultants. You're holding, actually, all the cards. One, you understand the arrangement better. You understand what each party doesn't know, and you are able to piece it together. Whereas if both parties on both sides had more knowledge to start off with, they would be able to talk more readily. But remn co chairmen, it's one of the things they do, and they are not experts in the whole thing. And therefore the conversation doesn't go... you're not talking at the right level to start off with, so how can you cover the breadth if you haven't got enough knowledge? Whereas the consultants can go from here to there easily.
>
> Consultant

However, the institutions preferred to be able to discuss matters with the committee chairman himself, or at least with members of the company. The following extract from interview notes summarises the view of an institutional respondent:

> The company can put forward the chairman of the committee, the HR professional or the consultants. At different stages in the process, each could be acceptable. But for the set piece meeting when they are explaining to [institution] what they are proposing to do, that should be led by the remuneration committee chairman. And it's good if the chairman can come without the consultants - looks better.

This was reflected in the practice of one company, where the dialogue was at different levels depending on the matters being discussed. For technical issues, the consultants were involved; for matters of principle the committee chairman and the SID (senior independent director) conducted the meetings on their own.

5.4.8 How companies determine the structure of pay: summary of section

It is now appropriate to summarise how companies determine the structure of their executive pay. The use of PRP is ubiquitous – partly for HR reasons such as providing motivation and focus, and partly for reasons of legitimacy with the investment community and regulators. However, not all participants believe that PRP 'works'. Nonetheless, there is a perceived need for PRP; accordingly, schemes are structured to align with the company's strategy, and based on schemes adopted in similar companies, which are seen to be acceptable to the investing institutions.

5.5 Why companies change their remuneration schemes

5.5.1 Raising the issue

In arriving at the original research question, how companies determine the pay of their executive directors, the issue of why companies change their policies did not arise. It has not featured particularly in the academic literature (other than to note the continual rise in pay and the increased levels of PRP). However, in conducting the interviews it became apparent that most of the companies in the sample had made changes to their policies and packages during the period under discussion[52], and that the reasons behinds these changes were relevant to an understanding of the remuneration-setting processes. Hence in this section I discuss the changes that were made and the reasons given.

[52] Most of the changes discussed had taken place within the last two years. In one company, one change was five years earlier.

To place this in context, Appendix 9 sets out a summary of the reasons given for changes made over the past few years by each company.

5.5.2 Changes made to remuneration policies and packages

The main changes made by the case companies are summarised in Figure 5-4.

Figure 5-4 Main changes to remuneration policies and packages

Performance measures changed (short-term and long-term)
Type of scheme changed (short-term and long-term)
Choice of comparator changed for long-term schemes
Introduced a shareholding requirement for executives
Salary levels increased
Perks increased
Level of bonus available increased
Level of long-term incentive available increased

None of the changes led to a decrease in executive pay: all resulted 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

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

5.5.3 *Why change?*

There were many different stimuli for change. The analysis in Appendix 9 sets out some detail of these; here I summarise them under broad headings, to show the key themes.

Market-related changes

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 this 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 Itip. 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

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. As discussed earlier in this chapter, the level of PRP is increasing. Companies are making these changes as they see other companies increasing the potential awards.

> ... if you took the fixed and variable mix of cash, 80% was fixed and 20% variable. We felt that was totally out of kilter with competitive companies, as it was. ... I mean, the role of the non-executive is to bring independent advice to the executive. And when we were talking with the then chairman about the company we asked him to consider the mix of fixed and variable, because we thought it was out of line with all of our experiences.
>
> NED

> Well the reason we're increasing it [long-term incentive] is that we think the marketplace again has gone more towards a greater than 100% basic.
>
> HR director

Changing schemes because they do not pay out

Another major reason for making changes to executive remuneration schemes was that the performance-related elements were not paying out, or not paying out to the extent expected when they were set up[53]. The interpretation of this fact in the companies 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 seemed eminently fair – 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

It could be argued that it is the role of 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. However, the tendency to change schemes that were not paying out was consistent over all sectors, and related not just to the regulatory impact. The following quotations illustrate this.

> I know we certainly came to the conclusion that the bonus scheme was not operating effectively for a number of reasons; we didn't have the correct ...

[53] For example, one bonus scheme was changed because the anticipated payout of about 40% of salary had turned out 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.

targets for individual executives. And because of the regulator's settlement, we knew that the total shareholder return target we had was quite useless.

NED

But what it really basically meant was that we were sitting there with no long-term incentive plan that was worthwhile having, with anybody having anything in the bank, if you like. So we had to sort of look at it anew.

Company secretary

It clearly wasn't much of an incentive; it's been running [for a number of years] and hasn't actually paid out anything yet at all. So they thought that it was being almost disregarded by the senior management as an incentive.

Company secretary

But every time we put a report in, there's a summary that says "if that was the end product, if we were now at the end of a three-year performance period, then these are what the awards would be. i.e. nothing." And when you get a quarterly report - because our remuneration committee meets five or six times a year, perhaps more frequently than most would do - and every time they're meeting they're getting a report that says 'no payout if it stays like this', and it did tend to stay like that. Then the message is coming through loud and clear that they have the long-term incentive that is not incentivising. So when you then get a response from the executives which is reinforcing those sort of messages, you don't have to be a rocket scientist to work out that you need to do something.

HR manager

So the combination of the dissatisfaction with the construct of the schemes, the doom and gloom about their ability to pay out, and the general unease coming from the executives about pay levels in general combined really to start the engine running which was to produce the new incentive arrangements.

HR director

Really, it fell into disrepute as a means of remunerating people, because it did not pay out for two, and then three years. People just looked at it negatively. The fact that the company had not performed even at median level when compared with its peers in terms of total shareholder return was not something that they were focusing on.

HR director

In an earlier section it was noted 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 the performance measures and targets (both short- and long-term), 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 advise them, felt that schemes that did not pay out were not working, and needed to be changed. I suggested to some of the interviewees 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 (which approach would be in line with agency theory). Whilst none disagreed with this comment, the feeling was that it was not a very helpful way to approach matters:

> Oh, that is an argument that is put, but I don't think that it carries you very much further forward. You could say that they've gone so far underwater that the management doesn't deserve it. You could say that the management should therefore be sacked, you should find a new management. And there is a bit of that, I'm sure. But every day is the first day of the rest of our lives. And if you actually believe, and I think that there is some evidence that investors are coming round to this view, but these things do have a place in the pantheon, then actually that sort of statement is just a cop out. It doesn't get you very much further.
>
> NED

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 targets[54]. It thus appears that in many levels of the hierarchy, PRP is only considered workable when the schemes produce a reward.

Changes in the company

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. As discussed earlier, company strategy is an important input into the nature of the schemes, and changing the remuneration scheme was a fundamental part of changing the strategy – the performance measures and targets could be seen as symbols of the required commercial change.

> 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 director

> 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 director

[54] He also suggested that overachievement would lead to an increase in performance targets.

> That epitomises what it's been about. So, if you like, the incentive plans - or at least the short-term incentive plans - have been designed to support that particular objective.
>
> HR manager

> Well it reflects of course the changing nature of the company.
>
> CEO

> 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 overachievement, 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

Another related reason for changing the remuneration scheme was given by a 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.

Changes of personnel

It would be nice to think, given the above, 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 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 personnel 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 most 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

> Stage two was to increase the amount of options that could be granted at a critical time.
>
> Q Right, why?
>
> A Because they had to bring people in. They wanted to make people feel motivated, and they felt that the market had shifted quite a lot.
>
> Consultant

> I think the other real reason to lead to a change in the remuneration strategy was the arrival of a whole pile of new executives. I've been here three and a half years, I'm probably the fourth longest serving member of the executive. Only one of the executive directors who was here when I arrived is still here. So we got a new chief executive, new group finance director, several new MDs, a new group HR director. The change in composition of the executive team really generated quite a lot of tension. Because none of them could understand the regime we were under.
>
> HR director

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 manager

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 director

> I think that the simpler you keep remuneration schemes, the better. And if you have simple, clear measurements, which both your executives and your managers understand, and the outside world understands, then I think the likelihood of success and buy-in is a lot higher. I don't like complex schemes, because usually you have to employ an army of people to administer them and another army of people to work out what the benefit should or shouldn't be. And the people who are participating usually don't understand. So, simplicity I think is the essence.
>
> Committee chairman

In other instances, consultants' reviews suggested that schemes needed to be rebalanced, changing the mix between short- and long-term incentives.

> It came out of the advice they've had from [consultancy]. That the remuneration packages looked about right except that they were missing that long-term incentive component and that if they didn't have the long-term incentive component they were below market. So it was, you know, both that there was an element missing and it wasn't made up for in any other way.
>
> Consultant

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, 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 director

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 a couple of the interviewees believed that the existing scheme was more appropriate for the company. Appendix 10 sets out the changes made to companies' policies and their processes in order better to comply with regulation. It also sets out areas where companies acknowledge that they do not comply with regulation, but still do not make changes. In two companies, part of the bonus was treated as pensionable pay, which is frowned upon. In both cases the reason given was that this had been common practice throughout the company for many years. In three companies the company chairman sits on the remuneration committee, which is not considered good practice.

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' culture 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.

5.5.4 Why companies change their remuneration policies: summary of section

Most of the companies in the research study had made changes to their remuneration policies and packages. In some instances these were minor amendments, for example rebasing the salary or bonus level. Other changes had been more significant, with the whole structure of the schemes being altered. Many different reasons were given for making these changes. Of these, the most common were that the executive pay being produced by the scheme was below market, or that the PRP scheme was not paying out. Changes in company strategy or culture were also significant drivers of remuneration change, as were changes in personnel. Finally, evolving best practice in corporate governance often led to changes in policies.

5.6 Summary of chapter

In this chapter I have set out the data underlying several aspects of how directors' remuneration is set. Examining the five questions to be addressed by a remuneration committee, I have shown how companies determine the level of pay and its structure, mostly by reference to 'the market'. I have also demonstrated that different companies address remuneration issues in very different ways, and the processes they adopt vary considerably, although all could be said to comply with governance directives. Finally I have examined the issue of why companies change their remuneration policies and packages, which relates to the perceived need to pay market rates of base and PRP, and to changes in the company and its environment.

These issues will be considered again in chapters 6 and 7, which analyse these findings in the light of possible theoretical approaches.

6. REVISITING SOME THEORIES OF EXECUTIVE PAY

6.1 Introduction

In chapter 5 I set out the research findings on how companies determine their pay levels and structures, and why they make changes to their remuneration schemes. I pointed out some difficulties companies face in determining pay, and suggested that in the absence of a 'right answer' one key aim of committees is to justify their remuneration decisions, to achieve legitimacy with stakeholders such as shareholders, customers and regulators. The data found inside the 'black box' indicate a rich mix of approaches to and reasons for decisions. In this chapter and the next I will consider these data in the light of plausible theoretical approaches: this chapter sets them in the context of the extensive body of research into directors' pay, reviewed earlier in this thesis; chapter 7 extends the analysis to suggest some new ways of considering the data.

The structure of this chapter is as follows. I begin by considering how the rich and diverse research data unearthed by the methodological approach adopted shed light on the economic theories discussed in chapter 2, showing how they support some aspects of the theories and conflict with others. I then go on to perform a similar analysis for the social-psychological and organisational theories set out in that chapter. Again, I show that none of the theories in itself is sufficient to explain the phenomenon under investigation, or as Finkelstein and Hambrick put it a generation ago:

> *The complexity of CEO compensation cannot be easily understood by adopting single models. Over-reliance on any single perspective is incomplete and can easily lead to the conclusion that one is observing 'madness'. It is only when economic, social, political and individual forces are considered jointly that effective analysis can occur (1988: 544)*

To end the chapter, I re-visit the theoretical models from chapter 3, which were developed from the literature review, and show how they too are too simplistic, and suggest how they might be amended in the light of the empirical results.

6.2 Examining the data in the light of economic theories

In Table 2-1 I suggested that of the economic theories, agency theory aimed mainly to explain the structure of executive pay, whereas labour market and human capital theories focused more on its level. In this section I link this to the research data. No data were found that had relevance to tournament theory, and therefore this is not discussed further.

6.2.1 The level of pay

Labour market theory

Labour market theory suggests that executive pay will lie at the intersect of a supply and demand relationship for executives, at a level set by the market. In chapter 5 I showed that various somewhat arbitrary decisions have to be made by committees in determining their particular 'market': there is no one clear answer as to where pay should be set. However, the committee cannot afford to sit indecisively on the fence – ultimately they have to make a decision, and this decision has certain links to classical labour market theory.

The findings showed that the level of directors' base salaries (and therefore their total pay, elements of which are multiples of salary) is based on 'the market', as determined by size, industry and geography. Those market data come from several sources: the use of consultants' remuneration surveys is ubiquitous, and HR professionals also collect their own market data from annual reports, etc.

The finding that pay is determined by market factors is hardly surprising. Such factors, particularly company size, have been tested extensively during decades of research into executive pay. As shown in Appendix 2, many past studies have correlated pay with company size; those that do not test size specifically do use it as a moderating factor in their other tests. This was a finding of Tosi et al. (2000: 329) in their meta-analysis of the remuneration literature:

> *In our judgement, the results are consistent with those theoretical explanations that emphasize organizational size as an important determinant of total CEO pay; that is, indicators of firm size, taken together, explain almost nine times the amount of variance in total CEO pay than the most highly correlated performance measure.*

Tosi et al. noted that researchers had used some 16 different variables as proxies for company size, including sales, assets, market value and number of employees. In this research, the case companies mainly used turnover and market capitalisation as their benchmarks.

Furthermore, the link between size and pay has become causal, in the sense described by Jensen, Murphy and Wruck (2004):

> *As suggested by Baker, Jensen and Murphy (1998), the size adjustments used in the survey instruments both formalize and reinforce the observed relation between compensation and company size. In other words, what starts out as a simple empirical correlation between size of firm and size of remuneration for top-level managers is turned into a causal mechanism that rewards managers for increasing the size of the firms they lead even though they may destroy value in doing so. (2004: 56)*

This issue of company size influencing the level of pay is seen in managerialist theory (Tosi et al., 2000), which suggests that it is to the financial benefit of executives to increase corporate size rather than profitability. The data presented in chapter 5 refer to two companies that grew by acquisition, and whose acquisitions led to a significant increase in the level of directors' salaries. Although this would appear to be in line with managerialist theory, it is impossible to know the motives underlying these particular acquisitions. Accordingly, although the data appear to support the theory, this can neither be confirmed nor refuted.

As stated, the reason that pay is so closely correlated with company size is due to the universal use of remuneration surveys. In the case companies studied here, the surveys benchmarked companies of similar size, but also using industry as a relevant comparison. Although 'industry' is not highlighted in chapter 2 as a determinant of the level of pay (it is considered later in that chapter, as a determinant of structure), this research finding is consistent with the fact that much prior research has controlled for industry, effectively acknowledging its importance.

The third input factor for the decision on level of salary was a geographical one. Companies that were undoubtedly global tended to use US comparators; a local company used a more regional benchmark. Although geographical differences have been noted by previous researchers (for example Murphy, 1999; Conyon and Murphy, 2000), this is not a factor that has attracted much interest in prior research, although Lippert and Rahman (1999) indicated that the link between CEO pay and company performance is lower in multinationals than in purely domestic companies, and Duru and Reeb (2002) showed that geographical diversification leads to a premium in CEO pay.

There are several reasons why prior research should not have specifically identified geographical factors as a major influence on pay levels. Firstly, almost all studies are country-based, and geographical influences are either not relevant or not seen as relevant. Furthermore, a majority of the studies in this field are US-based; accordingly their results would not be biased upwards by US comparisons, as this is part of their data set. Finally, archival data are likely to be insufficiently granular to be able to identify and segregate individual companies that may have specific geographical comparators. Accordingly, although these results are not greatly supported by previous research, they are not incompatible with it.

Overall, there is much in this work to support labour market theory. However, on closer examination there is a problem. Pay is set in accordance with 'the market', but the market is defined idiosyncratically, with each company choosing its own comparators. 'Pure' labour market theory appears to suggest one equilibrium point for each job; in practice there will be as many as there are definitions of the market.

> In determining market position the first argument is what is the market, or what are the markets? Because if you would select your CEO from the utilities sector and your FD from a much wider sector, and you've actually defined two markets. You might have more jobs or you might have more markets.
>
> Consultant

A related observation was made by Ang, Lauterbach and Yu (2003: 28), who commented on the many characteristics that distinguish the labour market from more usual types of market where supply and demand operate in a more transparent manner.

> *The labor market for top executives is unique in several ways. First, the market is dispersed. There is no central marketplace or a commonly available source of key labor market information that would detail CEO asking prices, CEO characteristics, and other quality and experience indicators.*

In a real sense, therefore, a commonly-used term that has perhaps appeared non-problematic and transparent has a fundamental ambiguity and perhaps undecidability to it.

Human capital theory

The other key input to the pay decision is human capital, individual qualities such as age, qualifications and experience. The results reported in previous studies have been mixed, in that there appears to be a relationship between pay and human capital, but it is not as strong as that for other input factors.

The empirical research discussed in chapter 5 indicates that human capital does have a place in the inputs affecting the remuneration decision. All the individuals holding executive positions in the case companies appeared, from their published biographical details, to be qualified for their positions, implying that a certain level of human capital is an entry level qualification for the job. However, for most of the executives, human capital was not seen as a factor beyond that. These research findings support Agarwal (1981), in that human capital factors are relevant, but not of major significance in differentiating the remuneration of the majority of executives.

Taking the argument further, several interviewees stated that individuals with superior talents would attract higher pay. Those talents include both professional skills (for example an accountancy qualification) and also the individual's reputation – a 'heavy hitter' will expect, and receive, significantly more than other executives. It is reasonable to argue, in line with human capital theory, that what is happening here is that the qualities of the individual act as a signal to the potential employer, encouraging them to pay a high price for a valuable asset (the employee). However, theory does not indicate which qualities will attract more pay. In different circumstances, different individuals will appear more attractive, or different companies less so. The following extract illustrates:

> A high-profile company, particularly one facing quite significant challenges ahead, will only entice a high-profile, effective chief executive with an impeccable track record if they are able to satisfy that individual that they can compensate them for any potential loss of reputation for moving into a high risk job, where their untarnished record - with the best will in the world -- might be in jeopardy. So that individual may well have fairly forceful views about the package which would entice them to move. By contrast, a role in a company which is in a less turbulent state, a strong position, may feel able to resist the pressure from a particular candidate over their package. And then there would be a particular role, say a finance director there is a fairly standard remuneration. HR directors are more unpredictable. There is a greater range than people might imagine.
>
> Headhunter

Accordingly, although human capital theory may be relevant, it is insufficient to explain how pay is set. It is not clear how it helps to predict or identify what particular mix of talents will be more richly or poorly rewarded, since this appears to be contextually sensitive.

6.2.2 Agency theory and the structure of pay

A basic premise of agency theory is that executives, as agents of the shareholders, are risk-averse and effort-averse. Furthermore, the divergence of their interests from those of their principals means that they will seek to extract additional rents, in the form of extra remuneration and perks (Jensen and Meckling, 1976). In order to prevent this, agency theory suggests that contracts be written to control the rent-extraction by linking pay to performance. In this way the executives will be encouraged to behave in ways which are aligned to the shareholders' interests.

Examination of the research findings in the light of agency theory links closely with the work on performance-related pay set out in chapter 5. The use of PRP, which is ubiquitous, is in accordance with the principles of agency theory. However, the explanations given for that use are less so. This is illustrated in the following paragraphs.

Agency concept: executives are effort-averse and risk-averse

In discussing executive pay and executive roles with both executives and non-executives I found no-one who believed that CEOs and their colleagues did not work hard. In line with this, few believed that they would work harder for more pay.

The issue of risk was more complicated. One aspect of agency theory is that contracts are designed to enable risk-sharing between principal and agent. This issue rarely arose in the discussions, although risk generally was mentioned.

The phrase 'risk-averse' in the agency literature is often used to mean that executives would prefer their pay to be structured as mostly fixed rather than performance-dependent. By and large, most interviewees took a different view, stating that executives seek performance-related pay because it gives them the chance to prove their ability, and because it gives them the chance to earn more.

> There's a risk I think from the individual perspective that [if there were no PRP element] potential for improvement through salary would be lost. A lot of our people at the top of the organisation are quite driven by the prospect of personal wealth, and flat fees, and the level of them, seem to us to remove one of the carrots, incentives to get people to do more.
>
> HR director

An alternative explanation for this desire for PRP (one which supports the agency theory view) was put forward by a headhunter:

> Well I think the reality is that nobody is prepared to give a base salary which comes anywhere near what someone would hope to be able to earn on a base-plus-incentives.
>
> Headhunter

In referring to risk-averse behaviour, another aspect is whether PRP encourages executives to take riskier decisions for the business than they might otherwise do.[55] This also was mentioned in the interviews, and to some extent it seemed to be borne out in one discussion.

> It's something to do, of course, with risk-taking. Why should people take risks - because there is some reward.
>
> NED

More generally, participants put the view that having a high proportion of the package as PRP attracted a certain type of individual, who was more of a risk-taker. From this perspective, PRP does encourage more risk-taking behaviour, through the selection mechanism.

> To do that you need to hire combative people, who are aggressive, passionate, prepared to put in 60-70 hours a week, and who are certain types of personality. And you simply cannot attract those people without very significant performance upsides in their pay.
>
> Company secretary

However, this tells us nothing about whether such people, having been attracted by the package, live up to their advance billing. It is always possible that changed environmental conditions, or a change in personal circumstances, could leave the individuals acting in a different way.

