



The Regulation of the Determination of Executive Remuneration

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Abstract

Executive remuneration is a prominent issue of corporate governance in the UK. Executive pay packages are regarded as excessive with no apparent link to company performance. This study examines the regulation of the determination of executive remuneration, especially in quoted companies. The study considers the regulation of the determination of executive remuneration as an important foundation that can potentially link executive pay to company performance. The study considers the principles of UK Corporate Governance Code on the determination of executive pay, and the Companies Act 2006's provisions on executive remuneration.

The study adopts a mixed method approach which includes quantitative and qualitative studies. The UK Corporate Governance Code does not make recommendations on specific performance measures that companies should use to determine company performance. To investigate the link between pay and performance and the effect different performance measures have on the pay for performance link, the study examined 25 companies from five different sectors from 2010 FTSE 100 companies. Data was collected mainly from the company's annual reports and accounts to determine the link between executive pay and company performance. The results indicated in general a weak link between pay and performance. It also demonstrated that different performance measures have different effects on the pay for performance link. The Code does not make recommendations on the factors that the remuneration consultants should consider in benchmarking. To this effect, interviews were conducted to establish the method of executive remuneration benchmarking as there exist no guidelines on benchmarking. Six prominent remuneration consultants were interviewed for which the data was obtained to analyse executive remuneration benchmarking. The findings demonstrated a lack of uniformity in benchmarking practices particularly in the factors considered in selecting comparator companies.

The Companies Act 2006 makes no provision on the determination of executive pay but rather adopts a corrective approach towards the determination of executive remuneration. This position of the law has been analysed in this study and suggest that the role of the law is inadequate and ineffective. The study demonstrates a need for a reform on the provisions of executive remuneration.

Declaration

Whilst registered as a candidate for the above degree, I have not been registered for any other research award. The results and conclusions embodied in this thesis are the work of the named candidate and have not been submitted to any other academic award.

.....

Ernestine Ndzi

Dedication

I dedicate this thesis to God

My husband Eugene Ndzi

My daughters Gift Afanyu Ndzi and Simo Asonyu Ndzi

And

My mum Helena Nfah.

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The completion of this research programme was facilitated by the support and active cooperation of several individuals. I give praise and glory to the God Almighty for seeing me through this time of study.

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Table of Abbreviations

A & BR	Accounting and Business Research
Admin Sci Quart	Administrative Science Quarterly
AMJ	Academy of Management Journal
AMR	Academy of Management Review
Berkeley Bus. L.J.	Berkeley Bus. L.J.
BJIR	British Journal of Industrial Relations
Brit J Manage	British Journal of Management
Camb J Econ	Cambridge Journal of Economics
CGEFI	Corporate Governance: Economic and Financial Issues
CGIR	Corporate Governance: An International Review
Comp. Law.	company lawyer
Compensate Benefit Rev.	Compensation & Benefit Review
EJ	The Economic Journal
Eur Manage J	European Management Journal
Harv. L. R.	Harvard Business Review
Health Manpow Manage.	Health Manpower Management
HR	Human Relations
ICC	Industrial and Corporate Change
ICCLR	International Company and Commercial Law Review
IJBAM	International Journal of Business Administration
IJIO	International Journal of Industrial Organisation
IR	Industrial Relations
IRF	International Review of Finance
IRJ	Industrial Relations Journal
JAAF	Journal of Accounting, Auditing and Finance

JBF	Journal of Banking and Finance
JBR	Journal of Business Research
JCLS	Journal of Corporate Law Studies
JEMS	Journal of Economics and Management Strategy
JEP	Journal of Economics Perspectives
JES	Journal of Economy and Society
JF	Journal of Finance
JFE	Journal of Financial Economics
JFRC	Journal of Financial Regulation and Compliance
JHR	The Journal of Human Resources
JOB	Journal of Organisational Behavior
JOMS	Journal of Management Studies
LRP	Long Range Planning
Mich. L. Rev.	Michigan Law Review
PR	Personnel Reviews
RAE	Review of Applied Economics
RAS	Review of Accounting Studies
RS	Regional Studies
SMJ	Strategic Management Journal
TOJ	The Open Ethics Journal
U Tor LJ	The University of Toronto Law Journal
Vand. L. Rev.	Vanderbilt Law Review
J. Of Multi. Fin. Manag.	Journal of Multinational Financial Management
J.Pol.Econ	Journal of Political Economy
U.N.S.W.L.J.	University of New South Wales Law Journal

Introduction

This thesis discusses the regulation of the determination of executive remuneration of quoted companies in the UK. Executive remuneration emerged a controversial issue during the early 1990s. Executives of privatized utility companies received pay increases which were condemned by the public and the media as having no corresponding link to the performance of the company.¹ The criticism of executive pay by the public and the media came under headlines such as ‘Fat Cats in the Dock’,² ‘Executive Gluttony under Attack’³ and ‘Derailing the Gravy Train’.⁴ More than two decades later, executive pay continues to be a prominent issue of corporate governance in the UK. Firstly, there is continued concern that executives are receiving excessive pay packages with no corresponding link to company performance.⁵ Secondly, executive pay seems to be increasing even when company performance⁶ is falling. Third, directors’ pay (banker’s bonuses) was considered as partly responsible for the financial crisis in 2008⁷ and lastly, the pay gap between executives and average employee of the company continues to widen.⁸

The academic background

Academic interest in executive remuneration increased in the UK from the early 1990s following the excessive pay increases received by executives from privatised utility companies. Most of the early studies on executive pay were based on the remuneration committees (REMCOs)⁹; their composition,¹⁰ role,¹¹ independence¹²

¹ Discussed in detail under chapter 1.

² ‘Fat Cats in the Dock’ (1995) Economist March 4th.e

³ D Cohen, ‘Executive Gluttony under Attack’ (1994) Financial Times November 26/27th at 3.

⁴ ‘Derailing the Gravy Train’ (1995) Sunday Times January 22nd.

⁵ BBC News, ‘Why is Chief Executives’ Pay not Linked to Performance?’ (2012) February 9th.

⁶ the results of activities of an organisation or investment over a given period of time.

⁷ Paul Gregg, Sarah Jewell and Ian Tonks, ‘Executive Pay and Performance: Did Bankers’ Bonuses Cause the Crisis’ (2012) 12(1) IRF 89-122; Charlotte Villiers, ‘Controlling Executive Pay: Institutional Investors or Distributive Justice?’ (2010) JCLS 309, 310.

⁸ BBC News, ‘Pay Gap Between Executives and Employees is ‘Widening’ (2013) November 18th.

⁹ Martin Conyon and Simon Peck, ‘Board Control, Remuneration Committee, and Top Management Remuneration’ (1998) 41(2) AMJ 146-157.

¹⁰ Catherine Daily, Jonathan Johnson, Alan Ellstrand and Dan Dalton, ‘Compensation Committee Composition as a Determinant of CEO Compensation’ (1998) 41(2) AMJ 209-220.

¹¹ Martin Conyon and Simon Peck, ‘Board Control, Remuneration Committees, and Top Management Remuneration’ (1998) 41(2) AMJ 146-157.

and their effects on executive pay level.¹³ Past studies on the determination of executive remuneration have been based mostly on examining the links between executive remuneration and company size,¹⁴ industry,¹⁵ performance,¹⁶ human capital.¹⁷

Various pieces of research investigating the link between pay and performance have yielded inconsistent and conflicting results, suggesting that there is either no relationship or a weak relationship between pay and performance.¹⁸ Thus there is a need to investigate further the variation in results and examine the effect of different performance measures on the pay for performance link. Academic studies on executive remuneration continue to increase as pay continues to be a controversial issue in the UK. Recently, academic studies started investigating the use of remuneration consultants (RCONs) in advising the REMCO on the determination of remuneration structure and levels.¹⁹ The wide use of RCONs in advising on executive remuneration determination process in the UK has been evidenced by past studies.²⁰ However, no study has particularly considered what factors the consultants considered to arrive at their decisions.

Most past studies have examined the effectiveness of remuneration disclosure requirements²¹, shareholder voting²², but little has been done on these factors in the light of the determination of executive remuneration. The study of the role of law in

¹² A Zattoni and F, Cuomo, 'How Independent, Competent and Incentivized should Non-executive Directors be? An Empirical Investigation of Good Governance Code' (2010) 21(1) *Brit J Manage* 63, 66.

¹³ BGM Main, C O'Reilly, and J Wade, 'The CEO, the Board of Directors and Executive Remuneration: Economic and Psychological Perspective' (1995) 4 *ICC* 293-332.

¹⁴ Peter F Kostiuk, 'Firm Size and Executive Remuneration' (1990) 25(1) *JHR* 90-105.

¹⁵ Sydney Finkelstein, 'Why is the Industry Related to CEO Remuneration?: A Managerial Discretion Explanation' (2009) 3 *TOJ* 42-56.

¹⁶ S Girma, S Thompson and W Wright, 'Corporate Governance Reforms and Executive Compensation Determination: Evidence from the UK' (2007) 75 *The Manchester School* 1, 65-81.

¹⁷ Ian Gregory-Smith and Brian G.M. Main, 'Testing the Participation Constraint in the Executive Labour Market' (2013) http://homepages.ed.ac.uk/mainbg/Files/jobmoves2013_08_27.pdf 1, 2 assessed 22nd of June 2014.

¹⁸ H Jouber and H Fakhfakh, 'Does CEO Performance-Based Compensation Waits on Shareholders? A Cross National Analysis' (2011) 2(3) *IJBAM* 68-82.

¹⁹ See L Goh and A Gupta, 'Executive Compensation, Compensation Consultants, and Shopping for opinion: Evidence from the UK' (2011) 25(4) *JAAF* 608-644.

²⁰ For example, Ruth Bender, 'Paying for Advice: The role of the remuneration consultant in UK listed companies' (2011) 64(2) *Vand. L. Rev.* 361-398.

²¹ Lee Roach, 'The Director' Remuneration Report Regulations 2002 and the Disclosure of Executive Remuneration' (2004) 25 *The Comp. Law.* 141.

²² *ibid.*

the determination of executive remuneration is important, as it will inform policy makers on the gaps in the law, the effectiveness of the law, and possible law reforms that may be required.

Background of the regulation of the determination of executive pay

The determination of executive remuneration is regulated principally by the UK Corporate Governance Code (UKCGC) and the Companies Act (CA) 2006. The UKCGC makes recommendations on how pay should be determined, whereas the CA 2006 does not make any provision on how pay should be set. Rather it adopts a corrective measure which applies on the already determined pay package. The intention of the law-makers is for the outcome of the corrective measures to influence the executive pay setting process. For example, one of the measures is to provide shareholders with voting rights on the company's remuneration report. If the shareholders vote a remuneration report down, the REMCO would have to review the remuneration policy and consequently, review the pay setting process. The Act also establishes significant disclosure obligations, making it easier for shareholders and other interested parties to obtain information on directors' pay. The shareholders are expected to use the information to make informed judgment on executive remuneration. Therefore, the CA 2006's provisions on executive remuneration setting process are not direct as they do not make express provisions on how pay should be set, but rather make provisions that will indirectly influence the pay setting process.

The first UK corporate governance report was published in 1992 by the Cadbury Committee.²³ Since then corporate governance has gone through various reforms on various governance issues and in particular executive remuneration.²⁴ However, the UKCGC has made limited recommendations on how executive remuneration should be set (which are examined under chapters 3, 4 & 5).

The various recommendations on executive pay setting process did not abate the continuous rise in executive pay nor did it significantly strengthen the link between executive remuneration and company performance. The government consequently

²³ The Committee on the Financial Aspect of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992).

²⁴ Discussed in detail in chapter 3.

took interest in the levels of pay of some executives of quoted companies which led to the enactment of the Directors' Remuneration Report Regulations (DRRR) 2002. These Regulations only applied to quoted companies and were eventually largely incorporated into the CA 2006.²⁵ After the DRRR 2002, the government made more provisions under the CA 2006 which have recently been strengthened by the Enterprise and Regulatory Reform Act 2013.²⁶ The main purpose of the regulation of executive remuneration setting process by the UKCGC and the CA 2006 is to provide accountability and transparency on the determination of executive pay.

Research problem and question

The remuneration package of a director has a substantial effect on how the director behaves which is why remuneration is such an important governance mechanism. Research has demonstrated that executive remuneration continues to increase without a proportionate link to company performance. In addition to this, executive remuneration seems to be increasing even when the company is performing poorly. Furthermore, the pay gap between executives and average employees of the company continue to widen. Despite the vital need for an effective regulatory method on executive remuneration, limited empirical research studies exist in the UK that have considered the full extent on the determination of executive remuneration. Thus there is a need for this study to examine the regulation on executive remuneration determination.

The research question this study would be seeking to answer is 'how effective are the regulatory methods on the determination of executive remuneration in UK quoted companies?' The aim of the study is to evaluate the effectiveness of the regulatory methods in the determination of executive remuneration. The objectives of the study would be to examine the methods used in benchmarking executive remuneration particularly the factors considered when selecting comparator groups and its effect on pay levels. This thesis will investigate the link between executive remuneration and company performance. A comparative study of performance measures and their effect on the pay for performance relationship will be conducted to determine the effect of

²⁵ Companies Act 2006, s 420.

²⁶ The provisions of the Companies Act and its indirect influence on the remuneration setting process would be examined in chapter 6.

performance measures on pay. Furthermore, the study will examine the influence of remuneration disclosure requirements, shareholder votes and other shareholder remedies on executive remuneration determination.