Agency concept: motivate performance

In chapter 5 I set out at length the various views of the participants as to whether pay motivated. A conclusion from this was that it is not the pay itself that is important, but its symbolic value. A high bonus communicates an executive's worth, within the company and to his peers and rivals. As Finkelstein and Hambrick (1998: 550) stated: "Pay is an important scorecard for individuals with high needs for achievement and recognition".

Thus it is reasonable to assume that PRP motivates performance – in the areas that are relevant to achieve the specified performance targets. This relates back to the discussion in chapter 5 about focus: PRP does not motivate executives to work

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[55] Generally, shareholders holding diversified portfolios would prefer this.

harder, but to work on specific targets. This finding is in line with the work on agency theory by Holmstrom and Milgrom (1991) and by Indjejikian (1999).

Holmstrom and Milgrom referred to 'multitasking'. They suggested that when an employee has a job that involves several separate tasks, incentive pay serves in part to direct the employee's attention among the various duties. Indjejikian (1999: 152) developed this argument. He stated that the real agency conflict has less to do with getting employees to work harder and more to do with getting them to choose the right combination of actions and decisions to increase shareholder value. This seems particularly relevant to the broad role of top executives, and was borne out by these research findings. However, Prendergast (1999: 8) pointed out a difficulty in this area, in that whilst setting specific targets may provide focus, it can also lead to dysfunctional behaviour, with the agent gaming the system to focus only on the task that will produce the reward. She noted that in complex jobs, this can present a problem. Such problems were not evidenced in the research findings, although several of the participants emphasised the importance of selecting the right performance measures and targets.

> The most important thing is setting the bonus targets.
>
> Committee chairman

> You have to be sure that bonuses take care of an annual performance, and that your long-term incentives are truly long-term. If all of your incentives encourage short-termism, then 'robbing this year to gain a bonus' behaviour does happen.
>
> HR director

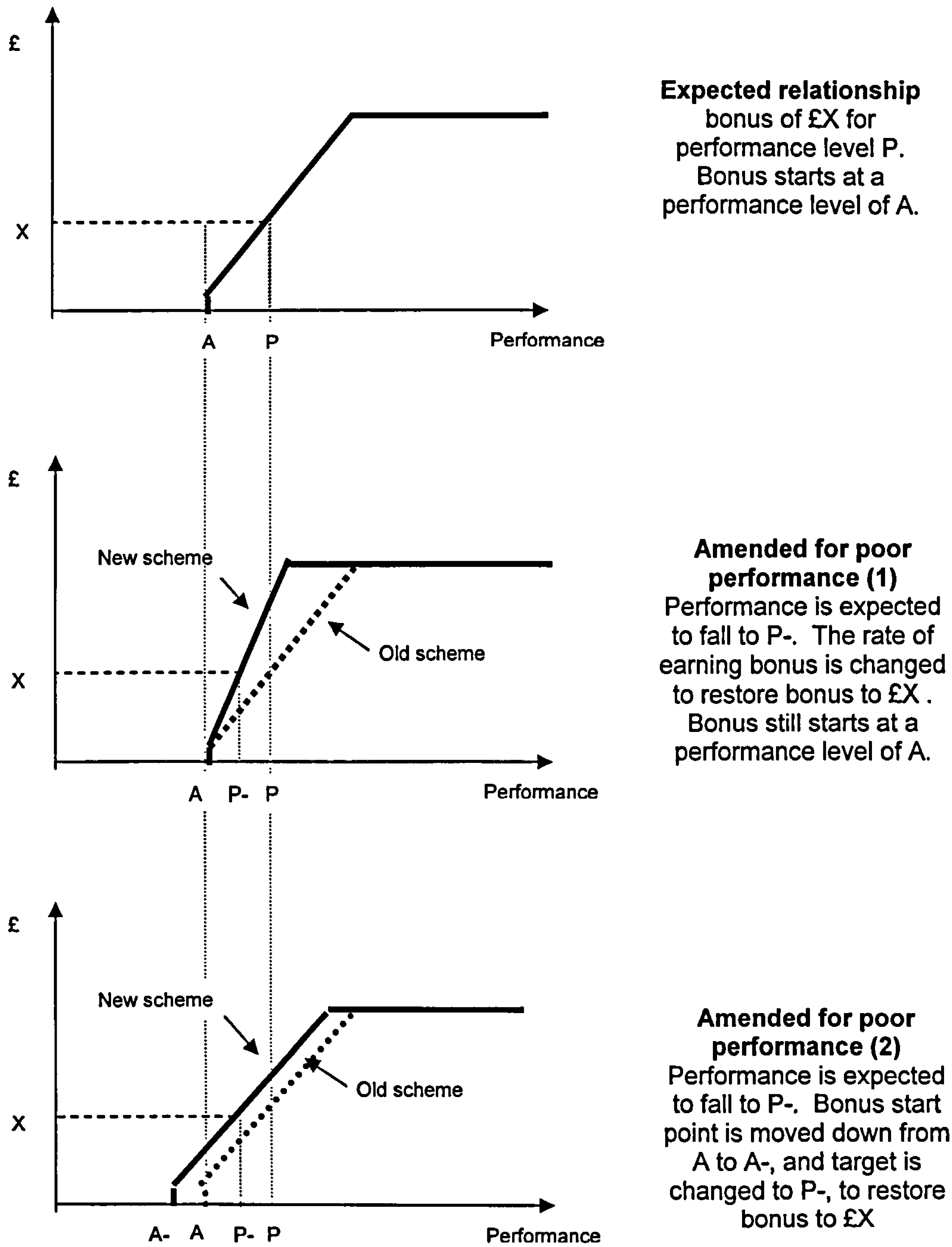
One further point on PRP is worth noting. The following extract from Tosi et al.'s meta-analysis refers to difficulties researchers have found with the pay-performance relationship.

> *Researchers express shock when they find pay/performance sensitivities are low and the results inconsistent with their theory. We suggest that there is a distinct possibility that perhaps the archival performance criteria may be deficient because they typically tap only a small portion of the CEO's job performance requirements, and therefore contain a large amount of noise, making unambiguous causal attributions for observed results very difficult.... Knowing this, boards of directors may well turn to measures of performance that include objective indicators as well as judgmental, clinical, and subjective assessments of other job-relevant dimensions. Such criteria are more likely to represent a holistic, multidimensional assessment of executive performance. Thus, the objective performance measures found in the executive compensation literature may be "deficient" for evaluation purposes by those responsible for corporate governance, who in turn use a subjective evaluation process to assess the executive's contributions. If this is the case, it would not be surprising that weak empirical relationships using archival-based criteria are found. This could mean, then, that the theoretical predictions are not disconfirmed, but only that the methodology employed does not properly measure the performance construct on which the agency contract is based. If this is so, then it may be premature to infer from the research that uses archival data of this sort, as Jensen and Murphy (1990) have done, that there is little support for the notion of "optimal contracting" to align interests.*
>
> *Tosi et al. (2000: 331)*

One factor in these research results confirms the reasons that Tosi et al. give for the lack of relationship. In Appendix 8 are set out the numerous performance measures used by the case companies in appraising short- and long-term performance. The majority of companies used more than one measure, and used a mixture of financial and non-financial measures. This confirms Tosi et al.'s view of multidimensional measures. A further research finding confutes, to some extent, the explanation given. The fact that companies change their remuneration schemes so frequently, often because those schemes are not paying out enough/at all to the executives, suggests that there really is not a strong pay-performance relationship once performance falls. Gillan (2001) suggests that the pay-performance relationship is asymmetrical: companies focus on PRP when performance is good, and on peer comparisons when it is poor.

Figure 6-1 illustrates the 'ideal' relationship, and examples of what might happen in practice.

Figure 6-1 The pay-performance relationship in conditions of poor performance



From these results it seems that a straightforward agency theory explanation, that contracts offering variable pay induce better performance, is an idea that meets with a mixed reception in the sample companies, and it is definitely not the sole driver of the use of performance-related pay.

6.3 Examining the data in the light of social-psychological and organisational theories

In chapter 2 I suggested that of the motivational theories, expectancy theory was used mainly to explain the structure of executive pay, whereas equity theory focused more on its level. Of the other theories discussed in that chapter, institutional theory and legitimacy related both to the level and structure of pay. In this section I discuss how those theories were borne out by the results. I also discuss theories of power and politics, which have great relevance to the way in which the remuneration committee interacts with the executive. Finally in this section I consider bounded rationality and decision theory, and the extent to which these have some relevance in explaining the research results.

Other social theories contained in chapter 2 were social comparison and social influence. No data were found (or directly sought) that related to social influence theory, and this is not discussed further. A small amount of evidence was found for social comparison – the mental benchmark held by remuneration committee members based on levels of pay in their jobs in and knowledge of other companies. As discussed in chapter 5, it is accepted (and indeed appreciated) that non-executives bring their experience of other companies to the debate. However, it was also argued that the mix of experiences on the board means that it is hard to see how any one individual's social comparisons would significantly influence the pay decision. Accordingly, it is difficult to find any great support for this aspect of social comparison theory, although the findings do not refute that theory.

6.3.1 Does pay motivate?

Equity theory

Equity theory suggests that executives will compare their work-reward ratio with that of peers (in the company, or in other companies) and feel dissatisfaction if the ratio differs. Considerable research evidence was found for the belief that executives who knew or believed themselves to be comparatively under-rewarded felt dissatisfaction[56]. This showed in the comments of executives, and particularly in the views of NEDs and consultants about how pay should be comparable. Most of the interviewees referred to the requirement for 'fairness' in this context.

> What [CEO] wants and expects is to be paid fairly. He would regard being paid fairly in two ways. One, that the basic amount he gets is reasonably comparable with those that he regards as his peers outside.
>
> HR manager

No evidence was found to support the alternative premise of equity theory, that executives who were relatively *over*paid would attempt to redress that imbalance. It is possible that these individuals changed their referent others (Adams, 1963) but this is not determinable from the research. Given that there is no correct way to define the market, it is not possible (for researchers or the protagonists) to determine whether the 'right' referents have been chosen.

[56] Although there was little evidence of such dissatisfaction actually occurring in most of the case companies.

Expectancy theory

Expectancy theory (Vroom, 1964) suggests that pay will motivate executives if they believe that by performing the (doable) task, they will receive the (desirable) reward. There is strong evidence for expectancy theory principles being applied in the companies. This was demonstrated in the perceived need to change schemes which had no potential to make a payout. The argument made in several companies was that underwater schemes, or those where the performance targets were unlikely ever to be met, would not motivate the executives - indeed, they may even demotivate.

> Really, it fell into disrepute as a means of remunerating people, because it did not pay out for two, and then three years. People just looked at it negatively.
>
> HR director

As regards the argument in expectancy theory that a potential reward will only motivate if it is seen to be attractive, only one participant mentioned this aspect:

> Q: Why set [bonus level] at 50% of salary?
>
> A: Because it's got to be important enough so that you feel as if there is enough differentiation. If I put it at 20%, let's take it to extremes, probably it wouldn't enable me to make enough differentiation between an excellent and an average performer, if it was only 20% of base pay.
>
> CEO

The implication of this is that a bonus of 20% of salary would not be sufficient to motivate extraordinary performance.

6.3.2 Justifying the package - institutional theory and legitimacy

From chapter 5 it can be seen that many of the practices adopted by companies can be explained through the approaches of institutional theory and legitimacy. This has relevance to both the level of pay, based on the market, and to its structure, based on institutional acceptance and other companies' practices[57]. It also contributes to an explanation of how remuneration committees operate, and of why they make changes to their schemes. In this section I highlight the ways in which the research data support institutional theory explanations and demonstrate companies' desire for legitimacy.

DiMaggio and Powell (1983) discuss three types of isomorphism: coercive, mimetic and normative. All three types are evidenced in the research.

Coercive isomorphism relates to pressures exerted on organisations by other organisations on which they are dependent; for example government agencies or the expectations of society. Scott (1987: 501) refined DiMaggio and Powell's definition, distinguishing two types of coercive pressures: those actually imposed by authority and those resulting from coercive power. We can see in the workings of remuneration committees that some practices are adopted because they are included in the Combined Code, or in the various regulatory reports, whereas others are taken up as being best practice. For example, as mentioned in chapter 5, many companies changed from option schemes to ltips after the publication of the Myners and Greenbury reports in 1995. Appendix 10 shows instances where companies have deliberately changed their practices in order to be compliant with best practice.[58] Table 5-2 shows that in considering the structure of their remuneration schemes, a prime influence stated by the interviewees was the reaction of institutions, a proxy for best practice.

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[57] Pay levels are also legitimised by institutional investors' acceptance. Holland (2002) points out that fund managers use 'the market' to justify pay levels.

[58] The Appendix also shows instances where companies have not complied with coercive forces, an explanation for which is set out in chapter 5.

The following extracts provide an illustration of coercive isomorphism.

> I mean, I'm reluctant to use the word box ticking, but you know what I mean in that the corporate governance officers - if it something they were familiar with, and they know what the norms are, then it's fairly easy to persuade them, but if you come up with something new then they might be suspicious and think 'oh we have got nothing to benchmark this against'. Therefore I know I'm going to have a tough time, and might face shareholder opposition.
>
> Consultant

> What I think we are seeing over the years is a greater dialogue betwixt and between companies and their major institutional investors. And that's a dialogue that's been favoured by the various committees on corporate governance. And indeed, it's an approach that's approved and recommended by the various representative bodies of institutional investors.
>
> Consultant

> I think that one of the criteria which we're told will come out with the DTI paper is that they will insist that you have taken some formal benchmarking exercises in arriving at salaries, so that's what we've done.
>
> NED

Mimetic isomorphism suggests that organisations model themselves on other organisations which appear successful. Often, this is because there is no right answer to what should be done, and other organisations' practices appear to be successful (Galaskiewicz and Wasserman, 1989). In the context of executive pay, this idea of 'no right answer' was illustrated by Mangel and Singh (1993: 339):

> *So far, much of research on executive compensation has focused on the strength of the link between pay and performance, even though economic theory offers little guidance on the appropriate magnitude of the relationship.*

March (1984: 61) discussed how this works in practice:

> *What makes a scheme appropriate is that it is being used by successful companies in the same industry. What makes it progressive is that it has been adopted by other firms that are viewed as being intelligently innovative. Compensation schemes spread from highly regarded companies to less highly regarded ones, as the latter try to present themselves as equivalent to the former; and the signal a particular scheme provides is gradually degraded by its adoption by companies that are neither well-managed nor progressive, thus stimulating the invention of new schemes.*

There is strong evidence for this in the data set out in chapter 5. Companies adopt schemes in line with market practice – or fail to adopt schemes because they are not in accordance with what other companies do. 'The market' is a key influence on how companies determine their executive pay structures.

> HR 1: So the herd instinct was alive and well. I think when you're starting off for the first time, there's quite a bit of pressure to be seen to do something which fits in. And of course you've got the pressure from the ABI and the NAPF...
>
> HR 2: ... it was 'market practice', if you want to use a euphemism.
>
> Two HR managers in same company

Examples of mimetic isomorphism demonstrated in chapter 5 were the move from ltips back to options in the late 1990s; the universal use of three years as a long-term performance period; and the fact that few companies were prepared to implement a novel remuneration scheme[59].

> But because of [high gains on post-privatisation options] ... a lot of people in the [utility] industry in particular did very well - it suddenly became not the thing to do, and therefore ltips became the flavour. And so that's why we went on to ltips. But the circle seems to be changing again now, and people are moving back to, recognising the problems of ltips, and they are moving back to having share options and the like.
>
> Company chairman

The evidence supporting normative isomorphism is less strong, but does exist. Normative pressures stem from professionalisation, with practices being spread

[59] This last example could also be seen as coercive isomorphism, illustrating Mizruchi and Fein's (1999) contention that there is much overlap in the categories, and that many examples of coercive isomorphism are classified as mimetic.

amongst networks of individuals undertaking the same tasks. The relevant networks as regards executive pay are: company secretaries and HR professionals, who administer the committees; networks of non-executives, who bring experience of practices in other companies; and of course remuneration consultants, who "like Johnny Appleseeds, spread a few organizational models throughout the land" (DiMaggio and Powell, 1983: 152).

Thus we have committees which, on the surface, operate the same working practices in each company, adopting similar types of remuneration scheme and justifying their pay levels with regard to 'the market'. These institutionalised practices provide the legitimacy that companies and their NEDs need to justify their decisions on remuneration.

It was clear from the interviews that NEDs and other protagonists were very aware of the need for legitimacy, and wanted to be able to justify both the levels of pay and the structures they adopted.

> But I do think, there is no doubt that part of this process is a covering of the back. It allows the board to say that it has consulted with consultants.

And

> It does behove a company that is in a monopoly position and requires a certain legitimacy and basic goodwill to conduct itself carefully.
>
> NED

> I mean, again, their [the NEDs'] criterion is 'could we be criticised for being unduly generous?'. And if in reality we can show that it's in line with market practice, that always is the crunch. If the consultants are happy, we think that it's a good idea, then it will have a good chance.
>
> HR manager

> We wanted to be whiter than white. The previous chairman was, quite rightly in my view, very concerned that whatever we did was publicly defensible. Not just in terms of shareholders, but particularly in terms of customers.
>
> HR director

> But at the end of the day there is that comfort factor [for the remuneration committee] of saying 'we have an arrangement which we can justify by reference to the market'.
>
> Consultant

It thus appears that institutional pressures – be they coercive, mimetic or possibly normative – and the need for legitimacy for the companies and their NEDs have considerable influence on the remuneration decisions.

Institutional pressures lead to companies adopting similar practices. However, the field of executive pay is one of continuous innovation – many schemes in use today did not exist five years ago. The discussion in chapter 5 of scheme changes indicates that, although many were to comply with 'the market', some were for other reasons, and that not all companies complied with standard practice. A reconciliation is needed between the pressures to change and the pressures to comply.

One relevant issue is that the change in executive pay is what Greenwood and Hinings (1996) refer to as "evolutionary" rather than "radical" change – it takes place slowly. As such, this can be accommodated by stakeholders: For example, Sjostrom (2003) refers to changes being met initially by investor resistance, which was gradually overcome. Bebchuk and Fried (2004b: 17) also address this issue. They comment on the "stickiness" in executive pay practices that arises from the tendency to conform conflicting with the need to evolve. They also rightly point out that institutional theory can provide an explanation for the "stickiness" but "cannot tell us much about why arrangements evolve in one direction rather than another".

6.3.3 How the committee operates - power and politics

In chapter 5 I showed that although all of the companies could tick the boxes for having good governance practices, their underlying processes were very different, and the influence of executives was much stronger in some companies than in others. This was not a surprising finding, as previous researchers, for example Pye (2001) have reported similar results. Stiles (2001), who conducted interview-based research on UK boards, discussed power relationships within the board:

> *The CEO has high structural power because of his/her position in the organizational hierarchy, while in terms of relational power, the CEO's expert and prestige power is also usually pre-eminent over other organizational members. The opportunities for board 'involvement' in strategic decision-making have therefore been viewed as problematic, due to the non-executive directors' lack of expertise and inferior access to information. (2001: 630)*

Lorsch and MacIver had similar findings in a US context:

> *In the corporate boardroom there are multiple sources of power, of which the directors' [NEDs'] legal authority is just one. Others are the confidence to express one's ideas and views, knowledge and information about the matter under discussion, and control over the agenda and the discussion process. There is power in unity too, whenever a majority of the board stands firmly behind a particular position. But essentially, directors are at a disadvantage when these sources of boardroom power are realistically considered. The CEO-chairman usually has greater knowledge and information and controls both the meeting agenda and the discussion process. (1989: 13)*

It is a well-known issue in corporate governance that a company's formal structures may not reflect the real distribution of power and influence. Harrison (1987), in a discussion of legitimacy, pointed out that the fact that a company sets up a board committee is a legitimising activity, but that structures are not necessarily indicative of committee processes:

> *For a board of directors, its committee structure symbolizes its method of operation, which itself is not readily observable. (1987: 111)*

Prior research on the link between executive pay and power, as discussed in chapter 2, has focused on aspects of power such as tenure, share ownership and the make-up of the board. No evidence that these factors were a particular source of power was found in this research (which was not particularly designed to highlight them). None of the interviews suggested any particular significance for any of these factors, except insofar as a dominant figure (usually the CEO) engineered a compliant board. In this respect, the 'political strategist' role discussed by Ungson and Steers (1984) did surface, as regards the CEO's role in managing relationships within the top echelons of the company.

The research literature generally examines power to determine whether CEO power leads to unduly favourable terms in CEOs' remuneration contracts. The nature of this study is such that it is impossible to conclude on this. However, it was obvious that the distribution of power amongst the protagonists - where power is defined in a more generally relational way - was a significant factor in the remuneration-setting process. This subject is discussed more fully in chapter 7.

6.3.4 A round-up of other relevant theories

In this section, two other theories that were introduced in chapter 2 are discussed in the context of the research findings.

Contingency theory

A contingency theory approach states that reward systems need to be consistent with a company's external environment and internal culture and strategy (Barkema and Gomez-Mejia, 1998). There was strong evidence that 'contingency' played an important role in the remuneration decisions of the case companies. Several of the interviewees remarked that no one scheme could suit all circumstances, and that schemes needed to be tailored to circumstances.

> Q: If you were to put the [Company X] scheme into [Company Y], what do you think would be the consequences?
>
> A: Well I don't think you could even think about it. [Company X] is a very low capital business; basically people. ... But [Company Y] is completely different. It is vast. .... [Discussion of different business characteristics.] So I don't think it would work.
>
> NED

Furthermore, as set out in the cross-case display in Appendix 9, there were several instances of schemes being changed to take allowance of changes in the external or internal company environment. This is in line with the findings of Kessler and Purcell (1992), where PRP was introduced in a utility to prepare it for a performance-oriented culture post-privatisation.

However, it should be noted that although contingency theory can provide a justification for schemes chosen by companies, it can be difficult ex ante to use it to predict a company's chosen policies. Bender (2003: 211) points out that two utilities with apparently similar businesses had chosen very different remuneration policies. Although these policies made sense when the protagonists were questioned in detail, it would have been difficult to understand those choices without that intimate knowledge of the companies.

Decision theory

The aspects of decision theory considered in chapters 2 and 3 were bounded rationality, and adjustment and anchoring. The decisions made by the remuneration committee reflect bounded rationality. They (or their advisors) determine which sub-set of the universe of available information will be used as a basis for the decision, and work on that. Even if the consultant or HR professional takes a reasonably wide view of who the comparators might be, from necessity by the time the information reaches the remuneration committee it has been distilled into a report.

The anchoring phenomenon is also seen in the setting of executive pay, particularly in the determination of salaries. Survey data are used, with companies generally choosing a median position compared to their peers. Existing salary levels also act as an anchor:

> Also remember that once a salary has been established, then they tend not to go down.
>
> HR manager

The level of the anchor has a significant influence on the ultimate salary and package.

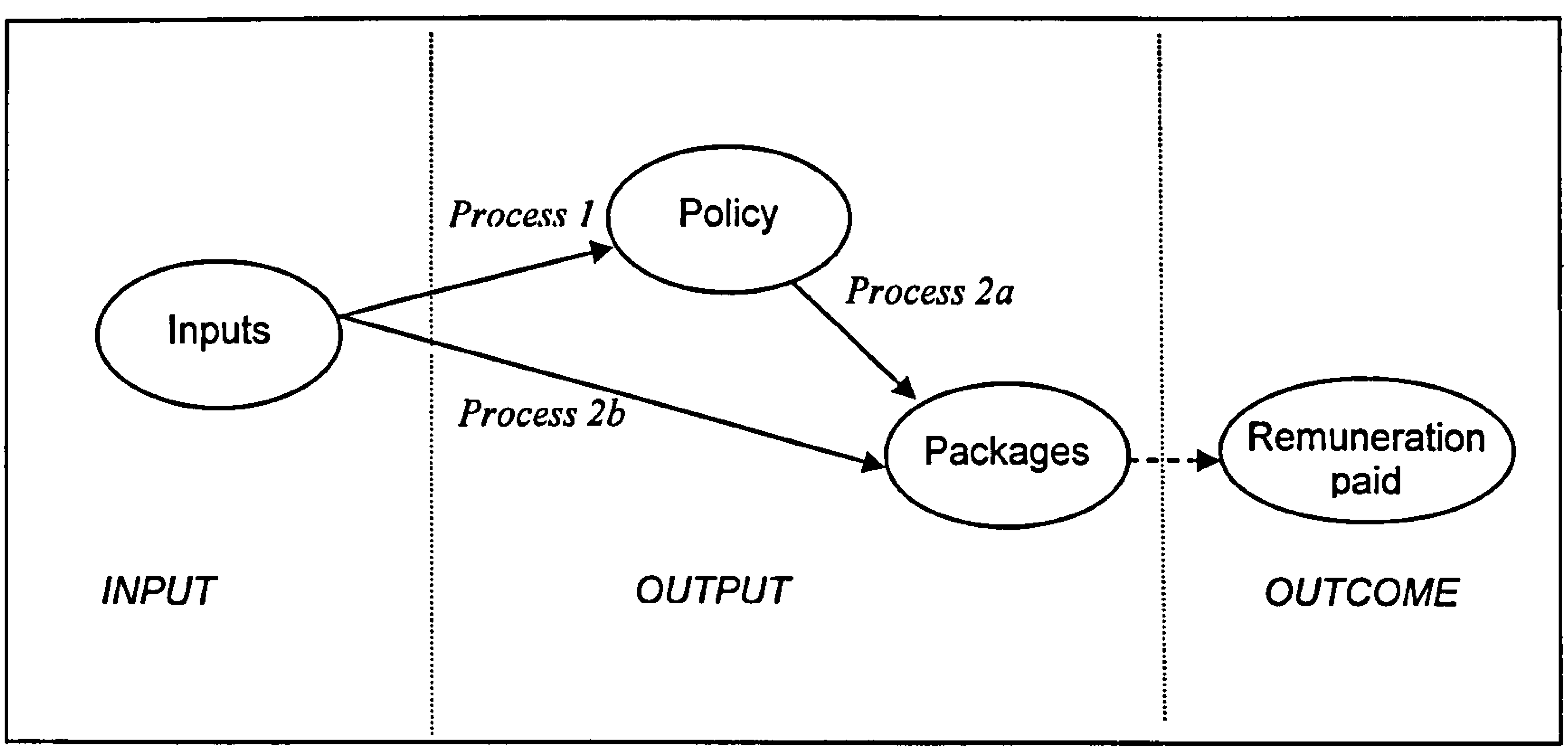
6.4 Revisiting the process model

> *Although it is hard to make strong statements about executive pay levels by looking at pay outcomes, it is possible to shed some light on this issue by looking at the pay-setting process. That is, it is hard to determine whether a pick-up baseball game was played fairly by looking only at the final score. But a closer examination of the circumstances would allow such a determination.*
>
> *Hall (2003: 31) [Emphasis in original]*

The main motivation behind this research was to do what Hall suggests, to examine the pay-setting process. I began this when, in undertaking the literature review, I developed the model set out in Figure 3-1 to illustrate how executive pay might be set. In this section I revisit that model, and discuss how the research findings support it in part, and lead to its development.

Figure 6-2 repeats the process model from Figure 3-1.

Figure 6-2 Illustrative remuneration-setting system



The model was not tested directly with most of the interviewees[60]. It was however discussed with two (an HR manager and an NED), both of whom agreed that it was a reasonable representation. It was also presented at a seminar I gave to the Remuneration Group, a gathering of remuneration professionals in FTSE 100 companies. About 26 members attended that presentation, and none took issue with the model.

Having said that, the results of the interviews do lead to a refinement of the model.

A major change is that a feedback loop needs to be added, with the Outcome of the processes becoming another Input. This was clearly evidenced in the companies that had changed their schemes due to insufficient payout (Appendix 9). Although I had originally asserted that the Outcome is just a mathematical consequence of the remuneration policies adopted by the company, it is much more than that. If the policies (or performance) are not leading to a satisfactory payout, that is an important factor for the committee to consider.

> And the upshot of it was that in the first few years that we ran this, their bonuses were pretty meagre. And I remember times when [executive] was getting sort of 6 or 7% bonus, a very small amount, I can't remember the exact figures.... ... I think it was simply that we had set the way that we'd operated the scheme too aggressively. We then thought what should we do? Shall we loosen the targets or shall we do something else?
>
> Company chairman

Other interviewees made similar comments, including an HR manager who pointed out that quarterly progress reports to his remuneration committee meant that they were aware long before the end of the performance period that the ltip would not pay out.

[60] This was deliberate, as the interview questions were designed to elicit information about processes.

Another change to the model is that the three processes originally described are more interlinked than expected. Although I had stated that the overall process would not be as linear as set out in the model, there is more interplay between package and policy than anticipated. One explanation for this could be that as they are at some level aware that there is no right answer, companies pay attention to the likely packages that will arise, and tailor their policies, at least in part, to the achievement of these. (This is illustrated in Figure 6-1, showing how bonus schemes change when performance undershoots target.)

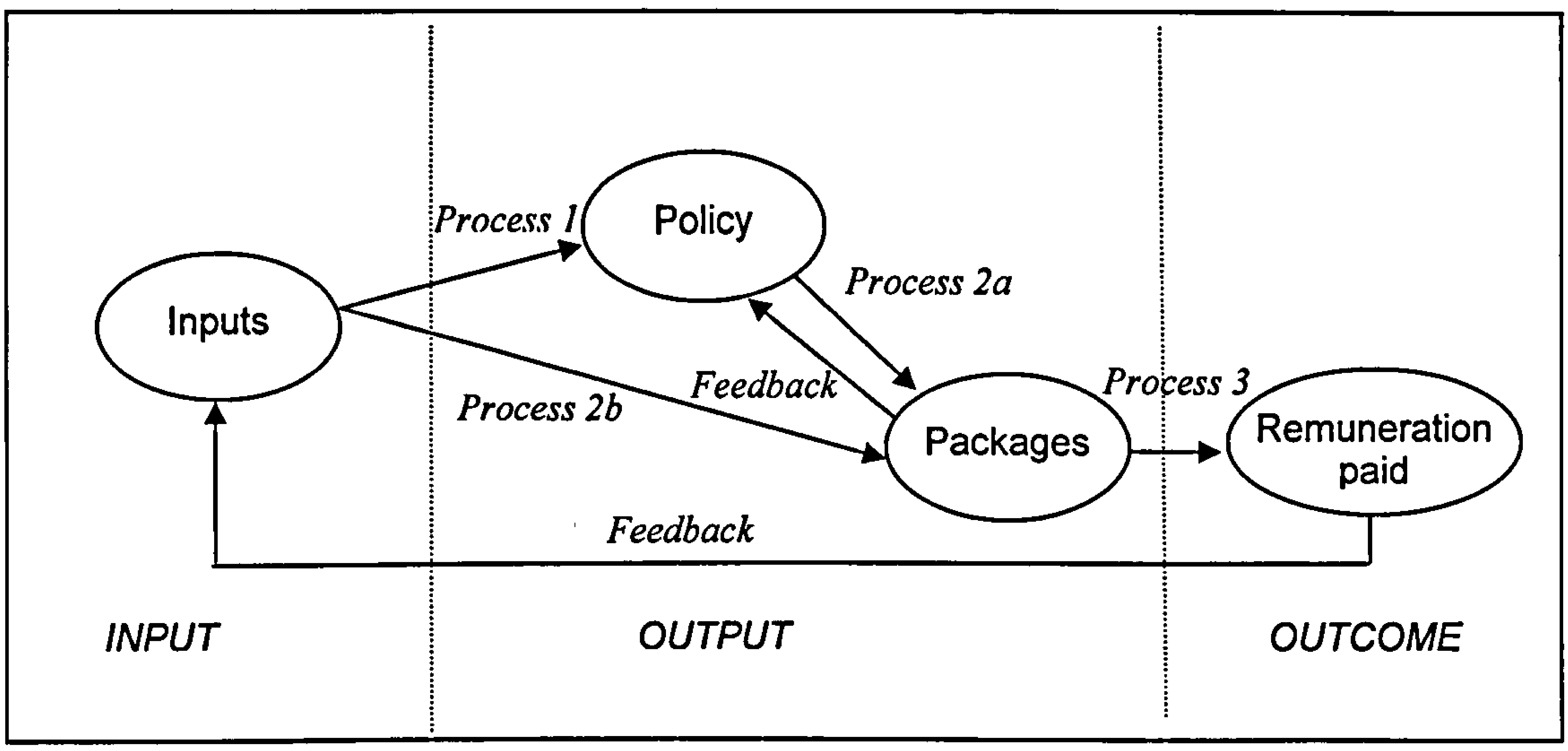
One final comment on the model is that the Outcome of the remuneration process is not merely the result of an equation, as initially thought. In some situations a judgement has to be made as to whether performance targets have been met, and there is no way of anticipating what that judgement will be – or indeed whether there will even be a judgement – ex ante. It is worth citing a long extract from an interview to illustrate this.

> And I'll tell you where it happens particularly it happens particularly in relation to long term incentive plans. Where we are we are asked to give our view or sign off despite the fact that the TSR measure or the EPS measure shows that only 50% of the award should vest, to give them a view that it should be 60% or 70%.
>
> Q: I didn't realise you got involved in that, I just assumed that it was a matter of fact at that stage.
>
> A: Well that's how we consider it. And we do quite a bit of measurement, we measure TSR for companies for the purposes of their long-term incentive plans. But we still get asked if we will say right OK well yes, the figures say this but we say...
>
> Q: How can they ask you I mean they must have a justification for asking.
>
> A: Oh they've always got a justification, they've always got a justification. The company that asked to do a spot price for them compared to their average price is probably a good example. 'Last week we had a particular announcement or something has happened that's had a big impact on...'. They've always got a justification ...
>
> Consultant

From the various performance measures that the case companies adopted, it is evident that some of these would also require the exercise of judgement. For example, one measure (one of many) for one CEO related to designing a suitable strategy – such issues are inherently judgemental, and cannot be reduced to a quantitative calculation or algorithm.

Given these considerations, the original process model can now be re-drawn.

Figure 6-3 Revised remuneration-setting system



In the revised model, feedback loops have been added from Outcome back to Inputs, and also from Packages back to Policy. This reflect the companies' apparent desire to ensure that the amounts paid are in line with expectations. A further process has been added – the link between Packages and Remuneration paid has been made into Process 3, to reflect the judgement that is sometimes needed.

6.4.1 Input factors to the remuneration-setting processes

The variables considered in the directors' pay decision, as discussed in the research literature, were set out in Figure 2-2. Many of them have been discussed in chapter 5. In Table 6-1 I set out the list of these inputs, and show their importance in this research, based on the interviews and questionnaires.

Table 6-1 Inputs which may impact on directors' remuneration

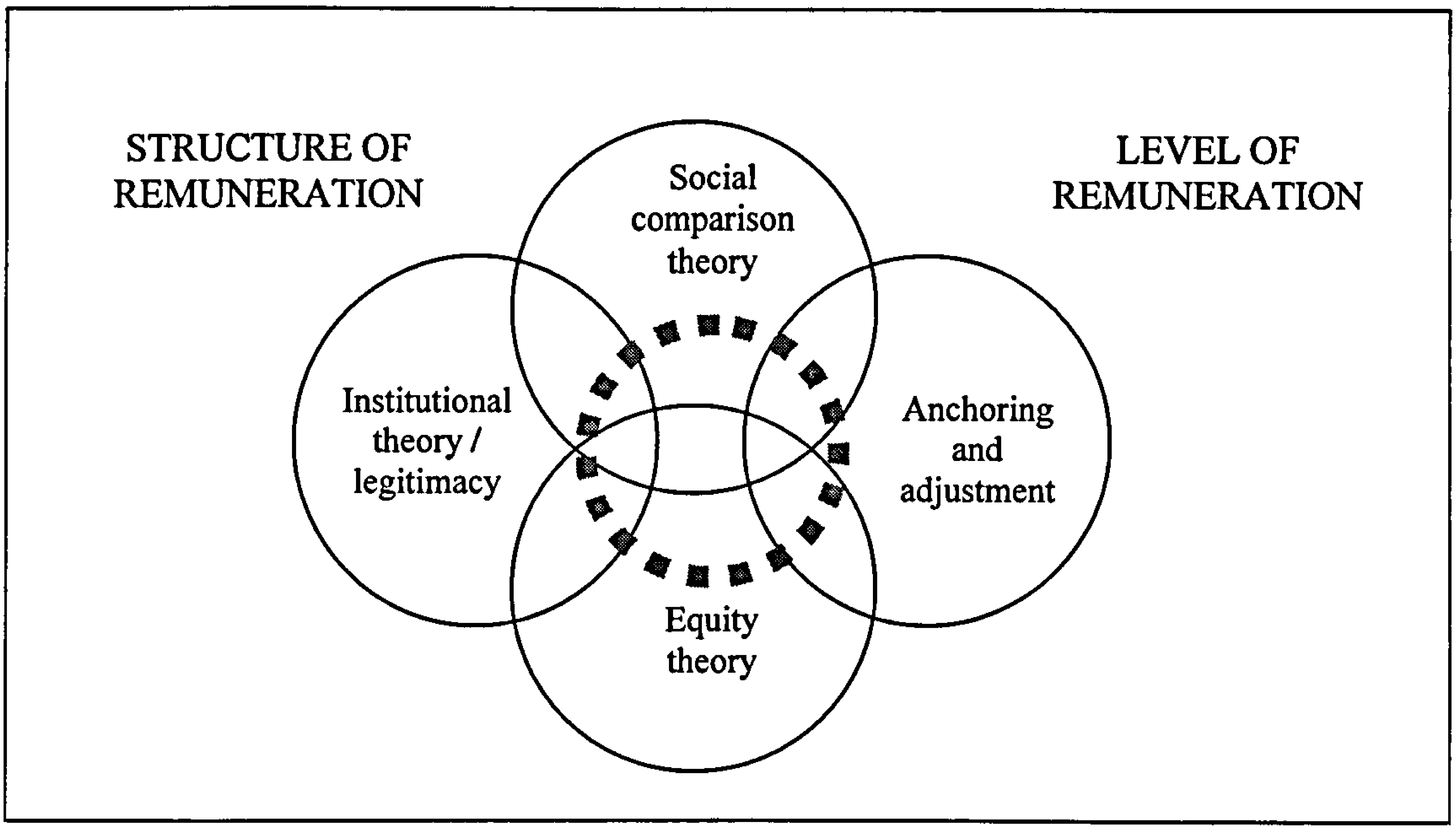
Input	Research finding
Company size	A strong influence on level of pay. An influence on pay structure to the extent that companies in a particular FTSE index look to others' practices.
Company performance	An influence on level of pay to the extent that all of the companies used some form of PRP. However, a range of performance measures was used, not all of which would be visible to the outsider. Also, schemes were changed in poorly-performing companies, in order to facilitate payout.
Remuneration surveys	A strong influence, as surveys are seen as a representation of 'the market'.
Industry	An influence on level of pay (through surveys and comparators) and on structure (a contingency theory explanation).
Country	There was evidence that geography is an influence on level of pay.
Human capital	This influences pay levels, particularly in attracting and retaining 'heavy hitters' to a company. In such circumstances, the structure of the package may also be tailored to the individual's circumstances.
Social comparison factors	Limited influence.
Strategy and stage in lifecycle	An influence on pay structures – a contingency theory explanation.

Ownership of the company	There was no evidence for this. However, all of the case companies were FTSE 350 with wide ownership, so this is not surprising.
Institutional influence	A strong influence on the structure of pay, and a lesser influence on its level. Companies seek legitimacy in the eyes of their major investors.
Board/committee structure	There was no evidence that different committee structures led to different types of scheme or different levels of pay. Given the design of the study, this would have been difficult to determine.
Cash resources	None of the companies appeared to be cash-constrained, so it is unsurprising that this influence was not evidenced.
Directors' requirements	Other than for incoming appointments, there was little evidence that individuals' requirements directed the nature of schemes.
Financial accounting	In no company was it suggested that schemes reflected advantageous accounting practice. However, one company changed its schemes the following year, citing as a driver changes in accounting for share options.
Tax – individual and corporate	Some companies used, or were considering using, share options to take advantage of the £30,000 tax allowance that individuals could obtain on options. No indication was given that corporate tax was a factor.
Retention needs	Committees are very aware of the need to retain good individuals. This was shown in the levels of pay, and in schemes designed to lock in individuals for several years.

6.5 Revisiting legitimacy-comparison theory

From the literature review, and from knowledge of executive pay obtained in the initial stages of the research, I drew up legitimacy-comparison (L-C) theory as a possible explanation for how executive pay was determined. Figure 6-4 repeats Figure 3-4.

Figure 6-4 Legitimacy-comparison theory



Although a driver of the original research design, this theory was not entirely confirmed by the research results. Elements of it are valid - indeed, the principles of 'legitimacy' and 'comparison' have been found to be fundamental to the remuneration-setting process – but the overall approach proved to be too simplistic to explain the phenomenon under investigation.

6.5.1 The level of pay

L-C theory suggested that the level of remuneration would be determined by several factors:

- Comparisons made by the executives with their peers in other companies (equity theory aspects).
- Comparisons made by the NEDs with their experiences in other companies (social comparison aspects).
- Anchoring on the numbers so produced.

In practice, the equity theory influence was clear to see in the research findings, as was the anchoring. Evidence of social comparison, however, proved elusive. As stated earlier, the mix of NEDs in a company, and the wide variety of influences to which they are subject, meant that only vague hints of this were noted.

A key influence on the level of pay, which was not directly noted in L-C theory, was the need for legitimacy (which had originally been considered only in respect of the structure of pay). The use of remuneration surveys and 'market' data (where the markets invoked are inherently multiple, opaque and subjective) is the key factor in setting pay levels. Because they recognise, explicitly or tacitly, that there is no clear right answer, companies justify their pay levels based on those paid by other companies. Thus it can be argued that labour market theory and human capital theory also provide influences on the level of pay, albeit not in such a way as to provide a comprehensively convincing explanation of any individual remuneration decision.

6.5.2 The structure of pay

In seeing institutional theory and legitimacy as a strong influence on remuneration structures, L-C theory was accurate. As stated earlier, coercive, mimetic and normative influences were all found. Aspects of equity theory also go towards explaining pay structures. In chapter 5 I show that one reason companies use PRP is because the executives expect it, because it gives them the opportunity to earn the same high levels of reward as do their peers in other companies. And social comparison influences do appear to feature here, inasmuch as the NEDs expect to see a PRP structure, because this is what they are used to in other companies.[61]

What is missing from the explanations put forward by L-C theory are references to agency theory and to expectancy theory. Although the findings highlighted some confusion as to how, or whether, pay motivated executives, it is apparent that one reason behind pay structures is the desire to motivate executive performance. (Or the desire to be perceived to be motivating executive performance – a legitimacy approach.)

> But what I would call the convention of the toolkit in executive remuneration is reinforced from two sides. It's reinforced by the advice companies get in terms of the acceptable range of remuneration tools and practices, to which there is a herd issue. But also it's reinforced from what executives expect and find acceptable.
>
> Company secretary

6.5.3 Concluding on L-C theory

Overall, L-C theory appeared to have been correct in the assertion that no single theory would suffice to explain both the level and structure of executive pay. However, as I have endeavoured to show through my observations of the inadequacies of each successive theory advanced as explanations of the data assembled here, each such explanation proves in itself insufficient to account for the variety of practices seen. Furthermore, there is no apparent mix of them that can be adduced as an overall explanation, at least currently: no such mix has been advanced and, further, there is no approach on the horizon that looks to reconcile economics-based and other theories.