Research methods and analyses

In order to effectively answer the research question, empirical (qualitative and quantitative) research methods are employed (discussed in detail in chapter 2). In brief, quantitative analysis was used to examine the relationship between executive pay and company performance. Data was obtained from the 1996-2011 annual reports of 25 companies selected from the 2010 listing of the FTSE 100, in order to provide a good time frame for data analysis. This time frame was chosen because companies started disclosing remuneration figures for individual directors in 1996. The time frame stopped at 2011 to enable time for data analysis and thesis write up. The fifteen year time period allows the identification of trends which might not be possible in a more limited time scale. After eliminating companies with missing and inconsistent data, 19 companies were used in the final analysis and statistical software was used to analyse the relationship between executive remuneration and company performance. The findings of the study are discussed in chapter 6.

Qualitative analysis was used to investigate the methods used in executive remuneration benchmarking. Data was obtained from six unstructured interviews with RCONs. Content analysis and thematic analysis were used to analyse the interview findings (discussed in detail in the methodology chapter 2). The finding of the qualitative analysis is discussed in chapter 4.

Significance of the study

A review of the existing academic literature revealed that little attempt has been made to explore the regulation on executive remuneration process in the UK. Studies on the determination of executive remuneration have examined different elements considered in setting executive remuneration.²⁷ None have examined specifically the factors considered in selecting comparator groups when benchmarking executive pay and its effect on the pay setting process. This demonstrates a gap in knowledge as

²⁷ As explained above, some studies have considered size, sector, human capital etc.

benchmarking is a key determinant of executive remuneration. The study will examine the methods of benchmarking and its effect on executive remuneration setting process and pay levels. The findings of this study will provide details on the factors considered by the RCONs in benchmarking executive remuneration which will give a wider understanding of pay determination process and pay levels.

The CA 2006 does not make provisions on how directors' pay should be set. However, its provisions on executive pay do have an indirect effect on the pay setting process. With most studies done base on examining the role of the law on the levels of executive pay it important that this study examines the regulation on executive remuneration determination. This study would examine these provisions of the law and discuss its indirect influence on the pay setting process which will expose how the law influences directors' pay setting process.

Past studies have examined the relationship between pay and performance using various performance measures but not much has been done in regards to comparative study on performance measures and its effect on the pay setting process whilst determining the pay-for-performance relationship. Studies examining the link between executive pay and company performance have used limited time frames and different methodologies. In this study, the time frame from 1996-2011 has been chosen, twenty-five companies of the FTSE 100 companies, and three performance measures used to analyse the pay for performance relationship. The study also considered separately the relationships between company performance with directors' cash pay, variable pay and total remuneration.

Major areas of contribution

The potential findings on the factors considered in executive remuneration benchmarking could influence policy makers to consider best practice on benchmarking or consider a law reform to incorporate benchmarking practices. Furthermore, the potential findings could also influence how individual companies benchmark executive pay. Most importantly, the Remuneration Code may be revised to include the best practice on how RCONs should select comparator groups for the purposes of executive remuneration benchmarking.

Furthermore, the findings obtained from the indirect role of the CA 2006 on executive pay setting process could influence the government to consider a law reform on executive pay. It could also influence the members of the company (particularly the shareholders) to be more involved in executive remuneration issues by voting in the annual general meetings. Also, findings on pay for performance relationship could influence the government on whether or not it is necessary for companies to use specific performance measures to measure performance. It will also influence the individual company's setting of performance targets and performance measures to better reflect company performance (preferably the long term success of the company).

In general, the results of this study could influence both the policy makers and the individual companies in their methods of setting executive remuneration. This is because curbing excessive directors' pay requires the joint effort of the policy makers and the individual companies.

Thesis outline

The thesis consists of three parts. Part 1 (chapters 1 and 2) provides background information and sets out the methodology used; Part II (chapters 3-5) looks at best practice recommendations; Part III (chapter 6) discusses the role of the law.

The thesis begins with an introduction which explores the research background, research problem, significance of the study, contribution to knowledge, research methods and analyses and the limitations of the study.

Chapter 1 will look at the components and drivers of executive remuneration package focusing on the evolution of executive remuneration package, elements of the remuneration package and factors that increases executive remuneration levels.

Chapter 2 will discuss the methodology of the study which covers the empirical research approaches followed in the study. The chapter includes the rationale for doctrinal, qualitative and quantitative approaches of this study, data sample, response rate, and selection of research participants, selection of companies and methods of analysis.

Chapter 3 will examine the corporate governance mechanisms discussing the evolution of corporate governance mechanisms in regulating executive remuneration determination process. This chapter serves as an introductory chapter to chapters 4 and 5 that follow.

Chapter 4 discusses the REMCO focusing on the composition of the REMCO, their role in executive remuneration determination process, the factors that they consider in setting executive remuneration package, RCONs and the advice they offer the REMCO on executive remuneration benchmarking. This chapter further provides the qualitative findings and analysis of this study.

Chapter 5 will look at pay for performance relationship, which will examine the performance measures used by selected companies to determine company performance, the link between executive remuneration and company performance, and how this link affects executive remuneration determination process. This chapter also provide the quantitative findings and analysis of this study.

Chapter 6 will look at the role of the law which focuses on the CA 2006 provisions on executive remuneration. It discusses executive remuneration disclosure requirement, shareholder voting rights on executive remuneration policy and its significance on the pay determination process; and shareholder remedy in cases of excessive executive remuneration and its impact on the pay determination process.

The conclusion will provide a summary of the key findings which answers the research question stated in the introductory chapter. It will also provide the study's contribution to knowledge, opportunities for further research in the subject area and suggest possible recommendations as to the determination of executive remuneration.

Chapter 1: Executive Remuneration Package

Introduction

Executives comprise an important (although small) part of the labour force as decision-makers in large public companies. Consequently, the remuneration of executives is of special interest because it could influence their decision-making process.²⁸ An executive is someone in the top level of an organisation. They generally receive high levels of remuneration in return for the work they do and the responsibilities they carry in a company. The remuneration package serves different objectives, which are to attract, motivate and retain high potential executives.²⁹ Without an attractive remuneration package, a company may not be able to attract and retain an individual of the required calibre.³⁰ Executive pay packages have evolved through the years from a simple base salary and benefits to a more complex package.³¹ The past two decades have seen a considerable increase in the levels of executive remuneration as well as increase in remuneration regulation. By 2011, executive remuneration in the UK had risen by up to 5000% since 1980.³² To aid the understanding on how executive remuneration is determined in the UK, it is important to discuss how executive remuneration has evolved in the UK, the components of the pay package and what drives remuneration levels. This chapter will therefore, be divided into three parts; part one will discuss the evolution of the executive remuneration package; part two will focus on the components of a remuneration package and; part three will examine the drivers of executive remuneration.

The Evolution of the Executive Remuneration Package

The last three decades have seen the development of widely varying forms of executive remuneration. Almost total reliance on wages and salaries as a means of

²⁸ Carola Frydman, "Learning from the Past: Trends in Executive Remuneration Over the Twentieth Century" (2008) CESifo Working Paper Series No. 2460, SSRN: <http://ssrn.com/abstract=1303386> assessed 17 of March 2011, pg 1.

²⁹ FRC, *UK Corporate Governance Code* (FRC, 2012) D.1; Steven H Appelbaum, 'Remuneration in the Year 2000: Pay for Performance' (1996) 22(3) *Health Manpow Manage.* 31,31.

³⁰ Brian Coyle, *Corporate Governance Essentials* (WM Print Ltd 2008) 190.

³¹ including base salary, annual bonuses, share options, long-term incentive plans etc.

³² Ben Heineman, 'The Political Case Against Out-sized Executive Pay' (2011) *Harv. L. R.* December 10th.

rewarding executives has given way to remuneration packages wherein fringe benefits and other non-salary items accounts for more than 100% of executive's base salary.³³ UK executives in the 1960s had no financial incentives and remuneration was not used to obtain effective utilisation of individuals. Rather honours and awards were used for services on government committees to motivate executives.³⁴

In the 1970s executive remuneration packages consisted of a salary and a pension together with a number of benefits selected mainly for a combination of status and tax avoidance reasons, of which the best known was the company car.³⁵ Base salary accounted for up to 90% of the remuneration package.³⁶

As time went on (from the 1980s), the increasing size of large companies and functional complexity of such businesses (both in terms of technology and management) meant that the company needed directors who had the interest of the shareholders and the company to make all necessary decisions for the company's growth. Executives had to research on ways of adapting the company's business policies and strategies to conform to the evolving technology.³⁷ This caused the UK companies to adopt the practice of offering defined profits to individual managers so they could take the responsibility of reorganising the company to make a profit. This practice was subject to detailed accountability and budgeting by the company. The bonus scheme motivated directors to work hard and acquire the knowledge required to take decisions that promoted the success of the company and in return be rewarded. This practice compelled companies to set a policy standard of efficiency and motivation to achieve their goal. It then follows that the main aim for introducing defined profits (bonuses) to executives was to motivate them to improve corporate efficiency.³⁸

Different companies used different motivational schemes to encourage executives to act in a way that was profitable to the company and the members at large. Companies used organisational motivation like specific individual responsibilities in the

³³ Thomas A Mahoney, *Remuneration Preferences of Managers: Managerial Motivation and Remuneration* (Michigan 1972) 315.

³⁴ AJ Merrett, *Executive Remuneration in the UK* (The Camelot Press Ltd, 1968) 2.

³⁵ AP Williams, *Just Reward? The Truth about Top Executive Pay* (Clays Ltd 1994) 104.

³⁶ *ibid.*

³⁷ *ibid.*

³⁸ *ibid.*

company, detailed reporting and assessment, competitive comparisons of performance, towards fulfilling a high standard of efficiency. Other companies used staff promotion to motivate their executives.³⁹

The introduction of share option scheme in the UK as part of the remuneration package started in the 1970s but its use was very far from popular among companies. In 1978, only 10% of UK companies offered share options to their top executives, but the number increased to 30% by 1983.⁴⁰ The use of share options increased dramatically between the late 1980s and the early 1990s with the majority of quoted companies offering share options to their executives in 1986.⁴¹ Companies realized that by requiring executives to invest a portion of their personal wealth in the company, it would encourage them to have the same objective as the company and maximize the share price.⁴² Furthermore, UK companies were conscious of the global executive labour market and did not want to lose their executives to US companies because the grant of share options had become an established remuneration component in the US since 1970s.⁴³ Share options granted to the executives at the time were not subject to rigorous performance conditions as is now the case. Executives were rewarded automatically as the share price of the company appreciated as oppose to the present day conditions in which share options are subject to challenging conditions that must be met before the award vests. Executives made lots of gains in share options especially in the bull markets which did not necessarily reflect the performance of the company.⁴⁴ Due to the lack of rigorous performance conditions attached to share options, it was criticised by shareholders and the media when executives in privatized companies began disclosing the gains made from share options in the early 1990s.⁴⁵

³⁹ AJ Merrett, *Executive Remuneration in the UK* (The Camelot Press Ltd 1968) 6.

⁴⁰ T Boeri, C Lucifora and K J Murphy, *Executive Remuneration and Employee Performance-Related Pay: A Transatlantic Perspective* (Oxford University Press 2013) 55.

⁴¹ *ibid.*

⁴² 'Re-examining Stock Options as a Way to Compensate Executives' (2002) Knowledge at Wharton March 13th <http://knowledge.wharton.upenn.edu/article/re-examining-stock-options-as-a-way-to-compensate-executives/> assessed 11 March 2014.

⁴³ K Keasey, S Thompson and M Wright, *Corporate Governance: Accountability, Enterprise and International Comparisons* (John Wiley & Sons 2005) 125.

⁴⁴ Alistair Bruce, Trevor Buck and Brian GM Main, 'Top Executive Remuneration: A View from Europe' (2005) 42(7) JOMS 1493, 1500.

⁴⁵ The privatization of UK's water, gas and electricity companies in 1990 e.g. the 70% pay rise of Cedric Brown the then CEO of British gas which was partly driven by share options.

This drawback on share options led to the introduction of long-term incentive plans (LTIPs) in the UK recommended by the Greenbury Report.⁴⁶ LTIPs are defined as the grant of shares or cash with performance conditions.⁴⁷ LTIPs were regarded as a more tailored, company specific and challenging incentive that would align the executive's interest with that of the company because it was based on performance. The performance conditions were in relation to specific targets over a pre-specified period, in which if the targets were met the award would vest, or if not met the award would lapse.⁴⁸ The performance conditions attached to LTIPs were intended to motivate the executives to achieve the long term strategic objectives of the company upon which rewards were based. LTIPs awarded executives with free shares that were contingent on the achievement of a level of relative performance that was more rigorous than the performance condition of share options. This introduction of LTIPs therefore added another component to the executive remuneration package to the already existing components of base salary, annual bonus, benefits and share options. In 2000, 60% of UK quoted companies offered LTIPs to their executives with a decline in the use of share options with only 18% of UK companies granting share options.⁴⁹

The mid-1990s was characterised by the evolution of deferred annual bonuses and the increase in performance share plans which are all designed to link executive remuneration to company performance. The graph below represents the shift in incentive plans in FTSE 100 companies from 2002-2010.