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[61] This explanation given for social comparison theory would of course be equally valid if described as normative isomorphism, passing on practices through professional networks. This is

6.6 Summary of chapter

The aim of this chapter has been to set my research findings in the context of the theories of remuneration discussed in the literature review, and to see how they are supported or otherwise. My overall conclusion is that while individual findings will fit with particular approaches, no approach to date seems adequate to explain the diversity of findings discovered here. The best that can be said is that considerable evidence has been found for an institutional theory explanation of directors' pay, closely linked to the desire for companies to achieve legitimacy with their stakeholders (including major shareholders and, for utilities in particular, customers). This provides an explanation of why so many companies adopt the same sorts of structure for their remuneration. Agency, expectancy and equity theories also contribute insights towards an understanding of pay structures. Pay levels are tied closely to 'the market', but only in the sense of a market constructed by each company to suit its own circumstances. Elements of labour market and human capital theory go to explain these pay levels, as does equity theory.

At the same time, every one of these theories offers only a partial and defective explanation, since each only explains one part or aspect of the complex acts of remuneration committees and their advisors as uncovered here.

The initial models developed from the literature review – the process model and L-C theory – were found to be useful but incomplete. The process model has been amended to show a fuller picture of how remuneration is set, and the list of input

another example of the overlap between many of the theories used in this field.

factors has been expanded and analysed. The weaknesses in L-C theory have been noted, but the theory has not been updated: the multiplicity of different theoretical influences means that this would not be particularly useful at this time.

One conclusion from the research is the fact that although 'the market' features extensively in companies' explanations of their actions (and in the theories underpinning prior research), that 'market' is not a coherent or clearly defined construct, but one that has a strong rhetorical function. The implications of this are discussed in chapter 7, which also examines more closely the question of how to understand the power relationships within the board and the remuneration committee.

7. THE REMUNERATION COMMITTEE: RHETORICS AND REALITIES

7.1 Introduction

In chapter 5 I presented data that illustrated how the case companies had addressed some of the key issues facing them in determining the pay of their executives, and in chapter 6 I set these data in the context of theories previously used to explain the phenomenon of executive pay. This chapter examines the findings in a different manner. It contains three main themes:

- It proposes that the remuneration-setting process envisaged in the Combined Code is an unattainable ideal, and examines the compromises that have to be made in practice.
- On the basis of the thesis that there is no one right answer as to the correct level and structure of pay, it considers, in a more fundamental way, how committees make and justify their decisions.
- In so doing it asks more searching questions about the inner workings of the remuneration committee and the key individuals associated with it, going beyond the formal structure to examine the relationships between the protagonists and what this means for how remuneration is set.

The three themes are interlinked, and one further focus of enquiry that emerges concerns the rhetorics used by the players to justify all of their actions and decisions to an increasingly interested body of stakeholders.

One interview extract is worth highlighting here:

> I'm fascinated at the way that you are approaching this, to tell you the truth. Because I think it's going to have a lot more people issues in it. I think it's a lot to do with the way that people interact, and the relationships of people, rather than it is about scientific proof of what does and doesn't work.
>
> Company secretary

This extract encapsulates much of the discussion that will follow. It reflects the fact that there is little science behind the determination of executive pay – as noted in chapter 5, the protagonists are honest in their intentions to use 'the market' as a benchmark, in the absence of an obvious right answer. It also highlights the importance of relationships in the remuneration-setting process. These are important findings, which could not have been obtained from other research methods. They start to answer the question 'how do companies determine the pay of their executives?'.

7.2 The ideal remuneration committee

Regulation demands that listed companies use remuneration committees to determine the pay of their executives. In order to appreciate how a remuneration committee operates in practice, it is first useful to discuss how the regulation appears to require them to operate. For this, it is helpful to start with the Combined Code (2003)[62], which sets out 'best practice' as required from listed companies. Table 7-1 sets out some key principles of the Code which affect remuneration committees.

[62] The 2003 Code was issued after the fieldwork for this research was complete. However, using this rather than the previous Code makes the research more relevant to the reader, without in any way changing the principles on which the research is based. Appendix 11 sets out some key differences between the previous Code and the 2003 version.

Table 7-1 Key principles of the Combined Code regarding executive remuneration

B.1. main principle	Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.
B.2. main principle	There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.
B.2. supporting principle	The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors.
A.5. supporting principle	The chairman [of the board] should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees.

From this, and from an awareness of the ongoing debate on corporate governance, we can surmise that the ideal remuneration committee is run by independent non-executive directors who are fully conversant with the company and who have a good knowledge of executive remuneration practices. They can determine the levels of pay suitable to "attract, retain and motivate" but are also aware of where the boundaries lie, so that pay is not excessive: they are sophisticated enough to establish 'the correct number'. They can, themselves, determine remuneration policy in such a way that it will link closely to performance, encouraging the executives to work better for the company. Having determined policy, they will discuss individual directors' packages with the line managers of those directors – the CEO or chairman; but in this the committee is discussing its proposals, seeking confirmation and opinions on individual performance rather than asking for recommendations on policy.

Underlying this picture of the ideal committee appear to be the following assumptions:

1. There is a correct number for the level of remuneration (the Goldilocks number: not too high and not too low).
2. Non-executives have a knowledge of the company that is comprehensive enough to be able to determine appropriate performance measures and targets, without needing extensive advice from the executives.
3. Non-executives have a good and up-to-date understanding of the types of remuneration scheme that may be used, and the practical implications of different schemes.

It is the contention of this thesis, based on the empirical work set out in chapter 5, that these assumptions simply do not apply. The remuneration committee envisaged in the regulations is similar in some ways to Weber's 'ideal type' (Gerth and Mills, 1967; Runciman, 1978): a conceptual tool against which one can judge reality. However, unlike the Weberian ideal type, which is designed to shine a light on 'real' practices by distilling the essence of a system, the regulatory ideal is not intended as a theoretical stereotype. It is a guide for committees against which they will be judged in a "comply or explain" regulatory environment (Combined Code, 2003: para 4). In this way one might say that it is less like a Weberian ideal type than a Platonic ideal as set out in the Simile of the Cave (Plato, translated by Lee (1997: 316)), in that it represents an impossible ideal for this world, of which the remuneration committees we see are mere imperfect shadows.

This is not to deny the validity of the Code in setting an ideal. There is nothing wrong with establishing an ideal, provided that it is understood as such. As Nicholas Rescher argued:

> *For while ideals put before us situations that, in a way, are mere fictions, these fictions nevertheless direct and canalize our thought and action. .. To be sure, an ideal is not a goal we can expect to attain. But it serves to set a direction in which we can strive. Ideals are irrealities, but they are irrealities that condition the nature of real thought through their influence on human thought. .. Ideals, though instruments of thought are not mere myths. For there is nothing false or fictional about ideals as such – only about the idea of their embodiment in concrete reality. Their pursuit is something which can be perfectly real and eminently productive.*
>
> *Rescher (1993: 130, 138), quoted by McSweeney (1997: 707)*

The ideal remuneration committee sets the standard against which all other remuneration committees are judged. The argument of this thesis is that the remuneration committees we see in practice do not – can not – attain the perfection of the ideal committee. The practical issues thus become: why do committees in practice fall short of the ideal, and how do they justify this?

7.3 Remuneration committees in the real world

7.3.1 The level of pay

Determining the 'correct' level of pay

Levels of pay, according to the Combined Code, should be "sufficient" but not "more than is necessary". How is this Goldilocks number to be calculated? The following paragraphs set out a history of problems in determining the 'correct' level of pay for any job. I then go on to explain that although in practice pay is set by reference to the market, that market is in fact a device, and produces benchmarking data that construct local 'right answers' rather than reflecting an underlying Right Answer. In a sense, the paradox is the same as that of the 'just price'.

Just price

> If salaries for the average FTSE chief executive were half as much, then relative to each other, they would still be more concerned about that relativity than they would about whether it's half.
>
> CEO

The 'just price' problem illustrates precisely why there is no right answer. There are two issues: the question of the 'market-clearing price' (an empirical question of multi-agent supply and demand) and the question of the 'proper recompense' for a specific deed or act. The latter question is that addressed as far back as the 13th century by St Thomas Aquinas, who wrote that "... as it is an act of justice to give a just price for anything received from another, so also is it an act of justice to make a return for work or toil."[63] Although Aquinas went on to discuss justice in terms of equality, he provided no answer as to how that "just price" should be established. Everyone was to be paid fairly, however 'fairly' was determined.

When the Church addressed the question again in the 16th century, theologians in the School of Salamanca now considered the former question. They argued that valuing labour and goods in terms of 'fairness' was a false determination of value, and recognised that price was determined by what people *thought* something was worth in a given circumstance ("the common estimation"). This is illustrated in the following quotation:

[63] This text can be found in *Summa Theologica*, first part of the second part, question 114:1, objection 3. This can be accessed from http://www.ccel.org/a/aquinas/summa/FS/FS114.html

> *Therefore, those who measure the just price by the labour, costs, and risk incurred by the person who deals in the merchandise or produces it, or by the cost of transport, or the expense of travelling to and from the fair, or by what he has to pay the factors for their industry, risk, and labour are greatly in error, and still more so are those who allow a certain profit of a fifth or tenth. For the just price arises from the abundance or scarcity of goods, merchants, and money, as has been said, and not from costs, labour and risk. If we had to consider labour and risk in order to assess the just price, no merchants would ever suffer a loss, nor would abundance or scarcity of goods and money enter into the question. ... Why should a bale of linen brought overland from Brittany at great expense be worth more than one which is transported cheaply by sea?... Why should a book written out by hand be worth more than one which is printed, when the latter is better though it costs less to produce?... The just price is found not by counting the cost but by the common estimation.*
>
> *Luis Saravia, circa 1544*[64]

Here we see a recognition that the price of goods, services or labour will be determined through their perceived saleability, irrespective of cost or justice. And 'perceived saleability' will be a function of (a) market supply and demand conditions, and (b) the perceived quality of the goods, services or labour in question. As described in chapter 5, this is precisely the technique that is espoused today in the determination of executive pay. Remuneration committees and their advisors obtain 'market data' from comparator companies, through surveys and other means. They define what they see as their relevant 'market' and the perceived level and quality of their executive labour, and make use of this as the basis to determine the levels of pay in their own companies. Judging both by prior research and the data gathered here, this is a universally adopted practice. However, my contention is that the approach is doubly flawed. It is flawed first insofar as it is then perceived as the means to establish a 'just price', as such a price cannot in principle be established independently of market perceptions, and so is a myth. But secondly, it is equally flawed in that it is

[64] This quotation appears in various places on the internet, but I have not verified it independently. Sources include a book review on http://www.ponderanew.com/r02-03-24.htm , which quotes

predicated on the idea that 'the market' is an independent and reliable touchstone for establishing such a price. This requires a somewhat lengthy discussion.

The myth of the market

Although it is universal practice for executive pay to be benchmarked against a market, this is not, in fact, a requirement of the UK governance regulations. The closest we have is the Combined Code (2003: B1) which states that committees should "judge where to position their company relative to other companies". The word 'market' is not mentioned, and the debate then centres around which other companies are appropriate comparators.

Gomez-Mejia and Wiseman pointed out that the answer to any such question about 'the market' is not obvious:

> *... a cottage industry of consultants that specializes in conducting surveys to measure a wide range of CEO compensation statistics ... [which suggests that] surprisingly, very little is known about the use of "competitive market going rates" as a criterion to set CEO pay, despite the lip service paid to it in economic theory, the human resource management literature, and compensation practice. (1997: 327)*

Porac, Wade and Pollock (1999), examining the comparators against which their US sample companies chose to benchmark pay, found that although companies tended to use their primary industry as a comparator, they selectively defined peers in ways that suited themselves when such peers could lead to an increase in pay levels. Although this study was not designed to highlight such practices, certain similarities can be seen.

---

from *Economic Thinking for the Theologically Minded*, by Samuel Gregg, University Press of America November 2001.

The first problem with using 'the market' as a benchmark is that the data being used are not neutral. A company choosing to take its comparators from a sector is making an implicit assumption that the sector is both appropriate and representative. This is not necessarily the case. One can envisage a situation (indeed, it was implied by the consultants' reports reviewed in this research) where the data become anomalous. Figure 7-1 illustrates how a 'benchmarking merry-go-round' might operate.

Figure 7-1 The benchmarking merry-go-round

- Utility A benchmarks pay levels against other utilities; including Utility B.
- Utility B is a multi-business company. Being inclined to expand its non-regulated activities, it chooses to benchmark pay against companies in a particular Services sector. Thus, it distorts the survey data obtained by Utility A.
- Within this particular Services sector is Company C. C too is a multi-business group. Only half of its business is in Services; the rest is in Technology. C's remuneration committee sets pay based on an average of Services and Technology companies.
- Thus C's Technology benchmark impacts upon B's Service benchmark which in turn affects the pay of A and of any other company which appears to be benchmarking against Utilities.

It can be seen from Figure 7-1 that the market against which Utility A – for which, substitute Any Company – benchmarks may not as such exist. This was illustrated by one of the interviewees:

> And we use the term 'labour market' generally as if there was such a thing as a labour market. Truly, the definition or the terminology 'labour market' is shorthand for a plethora of different markets.
>
> Consultant

Additionally, within any company, individual jobs may be benchmarked from outside that sector. This happens particularly in 'staff' jobs such as finance director, where individuals are very mobile between sectors. The net needs to be cast wider, to attract suitable individuals. This was illustrated in conversation with the committee chairman for a utility:

> If you're a good enough finance director, and the finance director we have at [company] did not come from any of those sectors. He came from [different] sector. Therefore, what you want is a market view, whatever that is, of how much it is going to cost you and what you need to pay a finance director, at a certain point in his career, with a certain profile. Quite often, salaries surveys don't help you. Because if you go to them you'll end up with the wrong answer and recruit the wrong person.
>
> Committee chairman

Furthermore, although our ideal remuneration committee will draw its information from sources covering the whole of the possible universe of comparators, the real world remuneration committee members operate under the constraint of bounded rationality; it is physically impossible for them to accommodate all possible sources of information, and so they just sample what is available. This is an interesting issue. It indicates that what is being benchmarked is not 'a market' but instead 'a sampling population': companies define their market as a limited population of elite salaries, sampled 100%.[65] This was discussed by Barkema and Gomez-Mejia (1998: 141):

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[65] In a chapter 6 I discussed the remuneration decision in terms of legitimacy. Here I would point out that the phase 'based on the market' carries considerably more legitimacy than the phrase 'based on a limited sampling population'.

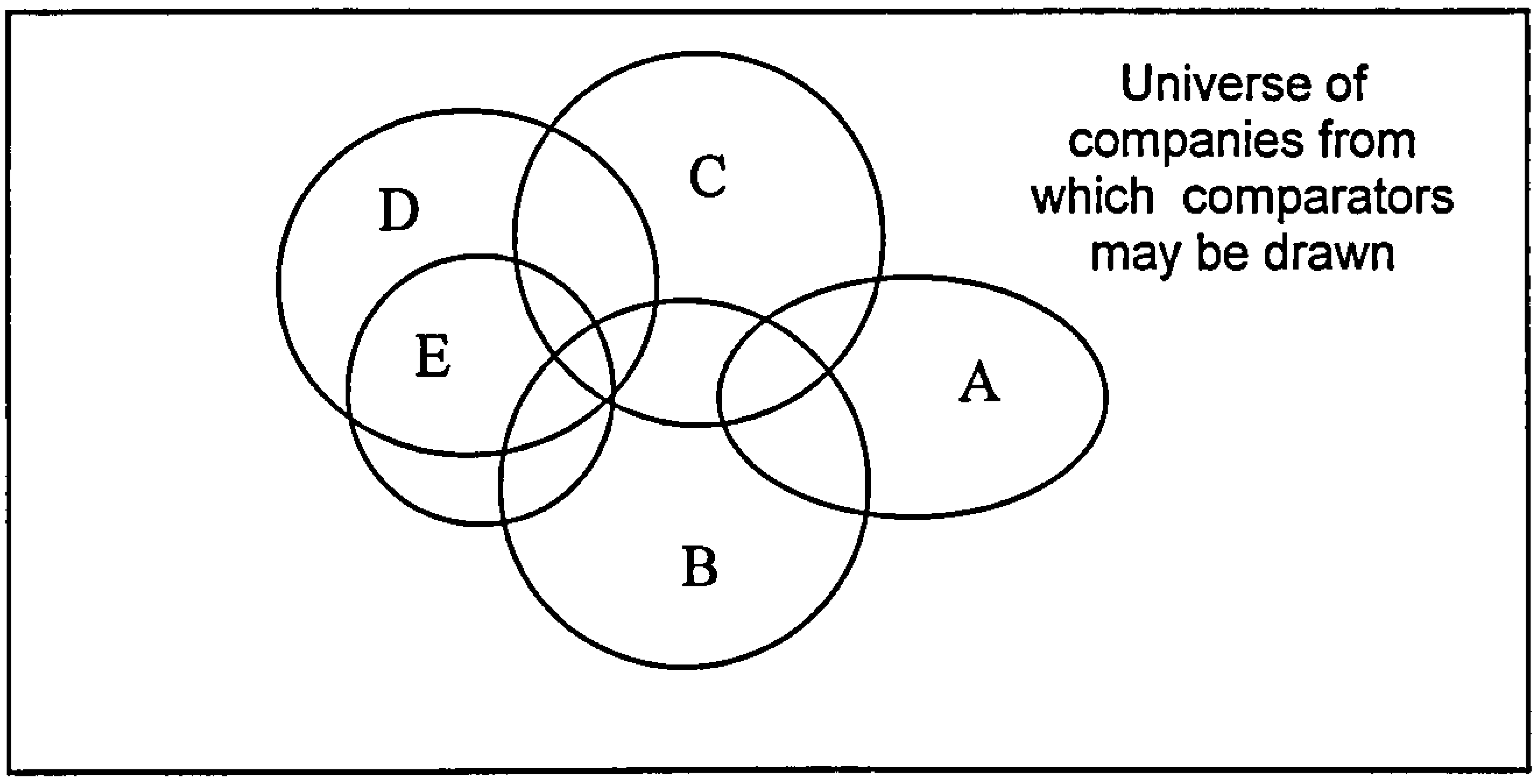
> *An important concern in this regard is how to define the market. The relevant market is an abstraction that exists in people's mind. Conceptualizing the market as a socially defined entity is a notion that can be traced back to labor economist John Dunlop's writings on "wage contours" in the 1950s (e.g., Dunlop, 1957). However, this notion has never been examined for CEOs. When a firm decides to pay executives the going rate in the CEO market, it must first decide on the appropriate "comparison other" in the market. Making this choice is a social and political process that may not be subject to explanation on economic grounds. Ezzamel and Watson support this sociopolitical interpretation since CEOs can benefit from remuneration committees' deliberately choosing higher-paid external CEOs as points of reference. This is a subjective process involving judgments of the committee members, legitimized by the opinions of external consultants.*

It is of course likely to be a process in which the companies do not simply choose "higher-paid external CEOs". However, even if they sample more widely, at any given moment their sample will incorporate only current survivors. So there is an embedded survivor bias as well.

The problem of how companies establish a market-aware but fair remuneration level was raised at the focus group meeting used to test some of the research findings. In a discussion of 'fairness' one participant stated that his company benchmarked similar companies on two different measures, to give enough data to form an opinion, but also, significantly, so that others (unspecified) could see that it was a fair way of paying; in this way the rate was seen as legitimisable to the outside world.

The conclusion to be drawn is that there is not one market but a series of overlapping markets, whose parameters are determined by perceptions of relevance. Different companies will make different selections. This is illustrated in Figure 7-2.

Figure 7-2 How companies define their comparator markets



Each of the five companies A to E selects a different comparator group as its 'market'. None is necessarily more correct than any other. Given the limited universe of legitimate comparators it is reasonable to assume that there will be overlaps, but it is important to appreciate that the intersects in their choices do not represent the 'right' answer.

Moving on, there is a second fundamental problem with this concept of salaries based on 'the market': it is not a market in the generally-accepted sense. Economists discussing theories of supply and demand (an underlying basis for labour market theory) assume a competitive market in which prices settle at the intersect of supply and demand curves to arrive at a market-clearing price. The goods being traded are identical, or at least closely similar. If a merchant sets his prices at a premium to the market-clearing price he will find that there are few buyers; likewise, setting below-equilibrium prices should increase the demand for his goods.

How does this differ from the 'market' for executives, which is used to determine their remuneration? Firstly, the executives, with different qualifications, talents, backgrounds and reputations, are perhaps less interchangeable than products in some other markets. These human capital attributes mean that any 'market-determined' price may need to be tailored to individual circumstances. However, this anomaly can be accommodated; as discussed in chapter 5, high-profile individuals move to companies for remuneration packages that are out of line with others, and this does not necessarily provide an immediate distortion of the market.

The main objection to this market hypothesis is more fundamental. The market prices reported in surveys do not themselves represent a price at which individuals could, to put it crudely, be acquired. They represent the prices currently being paid to other elite individuals. They are not an 'offer for sale' and will never be tested as such. The market data reflect what others are reporting as earnings, not what a market clearing price would be. For example, if the median rate for CEOs in a certain sector is £300,000 it would almost certainly be possible to find a qualified individual who would take the job for, say, his reserve price of £200,000. Paying the median gives that individual a surplus of £100,000. The money is certainly sufficient to "attract and retain", but it fails on the criterion of "not excessive".

An illustration of this point came in a discussion with a company chairman who had increased the salaries of his executives significantly, despite the fact that they appeared to be content at their existing, sub-market levels.

> And we increased salaries by some 30%, or probably a bit higher than that, to try to get them more in line with where they should be. To be absolutely frank, I've never had any representation from any of them [the executives] about salaries, it was never an issue.
>
> Chairman

This could be interpreted as the chairman's need for fairness in remuneration resulting in the executives being given a 'producer surplus', receiving a wage higher than they would demand in a free market.

7.3.2 Structuring pay to produce performance

> *[regarding the elasticity of directors' pay to performance]*
> *However, there exists no theoretical benchmark to serve as a guide for what size number should be expected...*
>
> *Rosen (1990: 3)*

In the ideal world, the remuneration committee will select policies that will best "attract, retain and motivate" and also "link rewards to corporate performance". In the real world this is more difficult. In chapter 2, Tables 2-2 and 2-3 set out the advantages and disadvantages of some common performance measures and scheme types, and noted that none met all these different demands. We may now better appreciate that this is impossible, as the demands are incommensurable. Thus the committee has to make a satisficing decision rather than a maximising decision. The recognition of this was illustrated in discussion with an experienced HR manager:

> You're most certainly not perfect, so it's how little imperfect you can be.
>
> HR manager

There is no one right answer to the question of how to structure remuneration policies (although there will be some wrong answers for each company in every circumstance). Nevertheless, remuneration committees still have to make a decision, to choose a scheme. The data set out in chapter 5 indicate that to do this they have regard in practice to two inter-related influences:

- What is being done in other, comparable companies?
- What is acceptable to the investing institutions?

This was illustrated by a consultant discussing how remuneration committees tend to take the safe option in determining their schemes:

> But at the end of the day there is that comfort factor of saying 'we have an arrangement which we can justify by reference to the market'.
>
> Consultant

The comparison with other companies came through consistently in chapter 5, with companies and consultants looking to 'market practice' in devising their scheme structures. Several instances of institutional isomorphism (DiMaggio and Powell, 1983) can be determined here. Most noticeably, it appears to be an example of mimetic isomorphism With no obvious answer, companies look to practices that appear to have worked in other companies, and apply those. A discussion of how the research data reflect the tenets of institutional theory was contained in chapter 6; here I merely note that this use of convenient comparisons bears no relation to the ideal behaviour of the knowledgeable non-executive described earlier.

7.3.3 The knowledgeable non-executive

In the ideal remuneration committee, non-executives consider the universe of potential structures and select the one that will best "attract, retain and motivate" and also "link rewards to corporate performance". This involves a good understanding of the attributes of different schemes, of market practices (the package has to be attractive to potential recruits), and of the company's key performance drivers. Some of this understanding can come by proxy, through remuneration consultants employed and briefed by the committee.

In practice, the situation has to be more fluid. NEDs are not at the company full-time, and cannot realistically be expected to understand it as well as the executives, nor to understand the ramifications of remuneration schemes as well as do HR professionals. Accordingly, they rely to a greater or lesser extent on advice from executives and HR staff within the company. This asymmetry of information is particularly relevant when considering the relationships between the various parties, considered later. Before that it is useful to examine the role of the other key player – the consultant.

7.3.4 The role of the consultant

The literature on management consultants suggests various reasons why companies might use their services (for example, Sturdy, 1997; Wood, 2002). The consultants may act as experts, extras or facilitators (Tisdall, 1982). Remuneration consultants bring expert knowledge of market practices, of remuneration schemes, and (importantly) of the preferences of institutional shareholders; they act as an 'extra pair of hands', gathering data on behalf of the HR professionals; and occasionally they act to facilitate and legitimate change in the companies' schemes. Such roles are seen in the narrative below.

All of the companies except one made use of consultants, some extensively[66]. In the context of this chapter, the key consultancy roles were:

- providing market data and details of schemes;
- providing training; and
- as intermediaries between the company and the investors.

[66] In the one company that was the exception, the view was that the internal HR professionals knew more about the company, and at least as much about schemes, than did the consultants, and so there was little to be gained from their use. This approach was put to the remuneration committee each year for re-consideration. This practice may represent an exercise of power as described by Lukes (1974), discussed later in this thesis.

In their role as experts, the consultants also act as a legitimising device. Companies can state that they have taken independent advice, and that they have benchmarked their schemes against those of peer companies, using objective data. This legitimacy arising from technical rationality is discussed by Sturdy (1997: 399). One of the NEDs phrased it succinctly:

> But I do think, there is no doubt that part of this process is a covering of the back. It allows the board to say that it has consulted with consultants.
>
> NED

The consultants reinforce their position as experts by running seminars (for directors and institutions) and publishing reports, thus establishing their credentials. Because of this, they are often used in the intermediary role, explaining the committee's decisions to the shareholding institutions. This again strengthens their position as a key link in the remuneration-setting process:

> [Name of Consultants] are well respected by the institutions, which is one of the reasons we would always be very keen to work with them.
>
> HR Manager

Although consultants clearly have a legitimising role, it is interesting that the substantial increases in executive pay in recent years have cast doubt on their independence, and hence their legitimacy. It is starting to become more common for companies to use two firms of consultants, one for the company and one for the committee. This split is intended to reaffirm the legitimacy of the external advice, although some interviewees cast doubt on its usefulness.

A further point about the use of consultants is worth considering. It was noted earlier that companies tend to adopt similar types of scheme. This has been ascribed variously to coercive or mimetic isomorphism, but it could also represent normative isomorphism, with practices passed on through a professional body, even if many would dispute whether consultancy is in fact a profession (Tisdall, 1982: 78). Sturdy (1997: 406) proposes another reason for this similarity of practice. He suggests that a main aim of any consultancy assignment is to generate further assignments, hence consultants cannot afford to be wrong in their recommendations. By following market practice they are in effect legitimising their own work, and minimising the danger of being caught out using a flawed technique. Somehow they manage to sell their work as being acceptable, in line with market norms, whilst also being tailored to the company's specific situation.

7.3.5 Playing the game: realities

> You want to avoid situations of what is perceived to be gross over-reward for poor performance. Sadly we've all had to deal with the media as much as the institutions, i.e. the owners of the company. Certainly, people like [name] and I will have as much if not more of a view on how something is going to be reported in the press as to how the institutions are going to react. Because we are who we are. ... The last thing I want – and the same with you – is to have shots being fired at our board remuneration practices on the front page of the Daily Mail!
>
> Focus group participant [Emphasis added]

The above quotation acts to illustrate the importance of the perception of remuneration by key others, as well as its reality. This section and the next consider what happens, and how the message is presented. This includes consideration both of the words used, and of the governance forms formally adopted.

Structures

The Combined Code (2003: B2) states that there should be "a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors". Much attention has been focused on the outward manifestations of this, with disclosure required of the make-up of the committee, the number of meetings, attendees, etc. Unfortunately, the result of this is that committees have what might be called a formal and transparent *structure*, but the *informal structure* and the underlying *processes* are opaque.

This was illustrated in a conversation with an HR professional, about the influence his company chairman had on the remuneration-setting process. His initial response was that several years earlier the company chairman had also chaired the remuneration committee, but due to the requirements of 'good governance' he had withdrawn from this role and from playing a very active part.

> Q. The reason I ask is just that in the work I've done, we've started from the point of view that the chairman shouldn't attend the meeting because that's good governance, and everybody has said well look, he is in charge of company strategy...
> A. Oh, off the record, it's ludicrous! ... To separate it like that, to separate the way they're paid, the way their performance is managed from the running of the company, I agree is a total nonsense. But I can't publicly say that...
>
> HR Manager

The company had formally structured itself to comply with the regulations, but the underlying processes had changed less than it might have appeared. This reflects comments made by Sonnenfeld (2002) who discussed the fact that many of the US's failed companies had 'good' governance in that they followed all of the required procedures:

> *In other words, they [the boards] passed the tests that would normally be applied to ascertain whether a board of directors was likely to do a good job. And that's precisely what's so scary about these events. Viewing the breakdowns through the lens of my 25 years of experience studying board performance and CEO leadership leads me to one conclusion: It's time for some fundamentally new thinking about how corporate boards should operate and be evaluated. We need to consider not only how we structure the work of a board but also how we manage the social system a board actually is. We'll be fighting the wrong war if we simply tighten procedural rules for boards and ignore their more pressing need - to be strong, high-functioning work groups whose members trust and challenge one another and engage directly with senior managers on critical issues facing corporations. (2002: 106)*

During the course of the research I interviewed at 12 companies, talking to three or more individuals at five of those companies, and learning too about other companies with which the interviewees were involved. What became obvious was that although each of the companies, by and large, could tick all the boxes to demonstrate good governance, within that constraint they all operated in very different ways. As set out in chapter 5, in some companies the NEDs appeared to control the process; in others the main focus was the executives. The balance of power and influence differed, with no two companies operating their executive remuneration processes in the same manner. This was foreshadowed by the comment of a company secretary in discussing my research:

> I'm fascinated at the way that you are approaching this, to tell you the truth. Because I think it's going to have a lot more people issues in it. I think it's a lot to do with the way that people interact, and the relationships of people, rather than it is about scientific proof of what does and doesn't work.
>
> Company secretary

This is demonstrated in the relationship summaries set out in Table 7-2. For each of the five companies where three or more people were interviewed (labelled A to E, to avoid the possibility of identification) this table shows who the main players were, who else was involved in the remuneration-setting process, and gives brief details of how the process worked.

Table 7-2 Relationships in remuneration-setting in five case companies

	Company A	Company B	Company C	Company D	Company E
Main players - influencing the agenda	Committee chairman HR professionals	Company chairman Company secretary Committee chairman	Committee chairman Company chairman CEO Senior independent director HR manager Company secretary	HR professionals CEO Committee chairman	HR director CEO Committee chairman
- *not having particular input into the agenda*	*NEDs (inc company chairman)*				
Other players	CEO Consultants	NEDs HR director Consultants CEO	NEDs Consultants Executives (involved in one decision)	Company chairman NEDs	NEDs Company chairman Consultants
Commentary	There is a conscious effort to ensure that the non-executives control the remuneration process. Reliance is placed on the HR professionals, who are trusted and respected, but it is very clear that their role is merely advisory.	For historical reasons the (non-executive) chairman plays a large part as an advisor, and the committee maintains its independence from the HR director. The committee has made few major changes to policies in the last few years and so has perhaps felt that it needed less technical	In this company there is extensive communication between all parties, and a conscious effort to follow good governance practices. Pay policies have changed considerably in the last few years, and all parties have been involved in determining these changes.	The HR professionals play an important role in this company, which does not use consultants. The company chairman is consulted regularly.	The three main players between them manage the remuneration process. The company chairman is consulted regularly.

		assistance than some others. Thus it has possible that the 'expert' knowledge of an HR professional has not been missed.			

The consultants do not have a permanent position, and only really become a player when a scheme may change.

Before analysing the relationships further, it is useful briefly to consider different aspects of power and influence. Power is discussed in chapters 2 and 6 as regards the literature on remuneration. Here I approach the subject more generally.

Power in the boardroom – prior research

There is an extensive literature on power and influence, which have been categorised in many ways. In order to make sense of the research findings, three approaches are considered here: Handy's list of sources of power (1993); Pettigrew and McNulty's studies of power and influence in the boardroom (1995, 1998); and Lukes' 1974 work on the dimensions of power. Each has a contribution to understanding how remuneration committees operate.

Sources of power

Handy (1993) defines influence as the process by which A seeks to modify the attitudes or behaviour of B, and power as that which enables him to do so: influence being the use of power. He draws upon a relational view of power: if A's power source has no importance for B, or B has greater power than A, then A's attempt at influence will be unsuccessful. Given this, Handy suggests several potential sources of power, some of which seem particularly relevant to this discussion. These are position power (which includes control over invisible assets such as information), expert power and personal power (charisma), all of which are individualist models, insofar as these attributes are portrayed as possessions or properties of a given individual or entity.

These different sources of power will be considered further when discussing the relationships in companies A to E.

Power and influence in the boardroom

As set out in chapter 6, previous research has shown that power relationships in a boardroom can undermine its formal structure. Pettigrew and McNulty's studies (1995, 1998) were interview- and survey-based, examining boardroom practices in large UK companies. Their findings, as relevant to this thesis, were as follows:

- Power is indeed a relational phenomenon; generated, maintained and lost in the context of relationships with others.
- Power sources relate to an individual's or individual entity's position, and to the ability to control rewards and sanctions. By and large, NEDs have few of these sources, and so have to be politically skilful in their work. Their power sources include prestige, experience, positional power on committees, and their role as a potential source of legitimacy.
- Boards have different cultures – some deliberately encourage NED contribution; others do not.

Dimensions of power

Lukes (1974) expands considerably on the relatively simplistic definitions of power such as those given earlier. Building on a paper by Bacharach and Baratz (1962) he states that there are three dimensions of power. For his third dimension, the one which is of interest in this thesis, he defines power as: A exercises power over B when A affects B in a manner contrary to B's interests (1974: 34). This is a more subtle definition, introducing the possibility of reciprocal interactions into the individualistic model of power. So, for Lukes, power includes shaping the way people think:

> *...is not the supreme and most insidious exercise of power to prevent people, to whatever degree, from having grievances by shaping their perceptions, cognitions and preferences in such a way that they accept their role in the existing order of things, either because they can see or imagine no alternative to it, or because they see it as natural and unchangeable, or because they value it as divinely ordained and beneficial? (1974: 24)*

Power is still a property or possession, but it can now, for Lukes, include the power to control the agenda – to prevent issues being considered. In terms of remuneration committees, this is literally true – the narratives in chapter 5 discussed who actually sets the committee agenda in the different companies, and whether others could/did put forward items for discussion. So, on this aspect of power, we would need to analyse committees in terms of who sets the agenda, both literally and in terms of institutionalising, for each committee, the areas which are considered within its remit and those which are not to be part of its debate.

Pye discussed power in the boardroom in a way that recognises this level of complexity. She stated that even those NEDs who are considered independent :

> *...are still very much in the hands of the Chairman and the CE in terms of how agendas are put together, meetings are framed, information shared and decisions made. ... If executives are "economical" with the truth or manipulate data or fail to share knowledge with NEDs, then NEDs cannot enact their role appropriately. Hence the culture which underpins boardroom conduct and which is underpinned by the relationship forged between the Chairman and the CE and honed over time by influential others (e.g. investors) is crucial. (2001: 191)*

Pye went on to report that NEDs who sit on different companies' boards say that they work differently in each company, as board cultures vary. The next section draws upon a similar nuanced understanding of power that is relational yet interactive, to interpret what goes on inside the 'black box'.

Power in the boardroom – the case companies

It was very obvious that the board cultures differed in the five companies. In some, the NEDs were a prime force; in others the executives were prominent in the process. The people defined as 'main players' in Table 7-2 were those who were involved in the dialogue in many ways, and who had a chance to influence the agenda of the committee meetings. In this category I have placed the supporting HR manager or company secretary, who not only had physical control over the distribution of the agenda, but generally influenced its content.

In considering the remuneration-setting processes in the five companies examined, it appeared from the interviewees' accounts that the CEO had a prominent role in two (D and E). In a further company (C) the CEO played an important part but the non-executives were very involved. For the other two companies, the process in one was dominated by the non-executives and the other (B) was managed by the company chairman. It is difficult to draw conclusions from such a small sample, but in considering the dynamics of these companies, their cultures and their histories, some tentative hypotheses came to mind:

1. In all of the companies the executives (in particular the CEO and the HR professionals) had position power due to their control over information. By definition executives know more about the business than the non-executives. In setting executive pay this knowledge is relevant in

determining appropriate performance measures, and establishing the targets. It is also relevant in assessing the performance of individual executives.

2. In all except one of the companies (B), the expert power of the HR professional was acknowledged. Even in the companies that used remuneration consultants, the committee placed great reliance on the HR support. In company B the reason lay in the company's history: a previous company chairman had himself been an HR expert, and had not needed professional support. When a new chairman was appointed, the company carried on its existing mode of operation, which had become institutionalised. (It took a lot of questioning to establish this reason: the circumstances lay back in the company's history, and most interviewees had forgotten why the HR director was excluded.)
3. The personal power will vary with circumstances. It is likely that the CEO will have the influence if (a) he has personal power arising from reputation, or from the company's need for him (e.g. in a turnaround); or (b) the company has a history of being successful under his watch. This was the case in the relevant companies although in one the personal power of the CEO also came from his long tenure.
4. Notwithstanding the potential sources of executive power, it is likely that the remuneration committee will have more influence if the company has been subject to critical attention from shareholders and media in the past. In this instance, more attention will be paid to the views of institutional shareholders than otherwise might be the case.

Overall, the data suggest that remuneration committees act in accordance with governance rules set down by the Combined Code etc, but these regulations do not – and cannot – dictate how individuals behave towards each other. These relationships guide what really happens in companies. This insight will not come as a surprise to anyone involved in corporate governance. Interview notes from a meeting with an institutional representative quote him as stating:

> At the end of the day, the boxes can be ticked in a wide variety of circumstances, but good governance comes down to the relationships between the individuals.

This disconnect between the formal and informal structures adopted by companies was also highlighted by Holland (1996: 54). In interviews with institutions (conducted in 1993 and 1994, before the Greenbury report) he noted that having a remuneration committee was seen as 'good governance', but quoted one interviewee as saying that it was relatively easy for companies to appear to comply (with the Cadbury regulations), but that this: "...would not tell investors if boards and managers were likely to comply in spirit and substance".

7.4 Playing the game: rhetorics

Given that there is no right answer, an important part of the remuneration-setting process is the communication of its output to stakeholders, in order to ensure legitimation. It is interesting to note the rhetorics used in this. The differences between the espoused practices set out in companies' rhetorics, and the enacted practices of their reality, are illustrated in Table 7-3.

Table 7-3 Rhetorics and realities

Rhetorics	Realities (enacted practices)	
	Practices that might reflect 'weak' governance	**Practices that might reflect 'strong' governance**
The CEO attends committee meetings by invitation	The CEO attends every meeting, and has considerable input into the meeting agenda.	The CEO is invited to attend certain meetings.
The committee employs the remuneration consultants	The consultants are employed by the HR professional, and take their terms of reference in part from the executives.	The committee members, led by its chairman, interview prospective consultants (either their suggestions or the HR professional's) at a beauty parade, and then make the decision as to who is employed. The committee and the HR staff have separate consultants.
Stretching performance targets are used	Performance targets are always achieved, indicating that they may not be stretching enough.	Bonus payments are never 100% of the possible, indicating that the targets are demanding.
Pay is based on the market	As discussed earlier in this chapter, the market is a social construction.	
A substantial amount of the reward is based on performance	Although a substantial amount is based on performance, this is always paid out	Although a substantial amount is based on performance, if this is not paid out on a regular basis the scheme is changed. *[This is not necessarily an example of strong governance.]*

The rhetorics set out in Table 7-3 are distilled from companies' published remuneration reports, and reflect common forms of wording. Within this public face of the remuneration committee, the realities differ.

One further piece of rhetoric is relevant to this discussion. Governance regulations always refer to the need to "attract, retain and motivate" executives. It is interesting to note that in discussing pay at lower levels of an organisation, the phrase more often used is "recruit, motivate and retain" (e.g. Kessler and Purcell, 1992: 19). The subtle difference between 'recruit' and 'attract' implies that senior directors are a breed apart, who need to be wooed, perhaps with higher pay awards. It suggests a seller's market for executives, who often receive 'golden hellos' (another piece of rhetoric) to attract them to companies, and a buyer's market for more junior employees. Thus the large pay awards may become more acceptable, on the implied understanding that somehow they are needed.

7.5 Summary of chapter

In chapter 5 I set out data showing how remuneration is set in large companies. All of the companies are obliged to follow the Combined Code and to meet with good governance practice. All do, with a few minor infractions. But their internal processes and relationships are very different, and each has a different approach to setting remuneration. Although regulation sets down what an ideal committee might look like, this is impossible in practice – the Goldilocks number does not exist, and the NEDs operate in a power structure dependent in part on the company's history and culture.

In practice, companies adapt to the reality of their situation. Their dilemma is that, given there is no 'right' answer, they still need to find an answer: the executives need to be paid, and that pay needs to be satisfactory to all key constituencies – in particular the executives and the outside world, represented by the institutional shareholders and the media. Accordingly, they rely on a 'market' to grant legitimacy.

> *Since the efficiency of various routines and practices (such as compensation design) is not well understood and, thus, not easily defensible on its own merits, firms may copy one another (thus lending support to claims for legitimacy). For example, when faced with defending executive compensation design, firms may find credibility in adopting compensation designs that follow industry or national practice.*
>
> *Gomez-Mejia and Wiseman (1997: 362) [emphasis added]*

Committees arrive at a level of pay by using comparators that can be justified rather than those that are 'correct': the 'just price' does not exist, and 'the market' is a myth. They adopt structures suggested by isomorphic practices, rather than attempting to find the unique 'best'. They legitimise their remuneration with reference to the market, and by using consultants who, in their (self-) designated role as experts, are perceived to be independent. They attempt to comply with regulation but are just as much concerned with the perception as the actuality.

Remuneration committees work within this general set of constraints and paradoxes, finding different (sometimes very different) ways to resolve the endemic problem – they have to come up with a number for each award. But although the approaches vary, as we have seen, at the level of detail, all are seeking to ensure external legitimacy (and perhaps internal self-justification) through ensuring that all the governance boxes can be ticked. So the inner workings of the committee will reflect a dynamic set of group and individual relationships which may bear little resemblance to its formal structure, but which will lead to disparate but recognisably similar decision outcomes.

8. SUMMARY, CONCLUSIONS AND IMPLICATIONS

8.1 Introduction

In this concluding chapter I summarise the research project and review its main findings, placing the work in the context of previous research, and attempting to explain its contribution to knowledge. The limitations of the work are also described, and areas for further research suggested. Finally, I discuss the implications of this work for practitioners involved in setting remuneration in listed companies.