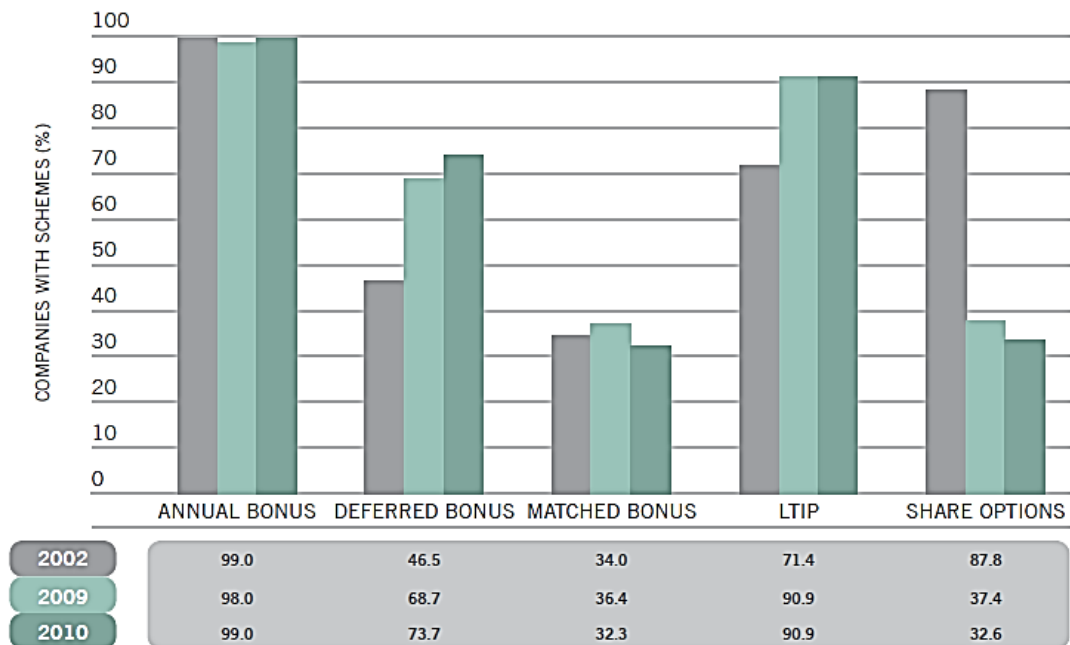
⁴⁶ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee, 1995) para. 6.23.

⁴⁷ Trevor Buck, Alistair Bruce, Brian GM Main and Henry Udueni, 'Long Term Incentive Plans, Executive Pay and UK Company Performance' (2003) 40(7) JOMS 1709, 1710.

⁴⁸ D Kershaw, *Company Law in Context: Text and Materials* (Oxford University Press 2012) 284.

⁴⁹ T Boeri, C Lucifora and K J Murphy, *Executive Remuneration and Employee Performance-Related Pay: A Transatlantic Perspective* (Oxford University Press 2013) 58.

Figure 1: A graph indicating the trend in incentive plans in FTSE 100 from 2002-2010



Source: Steve Tatton, Adam Alston and Jessica Matthews, ‘What are we Paying for? Exploring Executive Pay and Performance’ (The High Pay Centre, 2010) 13.

Deferred bonus requires participants to defer part of their award on a voluntary or compulsory basis or a combination of both to a later date (normally after three years). By 2012, 74% of FTSE 100 companies and 52% of FTSE 250 companies had deferred annual bonus plans⁵⁰, with about two-thirds of deferred annual bonus arrangements at FTSE 100 companies operated on a compulsory deferral basis.⁵¹ In reference to FTSE 100 companies, less than 10% of the companies have a policy of granting share options to their executives and about 30% of the companies operate a share matching plan. The share matching plan is an executive share incentive arrangement which encourages the executive to buy shares in the company as a ‘buy one get one free’ award.⁵² Three quarters of the FTSE 100 companies require part of their bonus to be deferred into shares for a period of time.

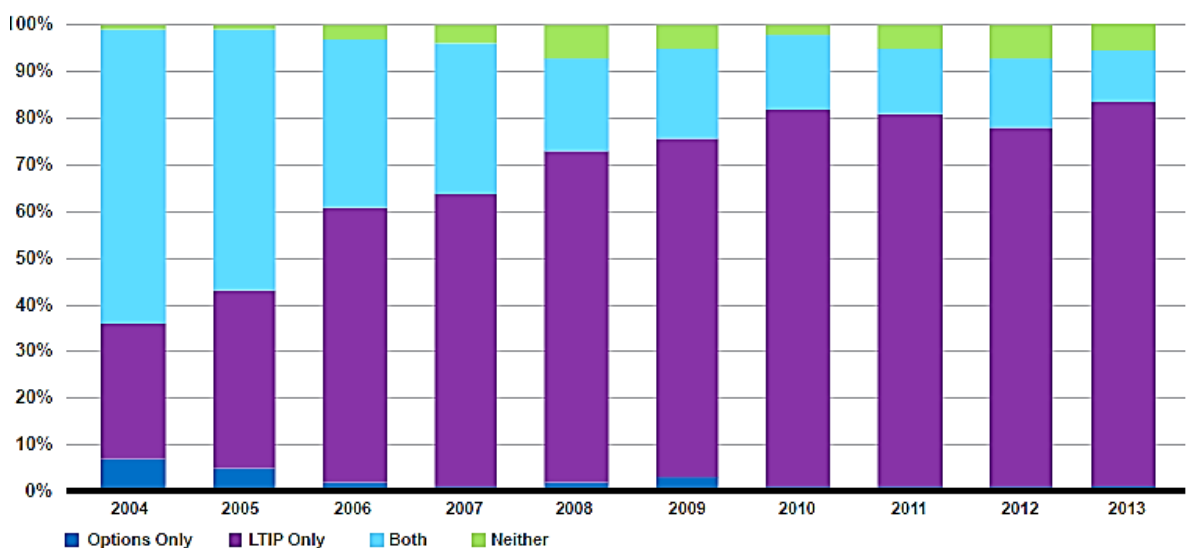
⁵⁰ James Barty and Ben Jones, *Executive Compensation; Rewards for Success not Failure* (Policy Exchange 2012) 8.

⁵¹ PriceWaterhouseCoopers, ‘Getting the Balance of Executive Pay Right’ PwC Executive Reward Survey, January 2012.

⁵² ‘UK Share Plans’ Pinsent Masons April 2014, <http://www.pinsentmasons.com/PDF/offeringshareincentives.pdf> assessed 25 May 2014.

The present day executive remuneration package is characterised by a shift in the balance between fixed and variable pay. Executive pay is based more on variable pay of executives which are dependent on contingent performance measures. The pay package of executives has the increasing potential of paying out the maximum for incentive schemes, and with more directors receiving incentives of higher values. Executive variable (variable pay includes pay from annual bonuses, share options and long-term incentive schemes discussed in detail later in this chapter) pay makes up 60%-65% of the pay package of FTSE 100 companies in 2013. Furthermore, 60% of variable pay was related to the long-term performance of the company. The FTSE 100's 30 highest paid executive remuneration packages were made up of about 70% of performance linked variables.⁵³ These figures demonstrate the great shift from fixed pay to variable pay so as to link executive remuneration to company performance. The chart below demonstrates the incentives used by FTSE 100 companies for their executives.

Figure 2: Chart demonstrating the use of incentive plans by FTSE 100 in 2013



Source: New Bridge Street, *Report on FTSE 100 Directors' Remuneration* (New Bridge Street 2013) 20.

From the chart above most of the FTSE 100 companies offer only LTIPs to their executives and very few companies offering only share options to their executives. These components of the executive remuneration package have different effect on the

⁵³ New Bridge Street, *Report on FTSE 100 Directors' Remuneration* (New Bridge Street 2013) 4.

remuneration levels. Therefore, it is of primary importance to this thesis that these components and their effect on the executive remuneration package be discussed. The next section will discuss the various components of the executive remuneration package.

Elements of the Remuneration Package

Executive remuneration package is made up of direct and indirect remuneration elements which take the form of monetary and non-monetary rewards. The common forms of direct remuneration are base pay and variable pay. The direct form of remuneration could also be described as annual remuneration and long-term remuneration. The level of executive remuneration depends on the type of remuneration package which includes annual and long-term remuneration.⁵⁴ Annual remuneration consists of a base salary and annual bonus pay tied perhaps to the financial performance of the company. Long-term remuneration consists of share options, long-term incentive plans and restricted shares. Executive benefits make up the indirect remuneration which consists of various perks such as health insurance schemes, private use of company aircraft or cars, pension etc. Other elements that feature in the remuneration package include severance payments, golden hellos and golden handshakes, which are not elements of executive package per se but are included in the remuneration package depending on the circumstances. Each elements of the executive remuneration package is discussed below.

Base salary

A base salary is the contractual amount paid to an executive on a monthly basis, and in the case of an executive director, it includes directors' fees although these are decided and disclosed separately.⁵⁵ This element is not related either to performance of the company or to the performance of the individual director.⁵⁶ The amount is set with due regard to the size of the company, the industry sector, the experience of the individual director and in comparison with other companies in the same industry.⁵⁷ The base salary is revised annually to take account of various factors like changes in

⁵⁴ Charlotte Villiers, 'Executive Pay: Beyond Control' (1995) 15 *Legal Stud.* 260,261.

⁵⁵ AP Williams, *Just Reward? The Truth about Top Executive Pay* (Clays Ltd 1994) 107.

⁵⁶ Christine A. Mallin, *Corporate Governance* (4edn. Oxford University Press 2007) 204.

⁵⁷ Christine A. Mallin, *Corporate Governance* (Oxford University Press 2004) 110.

responsibility, performance of the company and other elements that make up the remuneration package.

Base salary is a key component in executive pay as most risk adverse executive prefers a small increase in base salary to a much larger increase in ‘target’ bonus or variable remuneration. This is because executives devote substantial attention to the salary-determination process as most components of remuneration are measured relative to base salary levels (e.g. target bonuses are typically expressed as a percentage of base salary, and option grants are often expressed as a multiple of base salary. Defined pension benefits and severance arrangements also depend on salary levels). Therefore an increase in base salary has a positive influence on many other remuneration components.⁵⁸ For example, Tesco plc remuneration policy for annual bonuses is to award up to 250% of base salary. But the base salary of Tesco plc CEO increased from £1,093,000 in 2012 to £1,114,000 in 2013, reflecting a percentage increase of 1.92%. This implies that the annual bonus of 2013 at 250% of base salary would be more by 1.92% than the annual bonus of 2012 at 250% of base salary.

Annual bonus

Annual bonuses (or bonus schemes) were and still are used as a motivational factor for directors to achieve higher levels of performance.⁵⁹ Annual bonuses are obtained upon achieving a performance target set by the company for the executives.⁶⁰ Bonus schemes provide executives with the incentive to perform better and therefore are regarded as a mechanism for improving executive performance. Executive performance can be difficult to determine, but bonus remuneration must have to reflect some kind of performance criteria for it to be meaningful. The company will have to set a performance target for which the executives will achieve, and a performance measure with which the performance would be determined.⁶¹ This gives the executives the chance to share in the success of the company.

⁵⁸ Kevin J Murphy, ‘Executive Remuneration’ (1999) 3(B) Handbook of Labour Economics 2485, 2498.

⁵⁹ AP Williams, *Just Reward? The Truth about Top Executive Pay* (Clays Ltd 1994) 109.

⁶⁰ M Conyon, *Directors' Pay in UK Plcs: A Guide to Executive Pay Determination* (Chartered Institute of Personnel Development 2000) 2.

⁶¹ See p.182 of this thesis for more discussion of this topic.

Most companies use short-term annual bonus plans to remunerate their executives. Salary and annual bonuses are usually described as ‘cash pay’ although the bonus sometimes is paid in shares. One advantage in using an annual bonus is that it can better reflect current performance while at the same time managing costs for the organisation. There has been a rapid growth in the use of annual bonuses by companies over the years with most quoted companies in the UK offering bonuses to their executives. Annual bonus schemes can encourage short-termism at the expense of the company’s long term success if relied upon too much by a company. Annual bonus plans are constructed for a 12-month period in the UK in line with the company’s financial reporting year to encourage a year-on-year performance improvement. At the beginning of the financial year, performance targets are set, monitored during the year and assessed at the end of the year in order to determine payment. If the performance targets are met, the bonus will be paid and if not met the bonus will not be paid. Some bonus plans are paid in shares after a holding period⁶² or subject to other conditions set by the company. The successful achievement of the objective of bonus plans depends greatly on the performance target and performance measure set by the company. The performance target and measure must be chosen carefully to reflect the company’s strategy and promote the success of the company in order to achieve the desired outcome.⁶³ Even though bonuses are paid based on performance, it is distinguished from other forms of incentive pay in that, it is allocated on the basis of past performance rather than future performance. It is also based on subjective (rather than objective) rating of employees measuring individual executive performance rather than group performance.⁶⁴

Conyon et al.⁶⁵ cited a study carried out by the Income Data Services (IDS) in 1993 indicating that in 1979 only 8% of large UK companies had an annual bonus scheme for their top executives. The 1980s and 1990s saw a more obvious move to paying incentive bonuses to directors with most quoted companies offering bonuses to their

⁶² Shares the executives cannot freely trade on until after a certain period determined by the company.