8.2 Summary of the project

The research question that formed the basis of this thesis is:

How do companies determine the remuneration of their executive directors?

This question developed from my interest in the area, and from a literature review that demonstrated a clear gap in prior research.

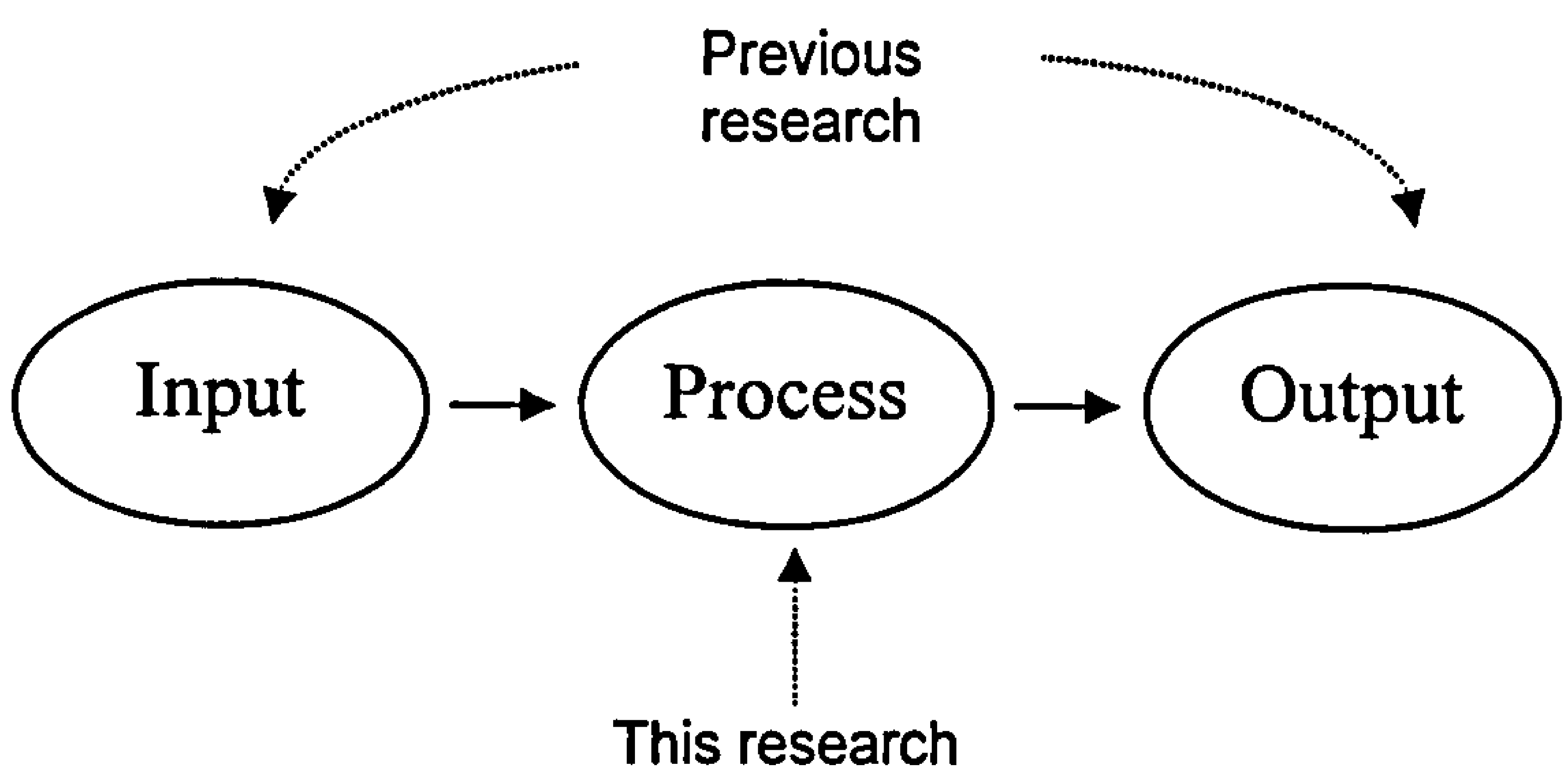
8.2.1 The research approach

In order to address the research question I adopted a qualitative approach, conducting interviews with people who sat on and advised remuneration committees, as these are the people who are best-placed to comment on what really happens. Such an approach has rarely been seen in studies of directors' remuneration. 40 interviews were conducted with individuals from 12 companies, institutional representatives and headhunters. These face-to-face interviews provided a wealth of data which has been analysed using an approach that is grounded purely in neither economic, social-psychological nor organisational perspectives, but has drawn upon a diverse range of theories previous used to address the executive remuneration problem. Such a multiply-influenced theoretical approach is itself uncommon in this field (Merchant et al., 2003).

8.2.2 Setting this project in the context of prior literature

The research question of this thesis has not directly been addressed in the extensive body of prior research into directors' pay. Many studies have used archival data to consider the statistical relationship between various input factors (for example company size, performance, characteristics of the board) and pay, determined in different ways. However, few have considered the *processes* that underlie the remuneration decision. Figure 8-1, repeated from chapter 1, illustrates this.

Figure 8-1 The territory covered by this research study



Furthermore, in previous research most studies that examined the level of pay have ignored its structure, and vice versa. This study considers both. An additional difference between this study and others is that the theoretical approaches adopted by previous researchers have mainly been situated in either in neo-classical economics, or in a social-psychological or organisational base; the multi-theoretical approach adopted here has rarely been used. Table 8-1 sets out the differences between this research and the body of prior literature as discussed in chapter 2.

Table 8-1 Differences between this study and the body of prior research

Prior research*	This study
Mostly quantitative.	Qualitative approach.
Mostly deductive.	A more inductive approach.
The use of data and constructs meant that the research was conducted at a distance from companies.	The research was close to its subject, embedded in companies.
Generally examines the determinants of pay in an 'input-output' model.	Examines the remuneration-setting processes.
Generally approaches the research through a particular theory. This means that most studies relate to the individual or to the market, but rarely to both.	A multiply-influenced theoretical approach, which considers the dilemmas of all relevant parties.
Focused on particular areas of executive pay.	A wide-ranging study that encompasses many different aspects of executive pay.

* Whilst there are exceptions, and it is unfair to characterise all previous research as fitting into the description set out above, this generic description would be recognisable by a reviewer of that literature.

In setting out the differences between this thesis and the existing body of research I acknowledge a debt to that body of knowledge. Without the prior literature this work would have been less clearly focused. This study has extended prior research, and shows the value of taking a qualitative approach alongside a body of quantitative work, as suggested by Werner and Ward, 2004.

8.3 The research contribution

This thesis has contributed both in its findings and in its methodology. Whilst the methodology used is not original, it had previously been unusual in this field. This study shows that it is possible to do interview-based work in this area, and that such work generates rich data that has opened up the 'black box' of process. I hope that this will encourage others to follow.

In this thesis I developed a typology of theories used by previous researchers, and used that to explore how useful these theories were in explaining how remuneration is set. I found that none in itself was sufficient to explain the complex processes uncovered by the research; nor was any combination of existing theories sufficient.

A major theme that emerged from the research has been the finding that institutional theory and 'need for legitimacy' approaches continue to make particular sense of certain features that are common to the disparate ways adopted by committees to solve the remuneration problem. As summarised in Tables 8-2 and 8-3, companies set their level of pay in line with 'the market' and they adopt the same pay structures as their peers. What is significant about this is that the participants appreciated that there is no single right answer to the question 'how should we pay the directors?' (although there may be wrong answers for any individual company at any time). Accordingly, a key constraint on any remuneration committee is the need to be able to justify its decisions, to legitimise the company and the NED committee members. The use of 'market comparators' is one way to do this, as is the rhetoric surrounding the remuneration decision.

8.3.1 Outcomes of the remuneration decisions

In examining the processes of setting remuneration, it was inevitable that I would also be enquiring as to the outcomes of the remuneration decisions on the level and structure of executive pay. Tables 8-2 and 8-3 set out the key findings as regards those outcomes.

Table 8-2 Summary of key findings regarding the level of pay

- Pay could be said to be justifiable if it were (a) the 'just price' for the job, or (b) a reflection of supply and demand in the market. As it is impossible to determine just price, companies have to set and justify their pay by reference to market forces.
- All companies report that the level of pay is based on 'the market', as determined by remuneration surveys and other benchmarks. These benchmarks, being external to the company, can confer legitimacy on the remuneration decisions. However, the market for executives does not exist independently: it is in fact a collection of elite referents established by each company. This socially-constructed market has become institutionalised, and is accepted by all players as a legitimate way to set pay.
- Given the existence of multi-business companies, and companies that aspire to be in sectors other than their own, there is no guarantee that these elite referents reflect what they claim. A benchmarking merry-go-round exists, making any independent comparison impossible.
- Where schemes were considered to be significantly below 'the market', levels of pay were revised upwards. No instances were seen of pay levels being reduced.

Table 8-3 Summary of key findings regarding the structure of pay

- All of the companies adopt schemes including salary and short- (one year) and long-term (three year) performance-related pay (PRP).
- A map was constructed (Figure 5-2) of the various structuring decisions a company has to make. The issues impacting these are both internal and external. The internal factors include the company's strategy and culture (current or intended) and the HR practices that it follows. External factors reflect an institutional theory explanation, with companies following 'best practice' in order to gain legitimacy. Institutional investors have a strong influence on pay structures.
- It was noted that companies adopt similar structures, but often for different reasons.
- The PRP element in pay packages is large, and growing, with bonus potential and long-term awards rising each year. This is claimed to be partly to motivate good performance (although many respondents argued that pay does not motivate performance) and partly in order to conform with good governance practice: PRP is seen as one way to legitimise large remuneration packages.
- By implication, pay is structured, at any given point, in comparison to successful or survivor companies, thus introducing a 'structural survivor bias'.
- When a PRP scheme does not pay out, or pays out less than was expected when the scheme was devised, the scheme is normally changed. Thus, pay is only related to good performance; for poor performance the rules change.

One contribution of this thesis is the finding that companies change their remuneration schemes frequently, and that such changes cover both the level and structure of the pay. No previous academic studies have been found that directly address this. The changes in the level of pay would be disclosed in companies' published remuneration reports, although changes due to a revision of the comparator group might not be very obvious. Likewise, many of the changes in scheme design (short- and long-term) would be disclosed, although some of the more subtle changes would not be reflected in the published remuneration reports.

The most common reasons for making changes included the desire not to be 'below-market' and to ensure a payout on performance-related schemes which were in danger of not paying out the expected amount. Changes were also made for reasons to do with the company's strategy and changes in its personnel.

The overall effect of the changes was to increase remuneration. This occurred due to increases in the level of pay and increases in the level of bonus or long-term incentive as a percentage of that basic pay. Thus there was a multiplier effect, total remuneration reflecting greater multiples of a larger amount.

A constant criticism of 'fat cat' pay is the fact that executive pay levels continue to rise more steeply than those for other employees. The changes discussed above are one reason for this. Another, related, reason is the use of a self-defined 'market'– whether consciously or unconsciously on the part of the players, there is always a survey available to show that a company is below the market, and NEDs feel obliged to meet that 'market' in order to avoid losing good executives to the competition. Given that there is no 'right answer', this ratcheting-up appears to be an inevitable feature of the system.

Previous researchers (e.g. Prendergast, 1999; Tosi et al., 2000) have commented that the lack of a clear relationship between pay and performance could reflect contracts that were not designed with this relationship in mind, or could reflect contracts too sophisticated to be captured in statistical studies done at a distance from the companies. In examining the detailed performance measures and targets adopted by the case companies, this study has demonstrated that the latter explanation might be true. In noting the continuing changes made to schemes that do not pay out, it has also suggested another explanation for other researchers' findings – that in practice pay is only performance-related when that performance is good (whether or not that good performance reflects factors outside the individual executives' control).

8.3.2 The remuneration-setting processes

The research has looked at the remuneration-setting processes through the eyes of the main players: the remuneration committee chairmen, other NEDs, CEOs, HR directors, company secretaries, company chairmen and consultants. It further considered the views of an institutional professional body and headhunters, to obtain their views on process.

Although a process model was drawn up (Figure 6-3) to show the influences on executive pay and outline how it is set, the actual processes of setting pay are more subtle than the model can accommodate. In each of the case companies, procedures could be said to follow those laid down in the governance regulations. Nevertheless, each company's remuneration committee operated in a very different way. In some companies the committee, and the NEDs on it, were clearly a major influence on how remuneration was set. In others it was apparent that the executives (particularly the CEO) controlled what was done, with the remuneration committee being there almost to rubber stamp some decisions. Although outwardly all companies were compliant with governance regulation, it was the relationships between the key players that determined what happened.

The Combined Code envisages remuneration being set by an independent remuneration committee, staffed by non-executives who are knowledgeable about both the company and remuneration schemes. This is an impossible ideal. The non-executives on the committee lack the time, knowledge and experience to contribute fully in this way, and need to take advice from internal staff as well as external consultants. The remuneration committees we see in practice are imperfect shadows of the ideal put forward by the Code.

The setting of directors' remuneration is an example of the 'is-ought' problem. There is no one right answer; we do not know what pay levels and structures *ought* to be. However, levels and structure do need to be determined for each company. Accordingly, they are set based on what *is*, using other companies and perceived best practice as a template. This enables companies to justify their pay decisions in an 'objective' manner. Although Legitimacy-Comparison theory proved inadequate as an explanation of the process, its two components – the need for legitimacy and the use of comparisons – are significant inputs into the pay-setting decision.

8.4 Limitations of this study and opportunities for further research

8.4.1 Limitations

This UK-based study has examined practices in 12 FTSE 350 companies. Its results must be interpreted in the light of the fact that participation in the study was at the discretion of the key participants. In those companies where there were several participants, the participation decision was often discussed at a remuneration committee meeting; in those where there was only one interviewee, that person had to be willing to volunteer their time. It is reasonable to assume that companies where the protagonists were in some way uncomfortable with their practices, or where they did not fully trust each other, would not volunteer to participate in this study. Accordingly, there is an inevitable bias in the sample.

Were it the intention of the study to generalise the findings to a wider population, or to constitute a set of universally-applicable conclusions about or principles for executive remuneration, this would present a problem. (Indeed, were there any such intention, this research approach would not have been adopted.) However, as one aim of the sample selection was to consider only companies that appeared to have good governance – in order to see what 'good' looked like in this context – the self-selection of the sample is an observation rather than a limitation. Further, while one might anticipate that similar characteristics will continue to be exhibited in the activities of remuneration committees, this cannot be a foregone conclusion. Indeed, the findings here may themselves constitute a potential intervention in such future activities, insofar as they are seen as relevant or insightful.

A limitation of the study was the inability to obtain more than one interviewee in five of the 12 case companies, and having only two participants from two other companies. The research design had originally called for five participants from eight companies; as explained in chapter 4, it was felt that this would provide a good understanding of each company's situation. The circumstances of the research prevented this, as discussed in chapter 4. Although there is no way of knowing whether further participants from these companies would have provided significantly different data from those who were interviewed, reassurance was obtained from the fact that the narratives of so many individuals in different companies coincided.

8.4.2 Opportunities for further research

This research could be extended in several ways. At a simple level, another researcher could duplicate the work in the same setting (FTSE 350 companies) in order to determine how committees work in the light of new governance rules, for example the Directors' Remuneration Report Regulations (2002). Alternatively, it would be useful to duplicate it in other contexts, for example listed companies in other jurisdictions, or in large private companies, to see how context affects the processes. Another useful variation would be to repeat the research during a time when stock markets were noticeably rising or falling, to see how this changes interviewees' actions and perceptions.

The design of this research was to consider remuneration as comprising salary and short- and long-term performance-related pay, in line with practices adopted in previous research. Pensions and perks are not included. At the time the research commenced, the issue of executive pensions was not a matter of great interest for the public or the institutional shareholders; over the last couple of years this has changed, and pensions have achieved prominence in the 'fat cat' debate (e.g. Cohen, 1993; Tucker, 2003). Extending the research to ask interviewees about their pension choices would provide an interesting insight to this debate.

The research could also be used as the basis for further studies into the roles played by the protagonists in the remuneration-setting discussion. This would include the executives, the NEDs and the consultants. Also, given the finding of the importance of investing institutions to the deliberations of the remuneration-setters, it would be useful to combine research of this type with research into how the institutional investors see the remuneration-setting process.

The findings of this research could also be used to develop new constructs, to test in qualitative and quantitative analysis. For example, it would be interesting to take the list of input factors developed in chapter 2 and examine the contexts in which each factor is considered appropriate. In particular, it seems that a company's history and culture have a significant impact on how the committee operates and how its remuneration is determined, and this would be a useful area for future exploration.

8.5 Implications for practice

To some, it might seem impertinent to suggest that this research has implications for practice: although the findings add to the academic debate, the findings were obtained in interview with practitioners, who are already aware of what is happening. However, the great advantage of the academic approach is the way that data are analysed in the light of theory. Accordingly, I believe that there are significant implications for non-academics, as set out below.

8.5.1 For those involved in the remuneration-setting decision

One finding of this research was that in each company the remuneration-setting decision was approached differently. In some, the remuneration committee members played a large part in determining pay, and in appointing the committee's advisors. In others, although the committee was nominally involved, the majority of the work was done by the executives. For non-executives sitting on remuneration committees the research should highlight the need for them to consider the following questions:

- How and by whom were the terms of reference of the remuneration committee set? Do they need altering?
- How many remuneration committee meetings are there in a year, and is this sufficient to do justice to the committee's terms of reference?
- How is the agenda for committee meetings set, and how easy is it for NEDs to contribute to this agenda?
- Who sets the terms of reference for external advisors, and is the committee satisfied as to their independence of mind?
- How do the CEO and the company's chairman interact with the committee and do they have undue influence over its decisions?

8.5.2 For those regulating remuneration

In recent months, the governance debate on both sides of the Atlantic has reflected companies' complaints that the burden of regulation has become too great, and that time and money are being spent in unnecessary compliance which does not add value (see, for example, Targett, 2004a, 2004b). This research shows that companies adapt to regulation in their own idiosyncratic ways. Each of the companies in the research could state that it complied with governance regulations – it could 'tick the boxes'. However, each complied in a different manner.

The practical implication of this is that although regulation can be used to set minimum standards (for example, levels of disclosure, the use of a remuneration committee), further layers of regulation may have little impact on pay levels and remuneration-setting processes. Companies can adapt to comply without necessarily changing their underlying governance cultures. As Jensen and Meckling (1994) argued, regulations will almost always generate unanticipated behaviour, as people invent ways to adapt to the constraints.

Further, given that there is no right answer, and that companies construct their own comparator 'market' in establishing pay levels and structures, it seems almost impossible that regulation can control the 'bidding up', or ratcheting of directors' pay. 'The market' is used both as a benchmark for HR purposes and to provide legitimacy. Although recent examples of shareholder outrage (e.g. Buckley, 2004) show that this legitimacy may be waning; this does not seem to be restricting awards (Tucker, 2004). In the absence of a government-backed incomes policy it is difficult to see just what will happen to control pay levels; companies fear losing valuable executives due to under-paying, so no remuneration committee will want to be the first to impose restrictions.

8.6 A final word

The aim of this study was to open up the black box of directors' remuneration, to find out how companies determine their executive pay. This aim has been met. It has been achieved by taking a novel approach to examine a field that has been the subject of much prior research. This thesis has added to the existing body of work in different ways. It has confirmed some of the findings of previous research, and explained why others may be problematic. It has extended the knowledge of the field by illuminating practices used in the case companies to determine executive pay, and their rhetorics of justification.

As such, as noted above in this chapter, the study is itself an intervention in the practice of remuneration-setting that might potentially make a difference to that practice going forward. Such an outcome may of course not take place, and certainly cannot be predicted; nor can any specific impact be anticipated. At the same time, it cannot be ruled out that there may be some impact, whether in terms of how this practice is theorised, or how well it is pursued in real-world business settings, or indeed both.

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GLOSSARY OF TERMS AND ABBREVIATIONS

ABI	Association of British Insurers
Cap	A bonus cap is the maximum level of bonus payable, normally expressed as a percentage of base salary.
CBI	The Confederation of British Industry: an employers' organisation in the UK.
CEO	Chief executive officer
CFO	Chief financial officer
Combined Code (on Corporate Governance) ("The Code")	A regulatory code annexed to the Listing Rules for listed companies. A new Code was issued in July 2003, following the publication of the Higgs report.
Directors' Remuneration Report Regulations (2002)	A Statutory Instrument requiring listed companies to increase substantially the level and quality of their disclosures about directors' pay. This applies for financial years ending on or after 31st December 2002.
DTI	Department of Trade and Industry
EPS	Earnings per share
Director	Executive director of a company
EBITDA	Earnings before interest, tax, depreciation and amortisation. A performance measure often used by analysts in examining a company.
Exercise price	The price at which the holder of share options is entitled to buy the shares.
FD	Finance director
FTSE 350	The top 350 companies on the London Stock exchange, by market capitalisation. The largest of these are the FTSE 100; the FTSE 250 includes the companies from 101 to 350.
Gearing	The relative level of performance-related remuneration (for example, annual bonus) compared to fixed remuneration (for example, basic salary). A highly-geared package will contain a high proportion of performance-related remuneration

Greenbury report	A report on Directors' Remuneration, published in 1995, commissioned by the CBI following concerns about 'fat cats'.
Higgs report	Review of the Role and Effectiveness of Non-Executive Directors, published in January 2003 as a consultative document, parts of which were later incorporated into a revised Combined Code.
HR	Human resources
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standard
In-the-money	Term referring to share options for which the exercise price is lower than the current market price, making it financially worthwhile to exercise the options.
Inputs	Factors, both company-specific and environmental, that influence the setting of the remuneration policy and the individuals' specific remuneration packages. (For example, company size, industry, individual's experience.)
L-C theory	Legitimacy-comparison theory; developed during the literature review for this study.
Leverage	As gearing
LT	Long-term
Ltip	Long-term incentive plan.
M&A	Merger and acquisition. A generic term for both types of corporate combination.
NAPF	National Association of Pension Funds
NED	Non-executive director
Option	A call option on the shares of a company. This gives the holder the right – but not the obligation - to buy shares at a set price (the exercise price) at some point in the future (normally after three years).
Out-of-the-money	Term referring to share options for which the exercise price is higher than the current market price, making it not financially worthwhile to exercise the options.