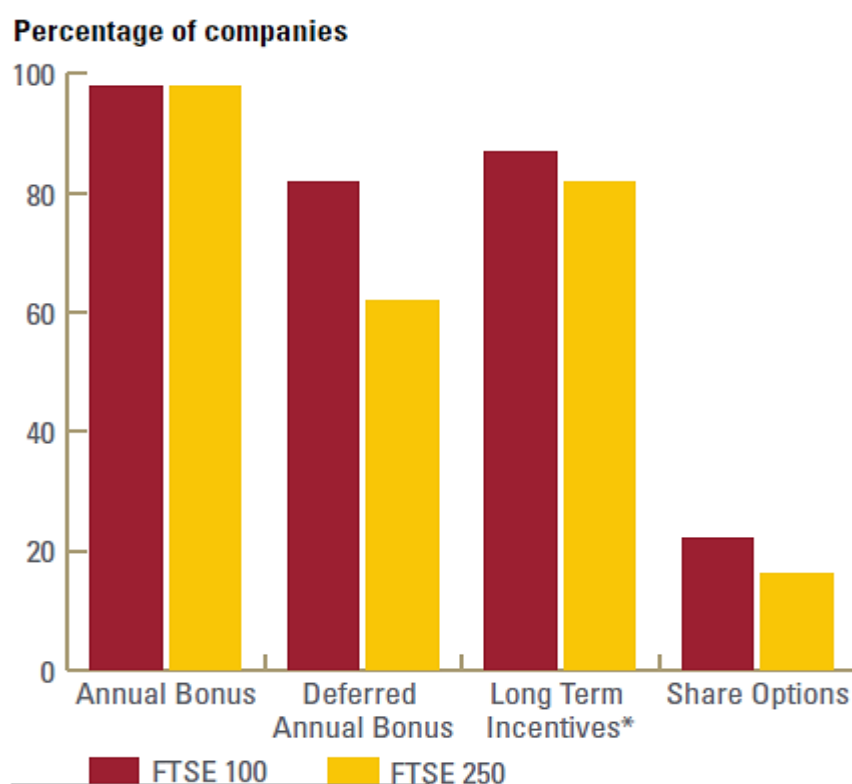
⁶³ Performance targets and measures are discussed in detail in chapter 5.

⁶⁴ Christopher Lowery, NA Beadles II, MM Petty and Gordon Amsler, ‘An Empirical Examination of a Merit Bonus Plan’ (2002) XIV(1) *Journal of Management Issues* 100-117.

⁶⁵ Martin Conyon, Paul Gregg and Stephen Machin, ‘Taking Care of Business: Executive Compensation in the United Kingdom’ (1995) 105(430) *EJ* 704, 706.

executives in 1993.⁶⁶ However, at the time executive remuneration was not disclosed in the annual reports and accounts according to the components of the remuneration package. A survey on executive pay by Labour Research⁶⁷ found out that of the one thousand companies involved in the survey, only two executive pay packages were broken down into base salary and bonus pay. By 2003 only six FTSE 350 companies had not offered an annual bonus to their executives, with 54.3% of the companies paying their executives bonuses in cash; and the rest of the companies paying bonuses in cash, shares, deferred shares and matching shares.⁶⁸ The use of annual bonuses has grown rapidly amongst the FTSE All-share companies, with FTSE 100 and FTSE 250 companies in 2011 offering annual bonuses to their executives as demonstrated in the chart below.

Figure 3: Chart indicating the percentage use of annual bonuses by FTSE 100 and FTSE 250



Source: KPMG, *KPMG's Guide to Directors' Remuneration* (KPMG, 2011) 13.

⁶⁶ Martin Conyon, Paul Gregg and Stephen Machin, 'Taking Care of Business: Executive Compensation in the United Kingdom' (1995) 105(430) EJ 704, 706.

⁶⁷ 'More Pay Rises for Rich Directors' (1985) 75(10) Labour Research 253 & 254.

⁶⁸ Alistair Bruce, Rodion Skovoroda, Jay Fattorusso, and Trevor Buck, 'Executive bonus and firm performance in the UK.' (2007) 40(3) LRP 280, 282.

There has been a massive increase in bonus payments over the years ranging from practically nothing to millions of pounds.⁶⁹ Executives can receive bonus pay that is more than 100% of the base salary,⁷⁰ although EU rules have put a cap on bonuses primarily in the banking sector (discussed below). Comparison with earlier years is difficult as prior to 1996, pay disclosures for named executives were rare and most companies disclosed only the cash pay of the highest paid director. Annual bonuses can have a massive effect on the total remuneration package of an executive as it increases remuneration levels. Sam Chisholm former CEO of British Sky Broadcasting in 1996 had a pay rise of 609.2% giving £4,716,000, which was boosted by a £2.7 million bonus following the company's successful flotation on the share exchange.⁷¹ In 2010, Bart Becht the CEO of Reckitt Benckiser plc, had a base salary of £987,000, plus a bonus of £3.5 million which was 354% of base salary.⁷² A more recent example is in 2013, Gulliver Stuart Thomson, the CEO of HSBC Holdings plc had a base salary of £1,250,000 and a bonus pay of £6,428,000 which was 514.24% of his base salary.⁷³ These examples demonstrate how much annual bonus can affect the total level of executive remuneration and also provide evidence that annual bonuses have increased and continue to increase.

The banking crisis of the year 2007 and 2008, in which five banks were saved from collapsing by the government in the UK, was alleged to be partly caused by the use of bonus plans.⁷⁴ Bonus plans encouraged excessive risk taking as executives focused only on the short term profitability of the company at the expense of its long term success.⁷⁵ Addressing this problem, the European Parliament on the 16th of April 2013, approved a cap on banker's bonus pay to a maximum of 100% of base salary, rising to 200% (if the shareholders agree) of the base salary applicable to all banks in the European Union. This cap indicated a massive cut back on the percentage of

⁶⁹ Alistair Bruce, Rodion Skovoroda, Jay Fattorusso and Trevor Buck, 'Executive Bonus and Firm Performance in the UK' (2007) 40(3) LRP 280, 282.

⁷⁰ Nick Fletcher, 'Executive pay rises while shareholder earnings fall, says MM&K survey' (2010) *The Guardian* July 5th.

⁷¹ 'Big Boost for Bulging Pay Packets' (1996) 85(9) *Labour Research* 23.

⁷² Louisa Peacock, 'FTSE 100 Pay Packets 'Scandalous' When Ordinary Workers Face Wage Cuts' (2010) *The Telegraph* October 28th.

⁷³ Details obtained from Morningstar Company Intelligence database <http://companyintelligence.morningstar.com/guru/searching/directors/remuneration.do> assessed 12 February 2014.

⁷⁴ FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (FSA 2009) 79.

⁷⁵ Stephen Bloomfield, *Theory and Practice of Corporate Governance: An Integrated Approach* (Cambridge University Press 2013) 144.

executive bonus pay in the UK. However, despite the bonus cap, banks have found a way of going round the cap and rewarding their executives. For example, in 2014, HSBC's CEO, Stuart Gulliver, had a pay rise of 140% after being handed a weekly allowance worth £32,000 as a means to get around the EU's cap on bonuses.⁷⁶ This act by the HSBC bank may be emulated by other banks. Furthermore, this cap might encourage banks to increase fixed pay which could be more risky to the banks because they will not be based on any performance conditions consequently unaffected by the company's performance.

Annual bonuses also represent the most direct and immediate link between managerial actions and consequences. It does not generate further risk or commitment to the executive director as it is based on past performance and is not affected by how well the company performs in the future.⁷⁷ The disadvantage of using annual bonus is that it encourages short termism in which directors will concentrate more on business strategies that will yield profit in the shortest possible time so that they can claim their bonus. This may cause directors to be reluctant to incur expenditure that is not immediately productive such as capital investment, maintenance and training.⁷⁸

Executive Benefits and Perks

Executive benefits include health insurance, flexible work schedules, deferred remuneration and club memberships. The difference between executive benefits and other employee benefits is that the normal benefit may be expanded for the executives. For example, the normal benefit of flexible work schedule may be expanded for executives to include reimbursement for travel expenses between the work place and the executive's home. In the 1970s, a director could receive benefits equal to about a quarter of his pay consisting of items such as company pension contribution, company car, housing, interest-free loans (e.g. Michael Nicholson was granted an interest free loan of £75,000 by Cigarette and Luxury Goods Group Dunhill)⁷⁹ as well as payment of private school fees for children, free company flat in

⁷⁶Graham Hiscott, 'HSBC Chief Banks Pay Rise of 140% in Order to Sidestep EU Bankers Bonus Cap' (2014) *The Guardian* February 24th.

⁷⁷ Alistair Bruce, Rodion Skovoroda, Jay Fattorusso and Trevor Buck, 'Executive Bonus and Firm Performance in the UK' (2007) 40(3) *LRP* 280, 281.

⁷⁸ Stephen Bloomfield, *Theory and Practice of Corporate Governance: An Integrated Approach* (Cambridge University Press 2013) 120.

⁷⁹ 'Pay Bubble Expands' (1989) 78(8) *Labour Research, Directors* 10.

‘town’, free meals and entertainments, lavish furnishing of offices and even homes. An example was BOC International that had a directors’ scheme allowing refurbishing of homes and other ‘hidden’ perks worth £2,500 a year.⁸⁰ Furthermore, in the 1970s, disclosure requirement of executive remuneration were limited and thus the annual report did not specify what the ‘fringe benefits’ were. Some executives receive benefits that are almost the same as their base salary. For example in 2013, Sorrell Martin Stuart, the CEO of WPP plc had a base salary of £1,300,000 and benefits of £1,296,000. These figures indicate that executive benefits are also increasing and almost reaching 100% of the executive’s base salary. This increase will raise the levels of executive remuneration.

Another unique component of executive remuneration package is perks also known as perquisites. Perks are additional non-monetary benefits that provide comfort and luxury to the work and/or personal environment, usually intended for senior managements and executives.⁸¹ For example, in 2012, Angela Ahrendts, the then CEO of Burberry plc received £387,000 as a ‘cash allowance’ which included a clothing allowance in addition to her staff discount, and money relating to her relocation to Britain in 2006, her children’s school fees and some travel.⁸² Perks are used to motivate the executives to work hard and have been seen to enhance productivity when it gives the executive all the facilities to carry out his contracted duties.⁸³ Firms find it cheaper to generate incentives by providing perks instead of additional remuneration to the executives.⁸⁴ Perks are not strictly necessary for the accomplishment of the executive’s duties and thus, have been criticized as being a diversion of corporate resources by the management at the expense of the shareholders and the company.⁸⁵ Executive perks are the least transparent of all the components of executive remuneration package. This is because they are hard to observe by the shareholders and the value is often underreported if disclosed in the

⁸⁰ M Conyon, *Directors' Pay in UK Plcs: A Guide to Executive Pay Determination* (Chartered Institute of Personnel Development 2000) 4 & 5.

⁸¹ Sandra Reed and Anne Bogardus, *PHR / SPHR: Professional in Human Resources Certification Study Guide* (John Wiley & Sons 2012) 456.

⁸² ‘Burberry Chief Ahrendts gets £15.6m Pay, Perks and Shares’ (2012) *The Telegraph* June 8th.

⁸³ ‘Pay Bubble Expands’ (1989) 78(8) *Labour Research*, Directors 4.

⁸⁴ *ibid.*

⁸⁵ David Yermack, ‘Flight of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns’ (2006) 80(1) *JFE* 211, 212.

company's accounts.⁸⁶ Rajan Raghuram and Wulf Julie⁸⁷ carried a research on perks and argued that perks are important and are regarded as an excess only when they are too large.

Pension

Executive pension is guaranteed as a function of base salary before retirement and plays a crucial role in affecting incentive schemes. Pension motivates the executive to work hard with a desire to remain on the job because pension is not received until the individual retires. The use of performance contingent pension is essential to ensure that executives continue to perform in their final years on the job.⁸⁸ An increase in salary will consequently have substantial implications for the pension fund for many years to come. There has been a significant increase in the amount of pension executives receives. For example, Sir Anthony's Tennant pension fund of £204,000 was largely criticised in the early 1990s but in 2005, the former Chairman of Unilever had a pension pot of £17million with an annual retirement income of £850,000.⁸⁹ Although some directors are experiencing pension cuts, others are still receiving substantial sums from pension pots. For example in 2013 Albanese Tom, CEO of Rio Tinto plc had a pension of £1,113,760.⁹⁰

Factors affecting pension build-up depends on whether pensionable pay is based exclusively on basic salary or includes some or all of any bonuses paid and length of service. For example Tony Greener former CEO of Diageo Food and Drinks Group, who had a pension fund of £437,000 in 1999, had a salary of £710,000 but a proportion of his bonuses were included in pensionable pay. Some of the pension are based on base salary alone like in the case of Sir Thompson Clive of Rentokil Initial

⁸⁶ Yaniv Grinstein, David Weinbaum and Nir Yehuda, 'Perks and Excess: Evidence from the New Executive Remuneration Disclosure Rules' (2008) 1 http://myweb.whitman.syr.edu/amanand/web/nyaff/weinbaum_perks.pdf assessed 1 May 2011.

⁸⁷ Rajan Raghuram and Wulf Julie, 'Are Perks Purely Managerial Excess?' (2006) 79(1) JFE 1, 2.

⁸⁸ Edward P Lazear, 'Pensions and Deferred Benefits as Strategic Remuneration' (1990) 29(2) JIR 263, 263.

⁸⁹ Julia Finch and Jill Treanor, 'Chief Executive Pay Rises to £2.5 Million Average' (2010) The Guardian August 4th.

⁹⁰ Morningstar Company Intelligence.

<http://companyintelligence.morningstar.com/guru/searching/directors/remuneration.do> assessed on the 12th of February 2014.

Business Service Group who had a pension fund of £314,000 based on his £840,000 base salary.⁹¹

Share Options

Share options are a benefit given by the company to an employee (executive) to buy shares in the company at a discount at a pre-specified price for a pre-specified term.⁹² It may require the employee to complete a specific period of service in order to be able to exercise the option or requires a specified performance targets to be met by the company or employee. In the 1980s when more companies started offering share options to their executives, the Inland Revenue Rules under the framework of the Finance Act 1984, plus Best Practice Guidelines from the Association of British Insurers 1995 and the National Association of Pension Funds placed a restriction on UK companies on how to grant share options. Share options were granted up to a maximum of four times the earnings⁹³ and exercisable within a period from 3-10 years after the date of the grant with provisions for automatic top-up (that is, the granting of additional option after exercise) to the specified multiple.⁹⁴ During this period, share option was granted at a discount of up to 15% of the share price and the discount generated instantaneous increase in director's wealth which was not linked to company performance.⁹⁵ Furthermore, the share options were unrelated to the long term success of the company. At the time and up to present, there exists no legislation providing express limits upon the remuneration of directors in quoted companies.

During the 1990s, share options were regarded as the most effective tool for linking executive pay to corporate performance and aligning the interest of managers and shareholders.⁹⁶ However, the share options schemes did not guarantee loyalty for which it was designed due to lack of rigorous performance conditions; rather they led to over generous pay.

⁹¹ 'Directors sit on Golden Nest Eggs' (1999) 88(2) Labour Research 11.

⁹² Brian Hall and Kevin Murphy, 'The Trouble with Stock Options' (2003) 17(3) JEP 49, 50.

⁹³ Coyle Brian, *Corporate Governance* (4edn. ICSA 2004) 142.

⁹⁴ *ibid.*

⁹⁵ Martin Conyon, Paul Gregg and Stephen Machin, 'Taking Care of Business: Executive Compensation in the United Kingdom' (1995) 105(430) EJ 704, 706.

⁹⁶ Edward Lee, Konstantinos Vonatsos and Konstantinos Stathopoulos, 'UK Executive Stock Option Valuation: A Conditional Model' (2007) 15(6) CGIR 1469, 1469.

Unlike in the US, share option seemed to have no motivational effect on executives in the UK.⁹⁷ The motivational aspect of share option was weakened in the UK with the collapse of the share market⁹⁸ after UK companies granted large quantities of option to many directors. The reason was that executives make high gain when share price appreciates but lose nothing when share prices are bad while the shareholder incur a loss. Meanwhile, in the US, options had been used in executive packages on a substantial scale and clearly had a significant motivational effect especially for its CEOs.⁹⁹ Premium-priced options were adopted and widely used in the US as an approach to enhance the motivational effect of share option, but very little used in the UK.¹⁰⁰

The value of the shares granted to the executives increases as the share price appreciates. The offering of share options in lieu of cash remuneration, allows companies to attract highly motivated and entrepreneurial executives.¹⁰¹ It also allows companies to obtain employment services without expending cash.¹⁰² More importantly, it also aims to link pay and performance. Share options are intended for only executives who remain with the firm to benefit thus providing retention incentives. They are non-tradable, and are typically forfeited if the executive leaves the firm before vesting (vesting is when the share option is exercised by the employee).¹⁰³ Granting of share options cost the firm more than the value of the share option to the director receiving it. Share options can be more valuable as the company improves financially, and therefore, ownership of share is intended to encourage the executives to make the organisation more profitable.

The purpose for introducing share options was to enable executives to become significant shareholders by purchasing shares cheaply and accordingly, linking executive's interest with that of the company and tying pay to company performance.¹⁰⁴ However, the granting of share options can dilute shareholdings by increasing the number of shares in the market. Directors like share options because

⁹⁷ Coyle Brian, *Corporate Governance* (4edn. ICSA 2004) 127.

⁹⁸ Black Wednesday, September 16, 1992.

⁹⁹ Coyle Brian, *Corporate Governance* (4edn. ICSA 2004) 127.

¹⁰⁰ *ibid.*

¹⁰¹ Brian Hall and Kevin Murphy, 'The Trouble with Stock Options' (2003) 17(3) JEP 49, 49.

¹⁰² *ibid.*

¹⁰³ *ibid.*, 50.

¹⁰⁴ *ibid.*, 49.

they offer a risk free opportunity to make a big profit.¹⁰⁵ It is risk-free to the executives because they do not lose anything if the share price falls and they make gains if the share price appreciates. Directors are then faced with a temptation of focusing on ways of ensuring that the company's share price increases when the share option vest. Thus, they might manipulate profit to improve the financial performance of the company to investors and the market as a way of giving upward impetus to the share price.¹⁰⁶ The purpose of share option seems to have failed as majority of shares acquired in this way are sold almost immediately and the gain being additional income to the executive, e.g. the CEO of Reckitt Benckiser in 2010 took home a total remuneration of £92.6 million in total driven by the crystallisation of share awards accounting for £88 million of his total pay package.¹⁰⁷ Also, the holding of shares makes the executive more sensitive to the interest of the company, but the executives do not exercise their right if the share price falls. Consequently, share option loses its incentive value if the share price falls, but at the time the option is negotiated, the executive is still incentivised.¹⁰⁸

Long-term incentive plans

The undesirable short-term behaviour of annual bonuses and the lack of rigorous performance conditions on share options in the UK, led to the introduction of long-term incentive plans (LTIPs). Before the 1990s very few companies had LTIPs in place. The number increased in the 1990s particularly following the Greenbury Report of 1995¹⁰⁹ recommendations for companies to replace share options with LTIPs. LTIPs encourage and motivate directors to concentrate on long-term strategic objectives, and to be less influenced by the short-term negative aspects of decisions. LTIPs usually comprise of share options and restricted shares.¹¹⁰

Long-term incentive plans (LTIPs) take the form of cash or a grant of shares that becomes transferable to the executive only upon attainment of certain performance

¹⁰⁵ 'Opting for a Share of the Profit' (1999) 88(6) Labour Research 15.

¹⁰⁶ Coyle Brian, *Corporate Governance* (4edn. ICSA 2004) 174.

¹⁰⁷ Louisa Peacock, 'FTSE 100 pay packets "scandalous" when ordinary workers face wage cuts' (2010) *The Telegraph* October 28th.

¹⁰⁸ Coyle Brian, *Corporate Governance* (4edn. ICSA 2004) 195.

¹⁰⁹ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee, 1995).

¹¹⁰ Christopher Pass, 'Long-term Incentive Schemes, Executive Remuneration and Corporate Performance: An Empirical Study' (2003) 3(4) *Corporate Governance* 18, 22.

objectives.¹¹¹ Companies use LTIPs as a means to encourage and reward long-term performance and thus align the interest of the executives more closely with that of the company.¹¹² LTIPs require the fulfilment of certain performance criteria over a period of time.¹¹³ Such criteria include total shareholder return, earnings per share, share price, profit, growth in net asset value, return on capital and cash flow (discussed in detail in chapter 5).¹¹⁴ Most companies in the UK use earnings per share or total shareholder return as targets for measuring LTIPs (discussed in detail in chapter 5).¹¹⁵

LTIPs are similar to share options in terms of the objective and the grant procedure but differ in the mode of vesting. LTIPs' performance targets are more varied and the company's performance judged relative to a group of other companies rather than the Retail Price Index.¹¹⁶ Setting the appropriate performance target can increase shareholder value while inappropriate performance criteria or a complex LTIP will act as an opportunity for the executives to tilt the design in their favour.¹¹⁷ This is because shareholders find it hard in judging the targets involved in complex LTIPs. For example, in 2003, HSBC Banking Group had an LTIP scheme that rewarded executive if the firm could clear a performance hurdle of earning-per-share (growth 2% above an average earnings-per-share rate) adjusted upward for inflation in Hong Kong (50% weighting), UK (35% weighting), and the US (15% weighting). If the hurdle was cleared, the number of shares distributed to the executive would depend upon total shareholder return in a comparator group of nine companies (50% weighting), a 'top 20' of banks (25% weighting) and an index of 300 other banks (25% weighting). If the HSBC's total shareholder return performance was above the fiftieth percentile of the composite group, executive received shares in full, with an additional 20% of the full award if the performance is in the top quartile. To

¹¹¹Peter Pope & Steven Young, Executive Remuneration: an Investor's Guide [http://www.manifest.co.uk/reports/remuneration/pope_and_young_executive_remuneration.html#The Components of Executive Pay](http://www.manifest.co.uk/reports/remuneration/pope_and_young_executive_remuneration.html#The%20Components%20of%20Executive%20Pay) assessed 13 March 2011.

¹¹² Christopher Pass, Andrew Robinson and Damian Ward, 'Performance criteria of corporate option and long-term incentive plans: a survey of 150 UK companies 1994-1998' (2000) 38(2) Management Decision 130-137.

¹¹³ Trevor Buck*, Alistair Bruce, Brian G. M. Main and Henry Udueni, 'Long-Term Incentive Plans, Executive Pay and UK Company Performance' (2003) 40(7) JOMS 1709, 1710.

¹¹⁴ Charlotte Villiers, 'Share Option Plans for Directors in Privatized Companies in the United Kingdom and Spain' (2001) 22(5) Comp. Law. 141.

¹¹⁵ *ibid.*

¹¹⁶ Christopher Pass, Andrew Robinson and Damian Ward, 'Performance criteria of corporate option and long-term incentive plans: a survey of 150 UK companies 1994-1998' (2000) 38(2) Management Decision 130, 130.

¹¹⁷ *ibid.*

understand the complexity of this LTIP required the shareholders of the HSBC to track the share prices of 329 companies to estimate the relative performance of HSBC's total shareholder return in the past, which was a very difficult task which no shareholder is willing to do except maybe the institutional investors.¹¹⁸

Dividends

Dividends are not regarded as remuneration per se, but there are considered for the purpose of this thesis as remuneration. This is because executives are rewarded by shares when they achieve certain performance targets, and they would consequently receive dividends on the shares which can be considered as remuneration. Dividends are the income that shareholders receive from their shares. They are payments from the profits the company makes and are not paid out from the company's capital.¹¹⁹ The methods of paying out the dividends are generally laid out in the company's article of association. Directors do not only profit from share options vested, but they also make profit from dividends paid on the shares. In 1996, Ronald Hobson of Group National Parking Corporation got an increased dividend of over 1000% and a special dividend of 155pence per share resulting in dividends of £60,413,139 on his 37.64 million share stake in the company.¹²⁰ Furthermore, an executive could acquire significant number of shares through share options and as a result receive large dividends on them.

Healthy and consistent dividend pay-out can convey information to investors who are not directly involved in managing a company, that its management has confidence in the business and its prospects. Such message passed to investors can increase the benefit to the company through the increase of the share price.¹²¹ Inconsistency in dividend pay-out is interpreted by investors as a signal of long-term problems within the company rather than a temporary crisis of profitability or liquidity.¹²²

The directors of a company recommend how much of the company's profit should be distributed as dividends. The directors understand the company and have more

¹¹⁸ Trevor Buck, Alistair Bruce, Brian G. M. Main and Henry Udueni, 'Long-Term Incentive Plans, Executive Pay and UK Company Performance' (2003) 40(7) JOMS 1709, 1711-1712.

¹¹⁹ Companies Act 2006, s830.

¹²⁰ 'Shares Multiply Executive Income' (1996) 85(5) Labour Research 7.

¹²¹ Eilis Ferran, *Company Law and Corporate Finance* (Oxford University Press 1999) 410.

¹²² *ibid* 411.

information about the company's affair than the shareholders. Thus the level of dividend which the directors recommend is seen as an important signal of what they think of the company's prospect. However, executives are capable of abusing this information privilege as they hold shares in the company and can make huge gains from dividend pay-out on the shares which is the reason why the directors' recommendation must be approved (declared) by the members.¹²³

Restricted Share

Restricted shares are shares held by the company in trust for the executive, for a predetermined period to ensure that they cannot be sold during the restricted time.¹²⁴ These restrictions lapse over a period of years provided the executive remains with the company.¹²⁵ Dividends may or may not be paid during the restricted period. Companies use restricted share as a retention incentive to reduce the likelihood of executives leaving the company. Restricted share is more commonly used in the US than in the UK.¹²⁶

Restricted shares differ from share options in that restricted shares vest regardless of the change in share price from the date granted to the date of vesting.¹²⁷ Restricted shares provide a stable incentive to the executives as it is not effected by share price, whereas the incentive value of share option depends on the market price of the share relative to the exercise price. Share option provides similar incentive as restricted shares only when the market price is well above the exercise price and zero incentive when market price falls below exercise price.¹²⁸ Companies treat restricted shares as

¹²³ Eilis Ferran, *Company Law and Corporate Finance* (Oxford University Press 1999) 410.

¹²⁴ *ibid*, 133.

¹²⁵ James D. Westphal and Edward J. Zajac, 'Substance and Symbolism in CEOs' Long-term Incentive Plans' (1994) 39(3) *Admin Sci Quart* 367, 369.