Outcome	The amount of remuneration (in all its forms) received by an individual director in a particular period (which may depend on performance achieved).
Outputs	The remuneration policies and packages determined by a company as a result of the remuneration processes.
Pay risk	The risk to the director of receiving lower pay than anticipated. A highly geared scheme carries high pay risk.
PRP	Performance-related pay
PwC	PricewaterhouseCoopers
Level of pay	The amount actually paid for expected performance, including both the fixed and variable elements.
Remn	Common abbreviation for remuneration.
Remuneration package	The translation of the overall remuneration policy into terms for an individual director. (The Hampel report (1998) uses the term "remuneration package" to cover both this definition and the amount of remuneration received in a period. To avoid confusion in this paper, the term "outcome" has been used to define the latter.)
Remuneration policy	The framework in which the directors' individual remuneration packages are set: the company's stance on remuneration issues. For example: selection of comparator group for benchmarking performance; positioning of remuneration relative to comparator group; level of gearing of the remuneration; choice of performance measures; choice of performance period; pensions policy. (A fuller list of items to consider in a remuneration policy is given in Section C of the Greenbury report, 1995.)
Remuneration processes	The processes of (1) determining a remuneration policy and (2) translating it into remuneration packages for individual directors.
RPE	Relative performance evaluation

RPI	Retail Price Index. Used as a benchmark for companies to assess eps growth.
SID	Senior Independent Director. An NED, other than the chairman, designated as a potential route for institutional liaison.
ST	Short-term
Structure of pay	The combination of fixed and variable pay elements, together with the performance measures and targets chosen, and the forms of payment.
TSR	Total shareholder return: the return to a shareholder over a given period, comprising dividend and capital gain/loss.
Underwater options	Colloquial term for out-of-the-money options.
Variable pay	Any element of pay which is contingent upon performance criteria or share price. Generally, anything other than base salary. (Used synonymously with performance-related pay.)

APPENDICES

1. Directors' remuneration in UK listed companies
2. Examples of variables used in previous research
3. Interview schedule and significant events affecting directors' pay
4. Interview guide
5. Questionnaire on factors
6. Letter to members of the Remuneration Group
7. Coding structure
8. Features of schemes in use in the case companies
9. Summary of reasons given for changing schemes
10. Changes made – and not made – for regulatory purposes
11. Differences between versions of the Combined Code

APPENDIX 1 DIRECTORS' REMUNERATION IN UK LISTED COMPANIES

The average executive director of a UK listed company will receive a substantial remuneration package comprising several different elements. This section provides a brief overview of what might be in such a package.

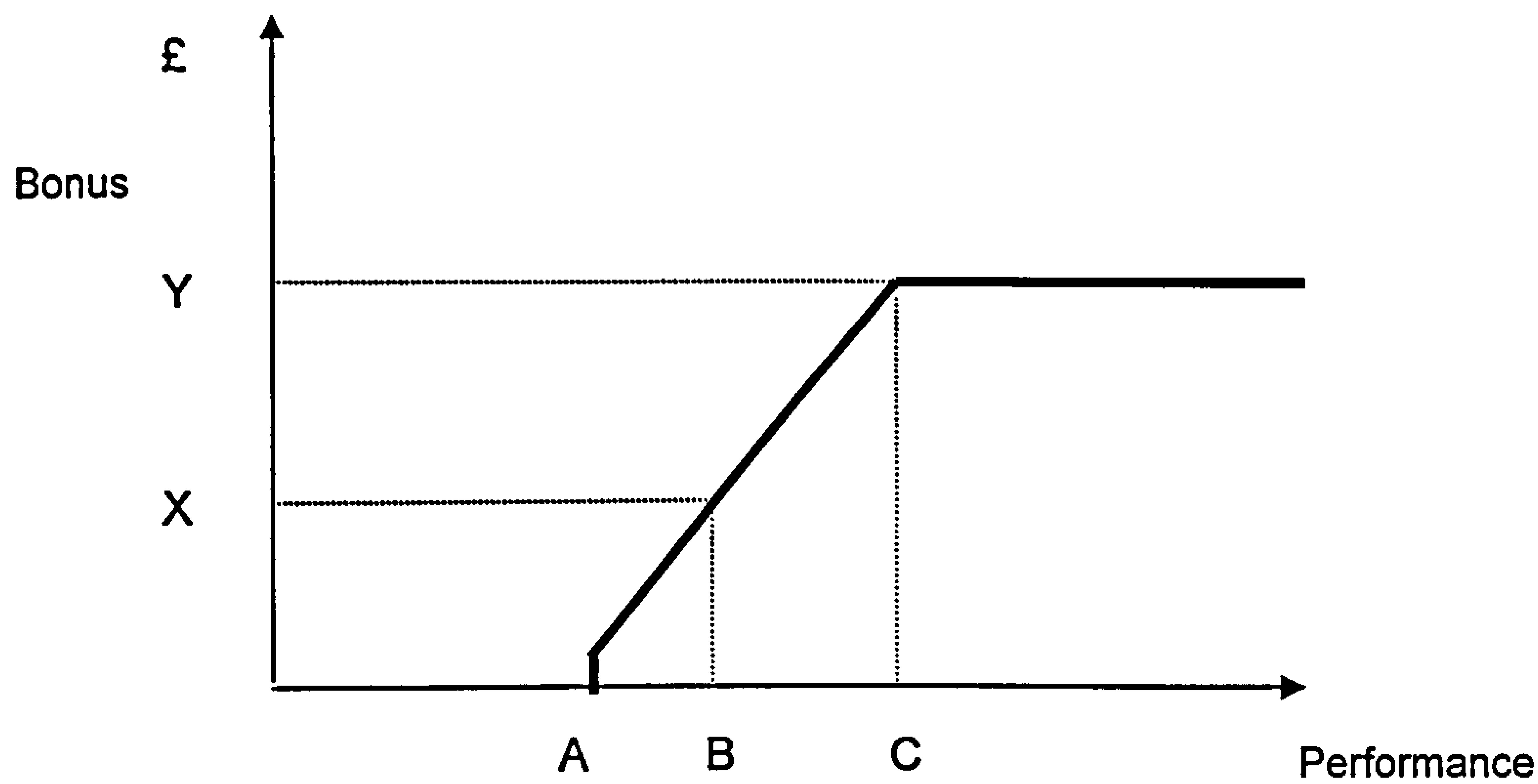
Salary

The package will be built around a base salary. Although the salary element may form proportionately a smaller part of the package than it has done in the past (Centre for Business Performance, 2003) due to the growing importance of variable pay, it is important for two reasons. Firstly, and somewhat obviously, it is the fixed pay which the executive knows that s/he can expect to receive. The other reason that base salary is important is that the amounts of variable pay are generally expressed as multiples of base salary. For example, the annual bonus may be up to 60% of base salary; the longer term award may be 200% of base salary. Accordingly, increases in base salary have a multiplier effect on the whole package.

Annual bonus

Most companies will award both short-term and longer term variable pay. The short-term award is generally in the form of an cash bonus, paid for achieving annually-set performance targets. The targets may be a mixture of financial and non-financial, individual and corporate. As stated above, the amount of bonus available will be a multiple of salary. Companies will often state that no bonus will be paid until a certain performance threshold is achieved, and then further performance produces increased bonus. Figure A1 (based on Murphy, 2001) illustrates a typical bonus payout.

Figure A1 Annual bonus payout



The bonus threshold is set at a performance level of A: until this performance is reached, no bonus will be paid. Expected performance is at level B, at which the expected bonus of X will be paid. The bonus is capped at Y, and even if performance exceeds level C, no additional bonus will be paid. The bonus cap will be set in relation to base salary, such that, for example, X is 60% of salary and Y is 100% of salary.

One further fact is worth noting about the annual bonus. In recent years it has become common for companies to permit or demand that part of the annual bonus award is commuted into shares rather than taken as a cash payment. Those shares will vest after a further period, sometimes with further performance conditions attached. Companies often 'match' these shares, such that if the executive commutes into shares an amount equivalent to say £100,000 of pre-tax bonus, when the shares vest the company will award him or her extra shares, the number of shares that that £100,000 could have bought at the time the bonus was awarded.

Long-term incentive plan

Common practice is to incentivise directors to think for the longer term, and companies also wish to align the directors' interests with those of the long-term shareholders. Accordingly, many companies use a long-term incentive plan (ltip). Ltip is the generic term for many different types of share-based plan. In a typical plan shares would be awarded conditionally to the director at the start of the plan, but the shares would not vest until a performance period (often three years) had passed and performance conditions had been met. The proportion of shares vesting would depend on how well the performance conditions had been met; as with the annual bonus, there is often a sliding scale of award for different levels of performance.

Share option scheme

Directors' share options are call options on the shares of the company, with an exercise price generally set at the share price at the date of grant, and a period of between three and 10 years during which the director can choose to exercise the option. It used to be the case that companies would either use an ltip or a share option scheme to reward their directors, but it is becoming common practice for companies to have both schemes available for use (New Bridge Street, 2003b).

Other forms of remuneration

There are two other forms of remuneration in common use in the UK – pensions and perks. Most directors belong to a company pension scheme, often a defined benefit scheme. Also, almost all directors will have some additional perks, for example a company car, health insurance, etc. The academic literature on directors' remuneration, reviewed in chapter 2, has almost nothing to say about these aspects of remuneration (for example, Murphy, 1999: 2517; Werner and Ward, 2004: 217). It focuses mostly on the determination of the level of base pay, and on various aspects of variable, performance-related pay. This thesis follows that tradition.

APPENDIX 2 EXAMPLES OF VARIABLES USED IN PREVIOUS RESEARCH

This appendix sets out examples of papers which were used to derive the list of input variables in chapter 2.

Table A1 Prior studies examining the relationship between company size and directors' remuneration

STUDY	REMUNERATION MEASURE	DETERMINATION OF SIZE	SAMPLE	RESULTS
Lewellan and Huntsman (1970)	Current income equivalent of all pay sources	(a) Sales and (b) Market value	50 large US companies, 1942 to 1963	Correlation between market capitalisation and pay but insignificant between sales and pay
Deckop (1988)	Cash compensation	(a) Sales and (b) Market value	120 large US companies, 1977 to 1981	Insignificant correlation between sales and pay. Difficult to interpret data re market value.
Finkelstein and Hambrick (1989)	Cash compensation	Total assets	110 large US leisure companies, 1971, 1976, 1982 and 1983	Strong correlation between size and pay
Boyd (1994)	Cash compensation	Sales	193 large US companies, 1980	Insignificant correlation between sales and pay
Conyon and Leech (1994)	Cash compensation	Sales	294 large UK companies, 1983 to 1986	Strong correlation between sales and pay
McKnight (1996)	Salary tested separately to bonus	Sales	90 large UK firms 1992 to 1994	Salary correlated to size; bonus correlated to size and performance
Ezzamel and Watson (1997)	Cash compensation	(a) Sales and (b) Capital employed	199 large UK companies, 1992 to 1993	Strong correlation with both factors
Finkelstein and Boyd (1998)	Cash compensation and long-term compensation	(a) Sales and (b) Total assets	600 firms in Fortune 1000, 1987	Strong correlation with both factors

Following the lead of Tosi et al. (2000), this table includes studies using size as a control mechanism as well as studies where size is the principal variable.

Table A2 Prior studies investigating links between company performance and directors' remuneration

STUDY	REMUNERATION MEASURE	DETERMINATION OF PERFORMANCE	SAMPLE	RESULTS
Lewellan and Huntsman (1970)	Current income equivalent of all pay sources	Accounting profit	50 large US companies, 1942 to 1963	Strong correlation between profit and pay
Murphy (1985)	Total compensation in all forms excluding pensions	Shareholders' returns	72 large US companies, 1964 to 1981	Strong correlation between shareholders' returns and pay
Deckop (1988)	Cash compensation	Accounting profit	120 large US companies, 1977 to 1981	Strong correlation between profit and pay
Finkelstein and Boyd (1998)	Cash compensation and long term compensation	Return on assets; return on equity	600 firms from 1987 Fortune 1000.	Low correlation between returns and pay
Jensen and Murphy (1990a)	Directors' wealth including current compensation, future revisions and benefits from stock ownership	Change in shareholders' wealth	1049 large US companies, 1974 to 1986	$1000 change in shareholder wealth led to $3.25 in directors' wealth, mostly from stock ownership – authors consider this a low impact
Gregg, Machin and Szymanski (1993)	Cash compensation	Shareholder returns and eps	288 large UK companies, 1983 to 1991	Weak correlation up to 1988; breaks down after that
Main, Bruce and Buck (1996)	Cash compensation and share options	Shareholder returns	60 major UK listed companies, 1989	Strong correlation between shareholders' returns and pay
Ezzamel and Watson (1997)	Cash compensation	(a) Return on equity (RoE) (b) Shareholder returns	199 large UK companies, 1992 to 1993	No significant correlation between RoE and pay. Significant correlation for shareholder returns in one year only

Table A3 Prior studies investigating issues relating to the structure of directors' remuneration

STUDY	ISSUES EXAMINED	SAMPLE	RESULTS
Balkin and Gomez-Mejia (1987)	Link between compensation strategy, organisation and environment	33 high-technology and 72 non-high-tech firms or business units in the US	Companies in the growth stage of their life-cycle had proportionately more incentive pay, and (in the opinion of managers responsible for pay policies) such pay was more effective for them than for mature companies
Gomez-Mejia, Tosi and Hinkin (1987)	Difference in remuneration structures between owner-controlled and manager-controlled companies	71 very large US manufacturers, 1980 to 1983	Owner-controlled companies pay relatively more for performance and less for size of business than counterpart firms with no dominant owner
Ely (1991)	Relationship between CEO pay and accounting-based firm performance variables in different industries	173 US companies in four industries (banking, electric utility, oil and gas, and retail grocery), 1978 to 1982	Different industries used similar performance measures but different pay structures
Beatty and Zajac (1994)	Relationship between firm risk and pay structure of the top team	435 US firms undertaking IPOs in 1984.	High risk companies had lower pay-risk (i.e. less gearing)
Conyon & Peck (1998)	Influence of board composition on top management pay	94 major UK listed companies, 1991-1994	Boards dominated by outsiders are more likely to use performance related pay
Daily, Johnson, Ellstrand and Dalton (1998)	Influence of compensation committee membership on CEO pay	194 Fortune 500 companies, 1992	No correlation between the number of non-independent directors and the level of CEO pay, small correlation with the gearing of CEO pay
David, Kochhar and Levitas (1998)	Influence of institutional investors on CEO compensation policy	Fortune survey of 200 largest US companies 1992 to 1994.	Companies with significant outside shareholders are more likely to use performance related pay
Finkelstein and Boyd (1998)	Relationship between managerial discretion and CEO pay	600 Fortune 1000 companies from 1987	CEOs with greatest potential impact on performance are paid more; greater relationship between CEO pay and managerial discretion in high- than low-performing companies
Bloom (1999)	Impact of risk on managerial compensation	536 large US companies, 1981 to 1988.	High risk companies tend to de-emphasise the use of incentive pay. Organisations relying more heavily on incentive pay offer higher levels of basic pay to offset some of the directors' risk

Newman and Mozes (1999)	Influence of compensation committee membership on CEO pay	161 Fortune 250 companies, 1991 and 1992	Relationship between CEO pay and performance was biased in CEO's favour when firms had insiders on compensation committee
Conyon and He (2004)	Determination of CEO equity incentives in US entrepreneurial high technology firms	320 internet /software and 154 biotech companies that floated 1996-9.	Compensation structures changed significantly in the years post float. Different structures for internet and biotech companies. Differences between founder/non-founder firms; venture capital investment also affected pay structures.

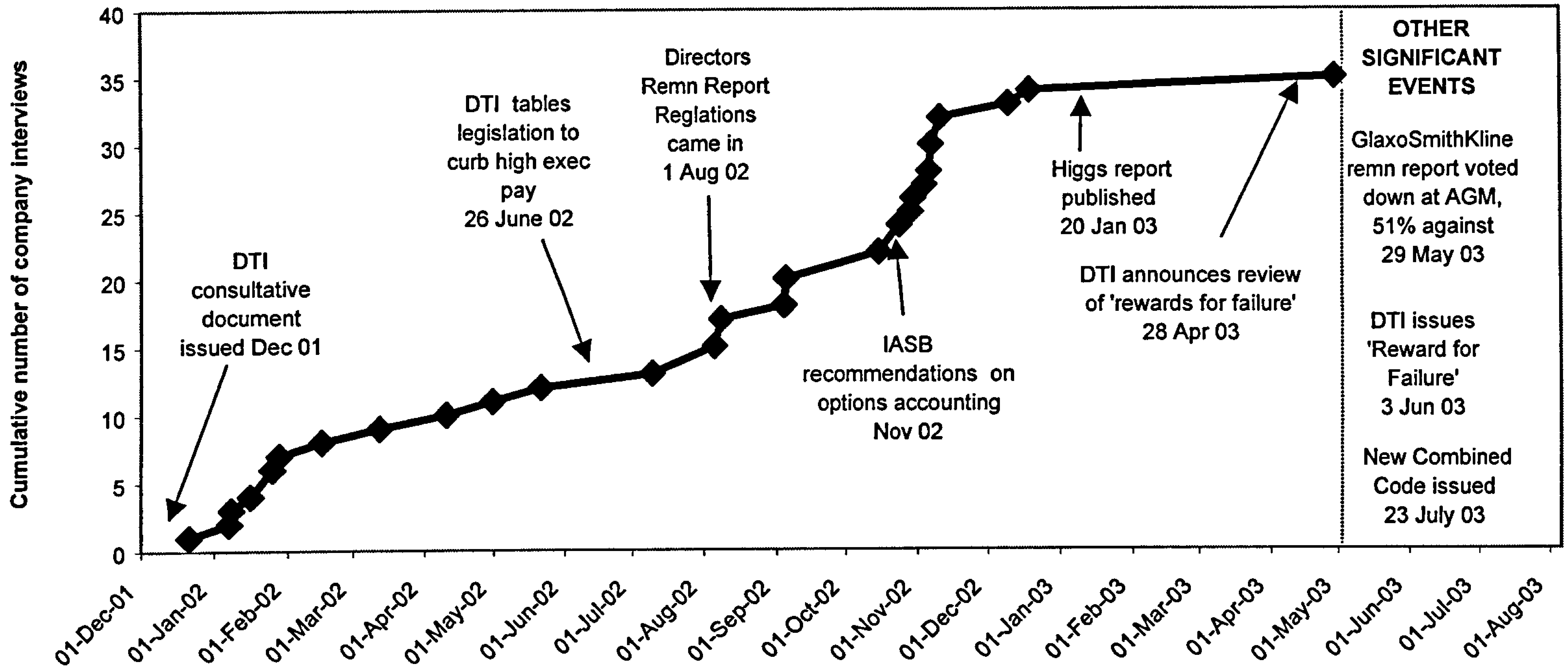
Table A4 Prior studies examining factors relating to the form in which directors' remuneration is paid

STUDY	ISSUES EXAMINED	SAMPLE	RESULTS
Jensen and Murphy (1990b)	CEOs' ownership of company stock	1400 large US companies, 1974 to 1988	CEOs need to own substantial amounts of the company's stock in order for this form of reward to affect performance
Main, Bruce and Buck (1996)	Link between directors' pay and performance. Differences in the use of options in the US and UK	60 major UK listed companies, 1989	Share options provide a performance-sensitive connection between pay and performance
Yermack (1997)	Timing of managers' exercise of stock options	620 option awards by Fortune 500 companies, 1992 to 1994	Executives appear to manipulate the timing of exercising share options to benefit from favourable stock market movements
Murray, Smithers and Emerson (1998)	Accounting treatment of stock options	100 large US companies	Different accounting treatments of options makes it possible to avoid or reduce a charge against income
Cooper and Hraiki (1998)	Financial reporting for stock options. Differences in US and UK accounting practices	Impact of fair value reporting on 50 largest US companies by market capitalisation	Net income would be reduced (in some cases significantly) if options were fully charged against income

Table A5 Prior studies examining the relationship between performance targets and directors' behaviour

STUDY	ISSUES EXAMINED	SAMPLE	RESULTS
Healy (1985)	Extent to which managers manipulate earnings, using total accruals, to maximise bonus payments	94 US companies, 1930 to 1980	Executives choose accounting procedures that manipulate profit downwards at upper bonus limit and upwards at lower limit
Holthausen, Larcker and Sloan (1995)	Extent to which managers manipulate earnings, using discretionary accruals, to maximise bonus payments	Data for 1982 to 1984 and 1987 to 1991 from two compensation consultants' surveys (443 firm-year observations in total)	Profits were manipulated downwards at the upper bonus limit, no manipulation found at the lower limit
Murphy (2001)	The impact of using internally-determined performance standards as against externally benchmarked ones	177 bonus plans for listed US companies, 1996 to 1997	Internal standards led to income smoothing and less variable bonuses

APPENDIX 3 INTERVIEW SCHEDULE AND SIGNIFICANT EVENTS AFFECTING DIRECTORS' PAY



This schedule sets the interviews in the context of external events that shaped the executive pay landscape over the past three years. It should be noted that many of the legislative proposals were trailed widely in the media in the months before their publication , and so would have influenced participants' views during that period. During this time there was also a significant media debate about 'fat cat' payments, and much discussion about institutional voting on remuneration schemes.