¹²⁶ Peter Pope & Steven Young, "Executive Remuneration: An Investors' Guide" (2007) [http://www.manifest.co.uk/reports/remuneration/pope_and_young_executive_remuneration.html#Restricted Shares](http://www.manifest.co.uk/reports/remuneration/pope_and_young_executive_remuneration.html#Restricted%20Shares) assessed 1 April 2011.

¹²⁷ Cal Christian, 'Employee Remuneration: Stock Options Versus Restricted Stock' (2003) 18 *Commercial Lending Review* 1, 10.

¹²⁸ Peter Pope & Steven Young, 'Executive Remuneration: An Investors' Guide' (2007) [http://www.manifest.co.uk/reports/remuneration/pope_and_young_executive_remuneration.html#Restricted Shares](http://www.manifest.co.uk/reports/remuneration/pope_and_young_executive_remuneration.html#Restricted%20Shares) assessed 1 April 2011 at 60.

remuneration expense when the restriction lapse and not at the time of the award. The expense is the fair market value of the shares at the time of vesting.¹²⁹

Payments for loss of office

Payments for loss of office (severance payments) are agreements in the executive's service contract or in the company's articles of association spelling out how long and how much he will be paid after termination of his contract. Senior executives are often given contracts that include a severance agreement and change of control protection. Change of control provisions provide the executive with protection in the event of losing his job as a result of the sale of the company, or any other event resulting in change of control. The provision of severance payment is intended to protect honest executives who faithfully serve the company.

However, pay-offs often go to directors who are sacked for not being up to the job, or have left the company to pursue other business interests, or have resigned over boardroom disagreement or merely retired from the boardroom.¹³⁰ For example, Peter Davis former chairman of publishers Reed International resigned after a dispute over management responsibilities and was paid £1,247,000.¹³¹ Sir Phillip Watts, former Chairman of Shell received £1 million as severance payment following an act of misrepresentation that cost the company's share price to fall. His severance payment was six times his basic salary under the contract.¹³²

Another form for payment for loss of office is golden handshake. A golden handshake is a payment made by a company to a senior executive upon termination of employment before the contract ends.¹³³ Golden handshakes emerged in the late twentieth century when severance packages were frequently offered to resigning executives. An example is the golden handshake awarded to Klaus Esser (who headed Mannesmann, the German Telecoms company before it was taken over by the UK

¹²⁹ Cal Christian, 'Employee Remuneration: Stock Options Versus Restricted Stock' (2003) 18 Commercial Lending Review 1, 11.

¹³⁰ 'Goodbye and Thanks a Million' (1998) 87(10) Labour Research 11; Tjomme O. Rusticus, 'Executive Severance Agreements' (2006) Working Paper, Wharton School, University of Pennsylvania.

¹³¹ 'Goodbye and Thanks a £Million' (1995) 84(9) Labour Research 27.

¹³² Mohammed B. Hemraj, 'Spotlight on executive remuneration' (2005) Comp. Law. 149.

¹³³ Mathias Nussbaum, 'Golden Handshakes and Golden Parachutes – Severance Packages for Corporate Executives' (2005) LLM theses.

Group Vodafone) by Vodafone of £9.1 million.¹³⁴ In 2012, Ian Marchant the then CEO of Scottish and Southern Energy plc took home a golden handshake of £15m after quitting the company.¹³⁵ Executives can receive golden handshake despite clear evidence of failure.¹³⁶ In 2001, Telecoms Company Marconi gave its former CEO Lord Simpson a golden handshake of £1 million plus a pension payment of £2.5 million less £300,000 after a protest by its shareholders. His package was criticised as a lot for someone who helped to bring the firm to the brink of collapsing. Prior to his departure the company had received a two profit warnings within two months and sacked thousands of employees.¹³⁷ Golden handshakes are regarded as excessive and not necessary at a time when the economy is suffering and companies are cutting back on jobs, the top executives that are affected walk away with big pay-offs while other walk away with absolutely nothing. For examples, Jim Mueller, the then CEO of Invensys plc, who presided over 14000 job cuts when a merger created Invensys, left the company with a £3.2 million handshake.¹³⁸

Golden Hello

Golden hello is a payment offered to induce a executive to leave one company and join another.¹³⁹ It is a guaranteed remuneration package with no link to company performance (because no performance has yet taken place). The UKCGC¹⁴⁰ recommends that executive remuneration be set as to link pay to individual and corporate performance. Golden hellos clearly undermine this recommendation, and could justify the weak relationship that exists between executive pay and company performance. For example, Mr Christopher Bailey, the new chief executive of Burberry, was given a golden hello in shares worth up to £7.6m.¹⁴¹ Mr John Browett former CEO of PC World and Currys was given a golden hello of £36 million by

¹³⁴ 'The £9 Million Handshake' (2002) 91(1) Labour Research 17-18.

¹³⁵ 'Scottish & Southern Energy boss gets £15m Golden Handshake - After Tripling Energy Bills' (2013) Daily Record and Sunday Mail January 24th.

¹³⁶ 'More than a Fond Farewell' (1994) 83(9) Labour Research 24.

¹³⁷ *ibid.*

¹³⁸ 'Company Directors get Record Golden Farewells' (2002) Labour Research Press Release Jan.

¹³⁹ Julia Cresswell, *Oxford Dictionary of Word Origins* (Oxford University Press 2010) 192.

¹⁴⁰ FRC, *The UK Corporate Governance Code* (FRC, 2012) D.1.

¹⁴¹ Simon Bowers, 'Burberry Hands Christopher Bailey Golden Hello Worth up to £7.6m' (2014) *The Guardian*, May 14th.

Apple for taking charge of its retail arm.¹⁴² Golden hellos have been criticised by shareholders as a waste of the company's resources. This criticism could be seen in the reaction of Marks & Spencer investors who voted against the remuneration report in protest of Marc Bolland (new CEO) golden hello of £15 million pay package and other boardroom bonus pay out.¹⁴³

Golden hello undermines the reason for which share options and executive long-term incentive schemes were designed; which is to encourage executives to achieve performance targets, and stay in the company to receive the full value of their remuneration package. Most golden hellos do not vest on the executive until they serve the company for three years.¹⁴⁴ This includes elements such as share options and restricted shares are always linked to performance and require some years of service to vest. Furthermore, elements such as pension benefits which require years of service get handed down to the new executive subject to three years of being in the company.¹⁴⁵ For example, WHSmith in 2004, awarded a golden hello of £2.6 million to its new CEO Kate Swann following the company's poor Christmas sales was criticised by the shareholders. Kate Swann had resigned as managing director from catalogue retailer Argos. Her golden hello package was made up of a bonus of £220,000 that could increase to £475,000 after Swann completes three years with the company, and a share option worth three times her annual salary – netting her £1.4 million. In addition, she was offered £500,000 remuneration over two years for the loss of benefits when she resigned from Argos.¹⁴⁶ There were no performance measures attached to Swann's pay package (presumably there were performance measures attached to the share options) apart from the fact that she has to remain in the company for three years. After discussing the elements that make-up the executive remuneration package, this next section will discuss the factors that increase executive remuneration levels.

¹⁴² Press Association, 'Former PC World and Currys Boss Browett 'to Get £36m Golden Hello' (2012) May 28th <http://money.aol.co.uk/2012/05/28/former-pc-world-and-currys-boss-browett-to-get-36m-golden-hello/> assessed 13 February 2014.

¹⁴³ 'No Headline' (2000) *SundayHerald* August 1st edn.

¹⁴⁴ Dan Sabbagh, 'Scant Time Wasted in Hiring New Misy's Chief Executive' (2006) *The Times (London)* October 17th.

¹⁴⁵ Dan Sabbagh, 'Scant Time Wasted in Hiring New Misy's Chief Executive' (2006) *The Times (London)* October 17th.

¹⁴⁶ 'WHSmith Gears up for Chief Executive 'Golden Hello' Backlash' (2004) *EGi Web News*, January 23rd.

Factors that can increase executive remuneration

Executive remuneration levels have increase greatly in the UK over the past two decades, e.g. the pay of an average FTSE 100 chief executive in the UK between 1998 and 2011 rose from £1 million to £4.8 million.¹⁴⁷ Companies in the UK are prepared to pay executives up to the value of their perceived potential contribution in the company. On the other hand, executives want a remuneration package that is at least equivalent to what they can earn in other companies. It is important that policymakers understand the factors that have led to this significant increase, when deciding how best to regulate the determination of directors' pay, starting with the effect that privatisation has had upon remuneration.

Privatization

Privatization of some utility companies in the early 1990s saw one of the striking consequences being the increases in executive remuneration.¹⁴⁸ Prior to privatization in the UK, the determinants of the level of remuneration was more bureaucratic with little variation across executives and firms, no pay for performance and systematic age-related pay increases. There existed two markets for executives, namely the market for executives in state-owned companies, and the market for executives in publicly traded companies. The executives in state-owned companies received about half what the executives in publicly traded companies were receiving.¹⁴⁹ The state-owned companies were characterised by limited managerial discretion, low incentives to those monitoring their performance and more severe political constraints on pay settings. These factors led to differences in the remuneration contract of executives in state-owned companies and publicly traded companies.¹⁵⁰ Executives in publicly traded companies had more managerial discretion and incentives (for example share options).

Privatization facilitated the convergence of these two markets giving the privatized companies the opportunity to access the same labour market and capital markets as

¹⁴⁷ Luke Hildyard, '*Huge Executive Salaries are Vital to UK Competitiveness*' (NEF 2013) 1.

¹⁴⁸ Andrew Pendleton, 'What Impact Has Privatization Had on Pay and Employment? A Review of the UK Experience' (1997) 52(3) IR 554, 563.

¹⁴⁹ Michael Cragg and IJ Dyck, 'Executive Pay and UK Privatization: The Demise of 'One Country, Two Systems' (2000) 47(1) JBR 3, 3.

¹⁵⁰ *ibid.*

existing publicly traded companies. An opportunity they did not have considering that their executives were drawn from a distinct labour market other than from publicly traded companies. Privatisation changed the contracting environment giving the managers increased discretion which increased their potential productivity. Competing with the market created increased demands for managers with financial skills and the ability to raise capital. The competition in this market forced newly privatized companies to offer competitive wage packages to their executives with reference to their peers.¹⁵¹ Furthermore, managers were allowed to diversify into businesses with other countries that were unregulated, creating the incentive to attract managers with broader set of skills, talents and experiences. Privatised companies were also given the opportunity to alter their remuneration policies at their discretion.¹⁵² Privatization affected executive remuneration in two ways: firstly, it removed the constraints on the level of top executive pay, thereby allowing directors' remuneration to rise to market levels. Secondly, top executives could as a result of privatisation be rewarded with share option schemes, thereby allowing the new owners to incentivise their managers in a way not easily possible in the public sector.¹⁵³

Due to the massive pay increase that the executives enjoyed as a result of privatization, agency theory suggested that new principles be sought to introduce incentive-based payment systems, especially among top management to ensure that the agents behave in the principal's interest.¹⁵⁴ However, the huge increases awarded to the executives could not be justified as there was no relationship between executive pay and company performance. The scale and structure of the companies were unaffected by the privatisation and there were no dramatic changes in the British labour market for executives (meaning there was so sudden demands for former public sector executives).¹⁵⁵ These increases aroused public scrutiny as there was no correlation between salary increases and share market returns, as well as other measures of firm performance.

¹⁵¹ Michael Cragg and IJ Dyck, 'Executive Pay and UK Privatization: The Demise of 'One Country, Two Systems' (2000) 47(1) JBR 3, 3.

¹⁵² *ibid.*, 7.

¹⁵³ Andrew Pendleton, 'What Impact Has Privatization Had on Pay and Employment? A Review of the UK Experience' (1997) 52(3) IR 554, 567.

¹⁵⁴ *ibid.*, 566.

¹⁵⁵ Catherine Wolfram, 'Increases in Executive Pay Following Privatization' (1998) 7(3) JEMS 327, 359.

Example of pay increases due to privatization includes Eastern and London Electricity in 1990/91 that increased the chairman's remuneration from £114,620 to £242,818 within a year.¹⁵⁶ A classic example of excessive executive remuneration that further fuelled the debate in the UK is the British Gas plc case that grabbed the attention of the media, public and policymakers.¹⁵⁷ When the government unexpectedly announced it was going to open the domestic gas supply industry to competition (privatization) in the early 1990s British Gas had to undertake one of the biggest corporate restructuring programmes ever undertaken in Britain to make its cost structures competitive.¹⁵⁸ This was a measure to enable the company to keep up with the competition in the market. In the late 1994, British Gas awarded the then CEO Cedric Brown, a 70% pay increase, thereby increasing his pay to £475,000 per year. The public condemned the pay rise and the media published articles such as the 'Derailing the Gravy Train'¹⁵⁹ and 'Fat Cats in the Dock'¹⁶⁰.

A study by Conyon¹⁶¹ examining the relationship between the remuneration of the highest paid director and company performance in the privatized utilities companies, found that top directors' salary plus bonuses increased but with no relationship between director remuneration and the company performance. He also found out that the use of share option as a result of privatisation considerably inflated overall remuneration.