APPENDIX 4 INTERVIEW GUIDE

1. Your thoughts on the debate about the level and structure of executive directors' remuneration

a. How does it affect directors' performance?
b. Does it motivate them?
c. What else motivates them?
d. Who are the stakeholders in the remuneration debate?
   e. How important is the drafting of the remuneration report. Who does it?
   f. What if you have a good structure as far as the company is concerned, but it is novel - no-one's ever done it before?

2. How the company arrived at its remuneration policies

<u>Committee meetings</u>
a. How often, who attends, who speaks most?
b. What information available? How long in advance?
c. What was the role of the consultants? Of the executives in attendance?
d. Any training given in remuneration matters?
e. How are the committee meetings conducted?

<u>The process</u>
f. Explain in more detail than in the remuneration report.
g. Link to the corporate objectives?
h. What else was considered and why was it rejected?
i. Time line of the process.
j. Did policies drive packages or was it iterative?
k. Directors' pay compared to pay levels in the rest of the organisation?

3. How do the company's remuneration policies compare to other companies of which you are aware

a. As regards level of pay?
b. As regards structure of pay?
c. Based on your knowledge of the 'industry', are there any companies whose policies and packages you believe to be particularly good (or bad)? Why?

4. (Not sent in advance)

Here is a list of factors that academic researchers have seen as important in determining directors' pay. Could you please indicate on a scale of 1 – 5 which you see as important in the remuneration decision in [Company].

(See questionnaire in Appendix 5)

APPENDIX 5 QUESTIONNAIRE ON FACTORS

FACTORS AFFECTING THE LEVEL AND STRUCTURE OF EXECUTIVE DIRECTORS' REMUNERATION

Many factors can be considered as having an effect on the level of directors' remuneration and the way in which remuneration contracts are structured. Set out below is a list of some possible factors. For each factor please identify, by ticking the relevant column, how relevant the matter is in determining directors' remuneration in your company.

Feel free to make any comments about the different factors, or to add factors that you think have been omitted.

	Affects the level of remuneration (1 = Not at all relevant, 5 = Very relevant)					Affects the structure of remuneration (1 = Not at all relevant, 5 = Very relevant)					Any Comments you care to make?
Factor	**1**	**2**	**3**	**4**	**5**	**1**	**2**	**3**	**4**	**5**	
Company size											
Company profitability											
Shareholder returns											
Cash flow											
Individual directors' experience and qualifications											
Company strategy											
Tax (for the individual)											
Tax (for the company)											
Financial accounting considerations											
Investors' views											

FACTORS AFFECTING THE LEVEL AND STRUCTURE OF EXECUTIVE DIRECTORS' REMUNERATION

The **level** of directors' remuneration relates to the amount of pay which is likely to be awarded for expected performance. The **structure** of directors' remuneration refers to the use of performance-related remuneration, the choice of performance measures and how they are divided between short and long term, and the choice of share-based or option-based remuneration schemes.

In respect of the factors listed in the questionnaire, some of the issues that might be considered under each heading are given below.

Company size	Turnover; market capitalisation; level of balance sheet assets; number of employees.
Company profitability	Profit before tax; profit after tax; earnings per share; return on sales; return on investment; return on equity.
Shareholder returns	Increase in share price; dividends paid.
Cash flow	Free cash generated by the company over the period.
Individual directors' experience and qualifications	Age, educational qualifications, experience in previous companies.
Company strategy	Situated in a turbulent or stable industry? Free market or regulated business? Early-stage business or mature? Strategic aims of the company?
Tax (for the individual)	Effect on the individual's tax liability of the structure of remuneration.
Tax (for the company)	Effect on the company's tax liability (actual and deferred) of the structure of remuneration.
Financial accounting considerations	Effect on the financial accounts (for example, charge to P&L account) of the remuneration structure selected for executives.
Investors' views	Views of any major investor, or of a group of investors.

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APPENDIX 6 LETTER TO MEMBERS OF THE REMUNERATION GROUP

2nd August 2002

Addressed to the HR professional who had mentioned the Remuneration Group

Dear [Name]

RESEARCH INTO EXECUTIVE DIRECTORS' REMUNERATION

When we met last month you kindly agreed to pass my details on to the members of the FTSE 100 Remuneration Group, so that I may ask for their assistance with my research. I have set out brief details of the project on the attached pages. I would be very grateful if you could circulate this to the Group members, and perhaps encourage their participation.

Kind regards

Ruth Bender
r.bender@cranfield.ac.uk

RESEARCH INTO EXECUTIVE DIRECTORS' REMUNERATION
Ruth Bender

The research question

How do FTSE companies determine directors' remuneration?

Why does it matter?

It's obviously a highly contentious area. With academics just crunching numbers about whether or not pay is performance-related, and regulators continually adding in layers of new rules, research that highlights the complexities of the issue could lift the debate to a higher level. Most authors, and the press, seem to work on the basis that it's a very simple issue, and that remuneration committees are working for the benefit of the executives. Shedding light on the judgements that need to be made should inform both the regulatory bodies and the public debate.

What's different about this research?

Academics have been researching this area for almost 80 years, generally by collating statistics about how pay has moved compared to company size, or profitability, or any one of a number of things. This is now a pretty barren area, and just tends to conclude that pay is increasing, but does not explore why. Almost everything that's been done has revolved around looking at the amounts actually paid by companies to their executives– looking at <u>what</u> they paid. I intend to look at <u>why</u> they paid it, and <u>how</u> the decision was made. Nobody's ever done that before, not in a formal and objective academic study.

Where will the research be published?

As well as my eventual PhD, the research will be disseminated in academic journals, at conferences, and in articles in management journals.

What is involved for the companies?

The research design involves interviews with the people most involved in the remuneration-setting decision. Generally, these are the HR director and/or the remuneration manager; the CEO; the chair of the remuneration committee; one other non executive who sits on the committee; and any remuneration consultants employed by the company to assist in this area. I would also want to review some of the documentation surrounding the process.

Interviews take place at a time and location convenient to the interviewee. Obviously, obtaining the time of such busy people is challenging, and although I would like about an hour of time for each interview, I am grateful for whatever people can make available.

In addition to companies participating in the full research programme, I am also interviewing just the HR director and/or remuneration manager in some companies, to broaden the scope of the research where full access has not been possible.

What about confidentiality?

The companies and individuals will not be identified in the research. They will be referred to as Company 1, Company 2, etc. Because I am researching the processes rather than looking at the actual amounts paid, there will be no need to present the actual levels of directors' pay in the published research, and this should make it easier to maintain anonymity. Likewise, any details of schemes from which it might be possible to identify a particular company will be omitted or disguised.

What's in it for the participants?

There are two sets of benefits. On a 'global' level there is the opportunity to move forward the debate on remuneration and potentially to influence future policy – or at least to give the policy-makers a better understanding of the issues. On a personal level for the individuals, the chance to discuss some very complex issues with someone totally independent. A summary of the research findings will of course be made available to the participants.

Who am I to be doing this?

I'm a finance lecturer at Cranfield School of Management, doing a PhD with Warwick Business School. My resumé is attached. My background is as a corporate finance partner with Grant Thornton. I became interested in directors' remuneration via an interest in shareholder value – I was asked to explain how remuneration schemes could add value to companies, and discovered that it wasn't as simple as everyone thought!

What's the next step?

If you are interested in hearing more about the research, please contact me. I'll be glad to explain it further, and to discuss how you may participate.

Also, if you are aware of other companies who may be interested, please pass this letter on. The criteria for participation are that the company should be in the FTSE 100 or FTSE 250, and that it should comply with good governance principles as regards having non-executives on the board and on the remuneration committee, etc. The aim of the research is to see what 'best practice' looks like from the inside, so I am not looking at companies which don't appear to comply with best practice. (However, I am working with companies whose schemes have not found favour with 'the authorities' but who have still complied with the various standards.)

Thank you very much for reading this. I do hope to hear from you about the research.

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APPENDIX 7 CODING STRUCTURE

NVivo revision 1.3.146 Licensee: SOM Cranfield School of Manag

Project: PhD 1 User: MN0678 Date: 8/3/04 - 11:35:45
NODE LISTING

Nodes in Set: All Nodes
Created: 4/11/02 - 03:03:00
Modified: 4/11/02 - 03:03:00
Number of Nodes: 169

1 Audit
2 Disclosure
3 DTI
4 Gain sharing
5 Hard work
6 Incomers earning more than existing
7 Independent
8 Luck
9 Message
10 NED risks
11 Not paying out
12 People are our greatest asset
13 Press comment~public eye
14 Public sector
15 Quote
16 Ratchet effect
17 Remuneration report
18 Team
19 Transparency
20 Trust
21 Turnaround

22 (1) /Economic
23 (1 2) /Economic/Agency
24 (1 2 1) /Economic/Agency/Conflict of interest
25 (1 3) /Economic/RPE
26 (1 4) /Economic/Tournament
27 (1 6) /Economic/Labour market

28 (2) /Organisational theories
29 (2 1) /Organisational theories/Power politics
30 (2 2) /Organisational theories/Institutional theory
31 (2 2 1) /Organisational theories/Institutional theory/It would be around already
32 (2 2 2) /Organisational theories/Institutional theory/Bahamas
33 (2 3) /Organisational theories/Legitimacy
34 (2 4) /Organisational theories/Social comparison
35 (2 5) /Organisational theories/Anchoring
36 (2 6) /Organisational theories/Equity theory
37 (2 6 1) /Organisational theories/Equity theory/Fairness
38 (2 7) /Organisational theories/Expectancy theory
39 (2 8) /Organisational theories/Social influence
40 (2 9) /Organisational theories/Decision theory

41 (3) /Inputs
42 (3 2) /Inputs/Market and benchmark
43 (3 2 15) /Inputs/Market and benchmark/Surveys

44 (3 2 25) /Inputs/Market and benchmark/Internationalism
45 (3 4) /Inputs/Size
46 (3 5) /Inputs/Industry
47 (3 6) /Inputs/Human capital
48 (3 7) /Inputs/Strategy
49 (3 7 1) /Inputs/Strategy/Volatility~Ability to forecast
50 (3 8) /Inputs/Tax
51 (3 10) /Inputs/Accounting
52 (3 12) /Inputs/Inputs - general
53 (3 13) /Inputs/Committee membership
54 (3 14) /Inputs/Governance considerations
55 (3 15) /Inputs/Input categories not used
56 (3 15 1) /Inputs/Input categories not used/Profit
57 (3 15 3) /Inputs/Input categories not used/Market performance
58 (3 15 9) /Inputs/Input categories not used/Cashflow
59 (3 15 11) /Inputs/Input categories not used/Ownership
60 (3 16) /Inputs/Motivate
61 (3 17) /Inputs/Attract
62 (3 17 1) /Inputs/Attract/Right sort of people
63 (3 18) /Inputs/Retain
64 (3 19) /Inputs/Jelly beans
65 (3 19 1) /Inputs/Jelly beans/Ego
66 (3 19 2) /Inputs/Jelly beans/Emotional issue
67 (3 21) /Inputs/Individual requirements
68 (3 22) /Inputs/Institutional input
69 (3 22 1) /Inputs/Institutional input/Vote
70 (3 24) /Inputs/History and culture
71 (3 26) /Inputs/Regulators
72 (3 27) /Inputs/Align
73 (3 28) /Inputs/Stakeholders
74 (3 28 1) /Inputs/Stakeholders/Greenbury
75 (3 28 2) /Inputs/Stakeholders/Pay dispersion
76 (3 29) /Inputs/Privatised utilities

77 (4) /Process
78 (4 1) /Process/People involved
79 (4 2) /Process/Consultants' role
80 (4 3) /Process/Committee role
81 (4 4) /Process/CEO role
82 (4 5) /Process/Company chair role
83 (4 6) /Process/Chairman role
84 (4 7) /Process/HR role
85 (4 8) /Process/Headhunters
86 (4 9) /Process/Committee meetings
87 (4 10) /Process/Secretary role
88 (4 11) /Process/Process
89 (4 12) /Process/Art not a science
90 (4 13) /Process/Modelling
91 (4 14) /Process/Negotiation
92 (4 15) /Process/NXDs
93 (4 15 1) /Process/NXDs/Sit on many boards
94 (4 15 2) /Process/NXDs/Stick your head over the parapet
95 (4 16) /Process/Need the facts
96 (4 17) /Process/Power

97 (5) /Policies and packages
98 (5 1) /Policies and packages/Salary level
99 (5 2) /Policies and packages/Annual bonus
100 (5 3) /Policies and packages/Options
101 (5 3 1) /Policies and packages/Options/Underwater

102 (5 3 2) /Policies and packages/Options/Black Scholes
103 (5 3 3) /Policies and packages/Options/Expected value
104 (5 4) /Policies and packages/Ltips
105 (5 5) /Policies and packages/Performance period
106 (5 5 1) /Policies and packages/Performance period/Short termism in the markets
107 (5 5 2) /Policies and packages/Performance period/Short v long term
108 (5 6) /Policies and packages/Pay~performance link
109 (5 6 1) /Policies and packages/Pay~performance link/Focus
110 (5 6 2) /Policies and packages/Pay~performance link/Poor performance
111 (5 6 20) /Policies and packages/Pay~performance link/Incentive~Reward
112 (5 7) /Policies and packages/Simplicity~complexity
113 (5 8) /Policies and packages/Aims of the scheme
114 (5 9) /Policies and packages/Performance measures - TSR
115 (5 9 1) /Policies and packages/Performance measures - TSR/Dividend
116 (5 9 2) /Policies and packages/Performance measures - TSR/Comparator group
117 (5 10) /Policies and packages/Performance measures - eps
118 (5 11) /Policies and packages/Performance measures - S~T
119 (5 12) /Policies and packages/Targets and budgets
120 (5 13) /Policies and packages/Risk
121 (5 14) /Policies and packages/Directors' shares
122 (5 15) /Policies and packages/Change in scheme
123 (5 15 1) /Policies and packages/Change in scheme/Change in company
124 (5 15 2) /Policies and packages/Change in scheme/Change in people
125 (5 16) /Policies and packages/Performance measures general
126 (5 17) /Policies and packages/Bonus in shares
127 (5 18) /Policies and packages/Bonus %
128 (5 19) /Policies and packages/Perks
129 (5 20) /Policies and packages/Contract
130 (5 21) /Policies and packages/Pensions
131 (5 22) /Policies and packages/Policy
132 (5 23) /Policies and packages/Structure of package
133 (5 24) /Policies and packages/Total package
134 (5 25) /Policies and packages/Gearing
135 (5 26) /Policies and packages/Policies and packages
136 (5 27) /Policies and packages/Highly geared schemes
137 (5 28) /Policies and packages/Holiday
138 (5 29) /Policies and packages/Pay bonus in advance
139 (5 30) /Policies and packages/Termination bonus
140 (5 31) /Policies and packages/Transaction bonus
141 (5 32) /Policies and packages/Flexibility
142 (5 33) /Policies and packages/Need to pay them a lot
143 (5 34) /Policies and packages/Quality of life
144 (5 35) /Policies and packages/Smoothing remuneration over time
145 (5 36) /Policies and packages/Strike a balance

164 (8) /Fat cats
165 (8 1) /Fat cats/Big sums
166 (8 2) /Fat cats/Compare with Beckham and VCs
167 (8 3) /Fat cats/Perception of waived bonus
168 (8 4) /Fat cats/Unduly generous
169 (8 7) /Fat cats/Fat cat coding

NB This schedule does not include those codes that were developed but found not to be relevant to this research.

APPENDIX 8 FEATURES OF THE SCHEMES IN USE IN THE CASE COMPANIES

This appendix sets out some of the features of the incentive schemes in use in the case companies. Individual companies' schemes are not identified; instead, the appendix illustrates the range of schemes and measures in use.

Annual Bonus Schemes

- Cash bonus, based on a percentage of base salary. Often, the bonus available to the CEO is greater than that available to other executive directors.
- Often, part of the cash bonus may or must be deferred. Deferred bonus is used to buy shares, matched (generally 1:1, often matching gross:net) by the company and vesting after two or three years. Some companies have an additional performance condition on the vesting (such as eps growth). Matched shares are forfeited if the executive leaves the company during the vesting period.
- Part of the bonus placed into a bonus bank, with one third of the bank balance available for withdrawal each year.
- In most companies, bonus is not pensionable.

Longer term schemes

Options

- Annual grant of share options at current market value. The amount of the grant will be based on a multiple of salary and/or performance in the year.

- Vesting after three years, subject to a minimum performance condition. The amount of options that vests will depend on the performance achieved; for example, only 30% of options may vest if eps grows at RPI+3%, rising to full vesting for growth at RPI+8%.
- Some companies allow re-testing of performance conditions at four or five years if the minimum target is not met after three years.
- Most, but not all, options have a 10 year life.

Ltips

- Annual award of shares. The amount of the award will be based on a multiple or percentage of salary and/or performance in the year.
- Vesting after three years based on a performance condition. (Vesting on a sliding scale, similar to that for vesting of options.)
- Some companies allow re-testing of performance conditions at four or five years.

Performance measures in use

For short-term schemes:

- Various, including: business unit financial targets, sales value, group operating profit, combined operating ratio, new business contribution, cashflow, personal targets, health and safety targets, risk targets, strategic objectives, EBITDA, cost control, financial ratios, environmental targets, corporate social responsibility targets.

For long-term schemes

- TSR relative to a peer group, or relative to a combination of peer groups. Generally, no vesting will occur if performance is less than median compared to the group; maximum vesting will occur for upper quartile performance.
- Eps growth based on a percentage above inflation (an RPI+X% formula).
- Eps growth in absolute terms.
- Return on capital.

Share ownership requirements

- Some companies combine participation in their incentive schemes with a requirement that the executives hold shares in the company, to a value based on a multiple of their base salary. Some schemes allow for cash bonuses to be paid in shares to encourage this.

APPENDIX 9 SUMMARY OF REASONS GIVEN FOR CHANGING SCHEMES

Company (identifiers changed to disguise identity)	Below market	Not paying out	Incoming execs/ CEO/ Chairman	Strategy change	Scheme or measure too complex	Culture change	Best practice	Change in company circum-stances	Needed better ST/LT balance	Execs dissatisfied / to retain executives	End of scheme life	Change in remn committee	To increase clarity of objectives	Change in organis-ational practices	*No. of reasons given*
A								Yes							*1*
B		Yes	Yes	Yes	Yes	Yes									*5*
C	Yes										Yes				*2*
D	Yes	Yes						Yes							*3*
E	Yes		Yes		Yes		Yes				Yes				*5*
F							Yes						Yes		*2*
G	Yes	Yes	Yes	Yes		Yes	Yes		Yes	Yes		Yes		Yes	*10*
H								Yes							*1*
I			Yes					Yes							*2*
J	Yes	Yes	Yes				Yes								*4*
K		Yes		Yes	Yes	Yes									*4*
L	Yes	Yes	Yes	Yes	Yes	Yes			Yes	Yes					*8*
No. of companies using this reason	*6*	*6*	*6*	*4*	*4*	*4*	*4*	*4*	*2*	*2*	*2*	*1*	*1*	*1*	*47*

APPENDIX 10 CHANGES MADE – AND NOT MADE – FOR REGULATORY PURPOSES

Company	**Things the companies changed deliberately in order to comply with regulations / best practice**
A	Employed another consultant to check what they were doing, independently
C	They are getting the remuneration committee chairman involved in the consultant decision
E	Rolling re-testing of option performance criteria will change.
F	Changed from subjective to more objective performance measures

Company	**Things they have not changed despite not being in compliance with regulations**
A	No performance condition on bonus match Use the auditors as consultants. (This is not actually against the rules, but interviewee mentioned it as not being recommended.)
C	Bonuses are partly pensionable Company chairman sits on the remuneration committee
E	Bonuses are partly pensionable Company chairman sits on the remuneration committee
F	No performance condition on bonus match
L	Company chairman sits on the remuneration committee

In this table I have omitted companies making changes in 1995 and 1996, moving from options to ltips post the Greenbury and Myners reports, as this was widespread.

APPENDIX 11 DIFFERENCES BETWEEN VERSIONS OF THE COMBINED CODE

The following table sets out some similarities and differences between the Code that was extant when the research fieldwork was done and the Code brought in during 2003. It does not include all of the remuneration-related sections of the Codes, just those that appear relevant. It will be seen that there are no changes which might affect the interpretation or relevance of this research.

	Code dated May 2000		**2003 Code**
B.1. main principle	Levels of remuneration should be sufficient to attract, retain and motivate the directors needed to run the company successfully, but companies should avoid paying more than is necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.	B.1. main principle	Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. *The key change here is that the word 'significant' was added in 2003.* *The word 'motivate' was also added to the principle, but this was included in the 2000 Code in provision B.1.1 which includes the phrase "attract, retain and motivate"*
B.1.2. code provision	Remuneration committees should judge where to position their company relative to other companies. They should be aware what comparable companies are paying and should take account of relative performance. But they should use such comparisons with caution, in view of the risk that they can result in an upward ratchet of remuneration levels with no corresponding improvement in performance.	B.1. supporting principle	The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.

B.2. main principle	Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.	B.2. main principle	There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. *No significant changes*
B.2.5 code provisions	Remuneration committees should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors and have access to professional advice inside and outside the company.	B.2. supporting principle	The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest. *This section has been strengthened in terms of the independence of the advice to the committee. This is discussed in the body of the thesis.*
A.1.6 code provision	Every director should receive appropriate training on the first occasion that he or she is appointed to the board of a listed company, and subsequently as necessary.	A.5. supporting principle	The chairman [of the board] should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. *This provision has been strengthened considerably.*