The graphs below show the difference in executive remuneration before and after privatization of some utility companies. This is a study that was carried out by Cragg et al¹⁶² examining executive pay systems in state owned and privatised firms against the backdrop of remuneration systems in publicly traded firms in UK. The graph below indicate that executives of privatised utility companies in the UK after 1990 were receiving a remuneration package that was equal if not more than publicly traded

¹⁵⁶ Peter Curwen, 'Director's Pay in Privatized Companies' (1994) 14(1) Public Money and Management, January-March 8-9.

¹⁵⁷ Lee Roach, 'The Directors' Remuneration Report Regulation 2002 and the Disclosure of Executive Remuneration' (2004) 25 Comp. Law 141, 141.

¹⁵⁸ Peter Hutton, 'Aligning the Organisation Around the Brand' (2001) Conference Paper, http://www.brandhomemuseum.com/docs/P0059_Aligning%20the%20organisation%20around%20the%20brand.pdf assessed 2 November 2011.

¹⁵⁹ Derailing the Gravy Train (1995) *Sunday Times* January 22nd.

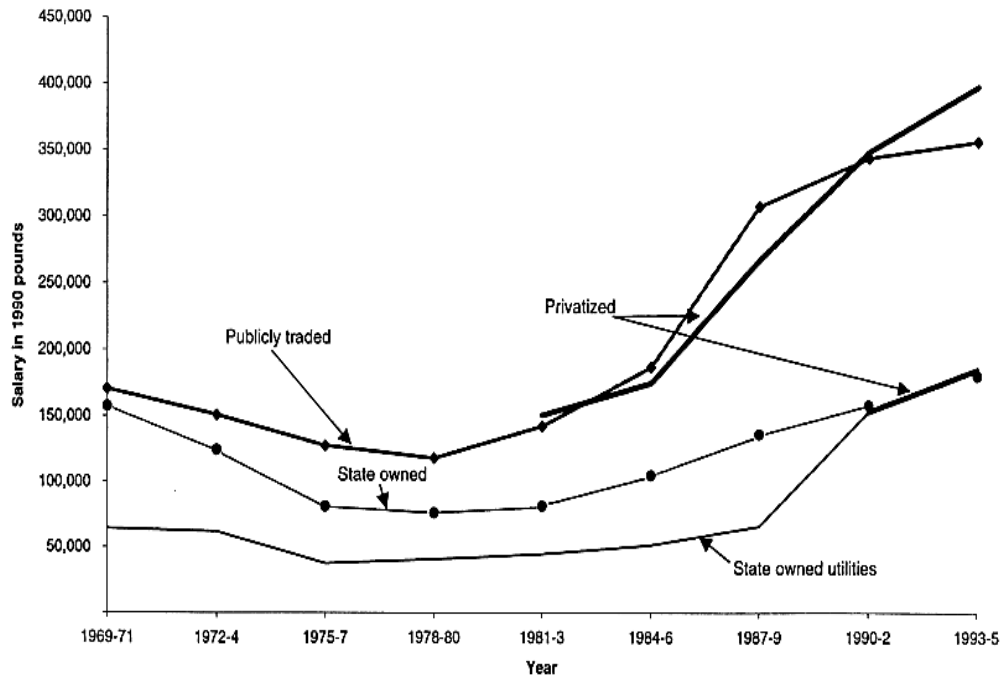
¹⁶⁰ 'Fat Cats in the Dock' (1995) *Economist* March 4th.

¹⁶¹ Martin Conyon, 'Directors' Pay in the Privatized Utilities' (1995) 32(2) BJIR 159-172.

¹⁶² Michael Cragg and IJ Dyck, 'Executive Pay and UK Privatization: The Demise of "One Country, Two Systems"' (2000) 47 JBR 3-18.

companies. Executives of non-privatised companies of the same industry (state owned utilities) were receiving less than their counterparts that were privatised. Looking at the graph it is obvious that privatisation increased executive remuneration levels.

Figure 4: Graphs indicating the level of executive pay in privatized utility companies¹⁶³



Although privatization is not still the driver of executive remuneration today, however, the effect of the part it played in the early 1990s is still being felt today as remuneration levels keeps increasing. Cedric Brown’s pay increases at the time was significant but cannot be compared to the present executive pay increases as they are many times more than Cedric Brown’s pay package at the time.

Globalisation and Executive Labour Market

The globalisation of the labour market, business operations and the capital markets produces incentives that result in a convergence in the remuneration practices worldwide. Globalisation in economic context includes:

¹⁶³ M Cragg and IJ Dyck, ‘Executive Pay and UK Privatization: The Demise of “One Country, Two Systems”’ (2000) 47 JBR 12.

the liberalisation and deregulation of markets, privatisation of assets, retreat of state functions... diffusion of technology, cross-national distribution of manufacturing production (foreign direct investment), and the integration of capital markets. In its narrowest formation, the term refers to the worldwide spread of sales, production and manufacturing processes all of which reconstitute the international division of labour¹⁶⁴

Executives in the US are the highest paid in the world.¹⁶⁵ This means that any non-US company facing US competitors, possessing US operations, employing a CEO capable of managing a US corporation, or exposed to the US legal environment has incentives to align their pay practices with those of the US companies.¹⁶⁶ The UK and other countries pay their executives less than their US counterparts however; their interaction with their US market may push up executive remuneration levels. Gerakos et al¹⁶⁷ studying 416 publicly traded UK companies over 2003-2007 found that UK firms that interact with US market are influenced by the US pay practices, with total remuneration increasing with firms exposed to the US market and the presence of US based operations. They found that the total remuneration of these companies had a direct relationship with the percentage sales derived from the US market and firms with greater sales using more incentive based pay.

It has been argued that the trade of UK companies with US companies puts pressure on the UK companies to offer similar pay packages to their executives to prevent them from taking up similar positions in peer companies with lucrative firms. However, a study by the High Pay Centre found that only 0.8% of UK companies recruited executives from outside UK, whilst 80% of the executives are promoted from within the company.¹⁶⁸ Although, the use of international talent is very limited, it might still have an impact on executive remuneration levels. One reason why US executives are paid the highest in the world is because US executive pay package is

¹⁶⁴ Richard Higgott and Simon Reich, 'Globalisation and Sites of Conflicts: Towards Definition and Taxonomy' (1998) CSGR Working Paper No. 01/98 1, 7.

¹⁶⁵ Brian Cheffins and Randall Thomas, 'The Globalisation (Americanization?) of Executive Pay' (2004) 1(2) Berkeley Bus. L.J. 223, 243.

¹⁶⁶ Joseph Gerakos, Joseph Piotroski and Suraj Scinivasan, 'Globalisation and Executive Remuneration: An Analysis of Pay Practices in UK Companies' (2009) <http://www.hbs.edu/units/am/pdf/Srinivasan.pdf> assessed 31 October 2011.

¹⁶⁷ *ibid.*

¹⁶⁸ 'The Myth of Global High Pay Talent Market' (2013) *High Pay Centre* February 11th.

highly incentivised as opposed to non-US companies.¹⁶⁹ Non-US companies place less emphasis on performance oriented pay and award executive remuneration packages that are less lucrative compared to their American counterparts. The award of variable pay is much more important component of executive remuneration package in US than any way else.¹⁷⁰ Share options and long-term incentive plans to base salary ratio are higher in US than non US counterparts. Annual bonuses for US executives are quite generous by world standards, but not inordinately so. Trading with US companies inevitably has a positive influence on executive pay levels in the UK.¹⁷¹

US executives do not sacrifice job security for higher pay as they are paid the highest in the world but with executives of non-US companies, there is a high potential of job sacrifice for higher pay. As a result of globalisation, most big companies are publicly traded with many investors owning blocks of shares. These investors could be from other countries trading in another and as a result there is bound to be a rise in executive pay levels.¹⁷²

The growing internationalisation of the executive labour market also accounts for increases in executive pay packages.¹⁷³ The international executive community has produced examples of executives using their business skills in countries other than their own. This is very common in companies of dual/cross listing in two or more share markets. Executives generally will want a remuneration package that is at least equivalent to what they can get elsewhere or can enjoy in other pursuits.¹⁷⁴ Executive remuneration packages are influenced by information available to the executives and any other source of negotiating power. Under the principal/agent dichotomy that arises from separation of ownership and control, information asymmetry is very important in the executive labour market.¹⁷⁵ This is because the executives acting like the agents in controlling the company are always in possession of very vital

¹⁶⁹ Towers Perrin, *Worldwide Total Remuneration 2001-2002*, 2001b.

¹⁷⁰ Brian Cheffins and Randall Thomas, 'The Globalisation (Americanization?) of Executive Pay' (2004) 1(2) *Berkeley Bus. L.J.* 223, 242.

¹⁷¹ *ibid*, 244.

¹⁷² *ibid*, 254.

¹⁷³ *ibid*, 256.

¹⁷⁴ Marc Gabarro, 'Top Executive Mobility and Firm Specific Skills' (2010) *Job Market Paper* <http://www.econ.upf.edu/docs/seminars/gabarro.pdf> accessed 11 March 2014.

¹⁷⁵ Productivity Commission, 'Executive Remuneration in Australia' (2009) Report No. 49, *Final Inquiry Report*, Melbourne 84.

information about the company. Considering that the company can only function properly with the information in the executive's possession, the executives can use this as a justification for high remuneration.

Executive remuneration packages should be designed to attract, motivate and retain executives.¹⁷⁶ A possible implication of this design is that companies would offer excessive pay to executives and justify it on the basis of attracting, retaining and motivating them.¹⁷⁷ Bebchuk and Fried¹⁷⁸ viewed this design of executive remuneration package as being the result from opportunistic exploitation of managerial power. They suggested that executive remuneration was subject to manipulation by the executives and using managerial labour market to justify their pay package. Gregory-Smith and Main¹⁷⁹ study considered the participation constraint in the executive labour market using a sample of 953 UK companies over the period 1995-2008, demonstrated that executives are more likely to move companies when their pay is low. The mobility of executives is more particularly when they are paid less than prevailing market conditions suggest is possible. The mobility of executives leads to increases in remuneration levels with the greatest improvement falling on the executives that switch companies. Marc Bolland left his former company (Morrisons) to join Marks & Spencer after the latter offered him a more lucrative pay package of £15m. In his first year, he was to receive at least £8.5m, a sum that includes £7.5m compensation for lost bonuses and shares that he would have received in his old job. On top of his basic salary, he could earn a bonus worth up to £2.5m. The package also included an 'exceptional' award of shares worth nearly £4m.¹⁸⁰

The fear of companies losing top management people as a result of global executive talent market can increase the level of executive pay in the UK. For example, in 2012 the Royal Bank of Scotland (RBS) awarded its then CEO, Mr Hester a £963,000

¹⁷⁶ FRC, *The UK Corporate Governance Code* (FRC 2012) D.1.

¹⁷⁷ Ian Gregory-Smith and Brian GM Main, 'Testing the Participation Constraint in the Executive Labour Market' (2013) http://homepages.ed.ac.uk/mainbg/Files/jobmoves2013_08_27.pdf assessed 11 March 2014.

¹⁷⁸ Lucian Bebchuk and Jesse Fried, 'Pay Without Performance: The Unfulfilled Promise of Executive Compensation' (2004) Harvard University Press, 2004; UC Berkeley Public Law Research Paper No. 537783.

¹⁷⁹ Ian Gregory-Smith and Brian GM Main, 'Testing the Participation Constraint in the Executive Labour Market' (2013) http://homepages.ed.ac.uk/mainbg/Files/jobmoves2013_08_27.pdf assessed 11 March 2014.

¹⁸⁰ Zoe Wood and Jill Treanor, 'The £15m Shopkeeper – Golden Hello for New M&S Boss Marc Bolland' *The Guardian* 1st February 2010.

bonus that was regarded as excessive and undeserving (he eventually gave it back), on top of his £1.2 million base salary. The company justified the bonus award by arguing that there was a real fear of losing Mr Hester and the rest of the board members had they been paid less.¹⁸¹ However, a report by the High Pay Centre on the contrary found out that lower pay does not drive executives overseas as 80% of executive appointments are promotions from within the company.¹⁸² Top management in the UK might be tempted to migrate to America to take up job opportunities that would offer them generous remuneration packages. As a result of this market force, the UK companies are forced to restructure managerial remuneration to close up the differences in pay package and retain their top management without fear of losing them.¹⁸³ The effect on remuneration package is not just as a result of executives from UK migrating to the US, but there exist same pressure when executives from the US migrate to the UK. Executives from the US are not prepared to migrate and assume a position in a different country if they are not going to be paid higher than he would receive in the US.¹⁸⁴ Thus UK companies recruiting from the US board will definitely pay more to attract, motivate and retain the executives and this ratchet up executive pay and eventually passed unto other companies in the same industry through benchmarking. The reason for which the UK would want to recruit executives from the US is because the US has a comparatively deep executive talent pool and UK companies might want to take advantage of this. The UK companies might also want to show to its investors that they are maximising shareholder value as their priority by employing highly skilled and talented executive in the executive market.¹⁸⁵ Gerakos et al¹⁸⁶ study found out that UK companies with executives that have US board experience tend to pay the executives more than companies without. UK companies do this to prevent the executives from seeking positions in a US peer company.

The competition for managerial skills and talent is causing most companies to want to recruit competent executives even from an international spectrum. Companies that

¹⁸¹ 'RBS Chief Stephen Hester's £963,000 Bonus Criticised' (2012) *BBC News*, January 27th <http://www.bbc.co.uk/news/uk-politics-16752358?print=true> assessed 27 January 2012.

¹⁸² 'Global CEO Appointments: A Very Domestic Issue' (2013) *High Pay Centre* February 12th.

¹⁸³ Brian Cheffins and Randall Thomas, 'The Globalisation (Americanization?) of Executive Pay' (2004) 1(2) *Berkeley Bus. L.J.* 223, 256.

¹⁸⁴ *ibid.*

¹⁸⁵ *ibid.*

¹⁸⁶ Joseph Gerakos, Joseph Piotroski and Suraj Srinivasan, 'Globalisation and Executive Remuneration: An Analysis of Pay Practices in UK Companies' (2009) <http://www.hbs.edu/units/am/pdf/Srinivasan.pdf> assessed 31 October 2011.

carry out business on an international scale seek executives who are capable of operating in a global market place irrespective of the country of origin. This internationalisation of the labour market has caused a significant convergence in executive pay between the UK and other countries.¹⁸⁷ UK companies, as well as other non-US companies, use the fear of losing their executives to defend and justify the significant increase in executive pay.¹⁸⁸ Further from the study of the High Pay Centre, this fear is not justified as most new appointments are staffs of the same company who have been promoted.

Factors affecting the executive labour market include supply of services, supply price and the company demands for executives. The minimum amount required by an executive is influenced by a number of factors. These factors include: the cost of accumulating the skills, education, experience, the nature of the job, the risk involved and the effort it demands, potential remuneration in alternative position, as well as any non-pecuniary benefits. Although there may be many people with managerial experience and qualifications, executive quality vary with limited number of executives perceived to have a range of key elements which includes leadership, communication and judgement skills to a sufficient high degree. Consequently, the sensitivity of supply of executive to the remuneration they get depends on the suitability of the executive to the job.¹⁸⁹

The function of the task, together with the skills and capability brought to the company by the executive determines the value of the executive. However, the demand value is always high in companies as executive functions can only be performed by an executive with appropriate characteristics. For a company that requires efficiency on the part of an executive will need to hire the most suitable executive, paying up the value of the executive contribution to the position. There is no single market price for executives as they all poses different abilities. Thus differences in their pay package reflect different levels of skills, talent and ability in a broadly similar job and willingness of the company to pay.¹⁹⁰ It therefore means that,

¹⁸⁷ Brian Cheffins and Randall Thomas, 'The Globalisation (Americanization?) of Executive Pay' (2004) 1(2) Berkeley Bus. L.J. 223, 257.

¹⁸⁸ Peter Martin, 'More Than Their Job's Worth' (1993) *Financial Times* May 15, at 8.

¹⁸⁹ Productivity Commission, 'Executive Remuneration in Australia' (2009) Report No. 49, Final Inquiry Report, Melbourne, pg 85.

¹⁹⁰ *ibid*, 87.

for a company to attract, motivate and retain talented executives, they must be prepared to pay what other potential companies are prepared to pay or even more.

If a US firm enters the UK executive labour market, it can also create an incentive to align pay with US executive pay practices. A US firm acquiring or starting a business unit in the UK may choose to pay their UK based executives in accordance with the US pay practices. Consequently, when other UK companies in the same industry benchmark with the US company the presence of the US company in the foreign market can exert pressure on the foreign company's remuneration practices.¹⁹¹ The presence of a US company in the UK market with its executive paid at the US rate causes disparities in pay within and across the firm. To alleviate the adverse incentive, the company may be required to revise its remuneration arrangement to resolve the differences in pay levels.

UK companies that list their shares on US exchange expose their executives to greater responsibilities and risk as a result of the company's exposure to US laws and legal environment. They would be expected to comply with US securities law and related regulation, including all provisions of the Sarbanes-Oxley Act and Foreign Corrupt Practices Act, exposing the executives to potential civil and criminal penalties. Listing on the US exchange will require the company to hire and/or retain a highly skilled executive able to comply with the market rules and thus will be expected to demand higher remuneration package to cover the incremental effort and extra risk borne.¹⁹² The UK and the US share strong economic interdependencies, with companies that have shares listed on each other's main exchange. The sharing of a common language and legal tradition and in many dimensions, similar financial and regulatory systems, there is an increase in the mobility of executive's talent between the two countries.

Transnational Mergers and Acquisitions

When two different companies from two different countries merge, there will be a need to merge managerial remuneration to a single pay system, as the two companies almost certainly had different remuneration arrangements. There is a convergence in

¹⁹¹ Joseph Gerakos, Joseph Piotroski and Suraj Srinivasan, 'Globalisation and Executive Remuneration: An Analysis of Pay Practices in UK Companies' (2009) <http://www.hbs.edu/units/am/pdf/Srinivasan.pdf> assessed 31 October 2011.

¹⁹² *ibid.*

remuneration practices following a merger, with the new company usually paying higher than what the executives had in their previous companies, if not adopting the remuneration practice from the company that paid more.¹⁹³ It is rare/almost impossible to find a company that will pay its executives the same or less after a merger.¹⁹⁴ Studies have proven that executive remuneration has a significant effect and relationship with the company size.¹⁹⁵ Consequently, increase in the firm size through acquisition could increase the remuneration of an existing executive, regardless of whether the acquisition creates value or not.¹⁹⁶ Companies always increase in size after a merger and as a result merger can be considered as drivers of executive remuneration. Companies increase the level of executive remuneration after mergers to avoid crippling efforts to attract, motivate and retain key incumbent talent.¹⁹⁷ No increase in the level of executive pay can cause the executives to seek for jobs in other companies that pay well.

The UK is one of the leading players in cross-border acquisitions, with an increase in the number and value of foreign acquisitions by UK companies since the mid-1980s.¹⁹⁸ When a UK company acquires a non-UK company, the home country remuneration practices are adjusted to facilitate the integration of the new businesses and to alleviate any pay disparities among the acquiring firm's executive relative to the target firm's executive.¹⁹⁹ Cross-border acquisitions may result in a complex organisation due to factors such as multiple currencies, cultural differences and geographical dispersion giving the executives to demand for higher levels of pay for the increase responsibility and risk that they are exposed to. The level of pay in the target company has a significant impact on executive remuneration in an acquisition.

¹⁹³ Paul Guest, 'The Impact of Mergers and Acquisition on Executive Pay in the United Kingdom' (2009) 76(301) *Economica* 149, 150.

¹⁹⁴ Brian Cheffins and Randall Thomas, 'The Globalisation (Americanization?) of Executive Pay' (2004) 1(2) *Berkeley Bus. L.J.* 223, 259.

¹⁹⁵ GP Baker, MC Jensen and KJ Murphy, 'Remuneration and Incentives: Practice Vs Theory' (1988) 63 *JF* 593-616; K.J. Murphy, 'Executive Remuneration' (1999) 3 *Handbook of Labor Economics* 2485-2563.

¹⁹⁶ Paul Guest, 'The Impact of Mergers and Acquisition on Executive Pay in the United Kingdom' (2009) 76(301) *Economica* 149, 149.

¹⁹⁷ Brian Cheffins and Randall Thomas, 'The Globalisation (Americanization?) of Executive Pay' (2004) 1(2) *Berkeley Bus. L.J.* 223, 259.

¹⁹⁸ Neslihan Ozkan, 'Do CEOs Gain More in Foreign Acquisitions Than Domestic Acquisitions?' (2012) 36(4) *JBF* 1122, 1122.

¹⁹⁹ Joseph Gerakos, Joseph Piotroski and Suraj Scinivasan, 'Globalisation and Executive Remuneration: An Analysis of Pay Practices in UK Companies' (2009) <http://www.hbs.edu/units/am/pdf/Srinivasan.pdf> assessed 31 October 2011.

Where the target's level of pay is lower than that of the bidder, there is a tendency for the target to increase their executive pay level to at least that of the bidder's level following acquisition. The same holds true for international acquisitions. With the US accounting for almost half of all cross-border acquisition by UK acquirers, UK acquiring US subsidiaries face huge internal pay inequalities which are often resolved by increasing home-country executive pay.²⁰⁰ Guest found out in his study on the impact of mergers on executive remuneration that pay changes resulting from acquisition are not affected by target nationality or organisational form, although cross-border acquisition results in higher executive remuneration.²⁰¹

Foreign acquisitions by UK companies lead to higher executive remuneration than domestic acquisitions. Executives who undertake acquisitions leading to a global diversification in the company's operations are paid higher. Girma et al²⁰² study on the impact of executive pay with the completion of acquisition activity found out that mergers increased the levels of executive pay. Their findings suggested that the executives of a company have more incentives to grow their companies by acquisition and merger as this will inevitably increase the size of the company and consequently their remuneration level. It can then be drawn from existing literature that the increase in executive pay after an acquisition is as a function of the increase in the company size after the acquisition.²⁰³ However, Girma et al studies also found significant and substantial executive pay increases in excess of those generated by growth in firm size consequent upon the merger. This could be explained by the fact that acquisition reveals more information about the quality of management (executive performance) which is useful to the firm's REMCO when setting executive remuneration.

The Growth of Multinational Companies

Companies that do business on a multinational scale almost always set executive pay levels at an agreed standard that will reflect the remuneration levels of the countries involved to ease the company-wide systems of promotion and incentivised

²⁰⁰ Paul Guest, 'The Impact of Mergers and Acquisition on Executive Pay in the United Kingdom' (2009) 76 *Economica* 149, 150.

²⁰¹ *ibid*, 149.

²⁰² Sourafel Girma, Steve Thompson and Peter Wright, 'The Impact of Merger Activity on Executive Pay in the United Kingdom' (2006) 73 *Economica* 321-339.

²⁰³ Peter Wright, Mark Kroll and Detelin Elenkov, 'Acquisition Returns, Increase in Firm Size, and Chief Executive Officer Remuneration: The Moderating Role of Monitoring' (2002) 45(3) *AMJ* 599, 599.

remuneration.²⁰⁴ Setting executive remuneration on a universal scale gives a uniform structure unlike on a local basis. UK companies that do business on a multinational scale with countries like the US (whose executives are the highest paid in the world) and adopting the universal remuneration level would mean adopting the US remuneration structure which will definitely increase the pay level.²⁰⁵ Companies that do business on a multinational scale are unable to pay levels with reference to the domestic remuneration norms, domestic national tax and consideration and other local conditions. Paying the executives in reference to the domestic characteristic will not lead to an increase in executive pay levels, but the pay structure may not be tenable for a multinational company headquartered outside the UK. Furthermore the company will not be able to keep up with the competition in the executive labour market, consequently, will be unable to attract, motivate and retain executives of a high quality.²⁰⁶ Executives that work in a multinational company have more responsibility and are also exposed to legal actions more and in return they always expect a lucrative pay package.

Board independence

Increases in executive remuneration are also driven by a weak or compromised board as they might be expected to give in to the executive demands for higher pay as opposed to an independent and competent board.²⁰⁷ In the UK, the board contains sub-committees that are responsible for different areas of the company. Among these committees is the REMCO²⁰⁸ The REMCO is responsible for setting the pay of all executives' directors and chairman of the company.²⁰⁹ This committee should be made up of independent non-executive directors (NEDs).²¹⁰ However, this committee is not totally independent from the board as the vital information they require to make informed decisions needs to come from the executives. The reliance of the REMCO on the executives for relevant information, gives the executives the opportunity to

²⁰⁴ Mark Baranski, 'Think Globally, Pay Locally: Finding the Right Mix' (1999) 31(4) Compensation Benefits Review July 15, 15.

²⁰⁵ Brian Cheffins and Randall Thomas, 'The Globalisation (Americanization?) of Executive Pay' (2004) 1(2) Berkeley Bus. L.J. 223, 260.

²⁰⁶ *ibid.*, at 261; JE Richard, 'Global Executive Remuneration: A Look at the Future' (2000) 32 Compensate Benefit Rev. 35, 35.

²⁰⁷ Productivity Commission, 'Executive Remuneration in Australia' (2009) Report No. 49, Final Inquiry Report, Melbourne pg 91.

²⁰⁸ Discussed in more detail in chapter 4.

²⁰⁹ FRC, *The UK Corporate Governance Code* (FRC 2012) Para. D.2.2.

²¹⁰ Discussed in details in chapter 4.

manipulate the information disclosed to the REMCO in a way that will work in their favour. Furthermore, the REMCO set the remuneration level of the executives bearing in mind that the satisfaction or dissatisfaction of the executives will either reflect their dismissal/retention on the REMCO or even in the company. The REMCO employ the services of the RCON to advise them on executive remuneration based on data from the market. Although, RCONs are experts in the market, their advice is not entirely objective as they are not independent from the board. They are paid by the board, and they also supply other services (advisory services such as share scheme, corporate tax planning, international taxation, and corporate finance) to the company apart from remuneration services. Consequently, they turn to act in favour of the executives rather than the shareholders to retain their positions and the other business deals they have the company.

Remuneration disclosure

It has been argued by Iacobucci²¹¹ that the enhanced requirement for the disclosure of executive remuneration in the company's annual report has been a significant contributor to pay increases. Remuneration disclosure improves access to market comparator information for both the executive and the board and could strengthen executive bargaining power.²¹² Disclosure requirements increase pressure on executives to set pay packages that are more sensitive to the company's performance. This adoption of pay sensitivity pay increases remuneration levels, because to provide incentive for executives, the size of pay would have to be more than pay without incentive.²¹³ Furthermore, linking pay to performance, the executive is risk-averse because if the performance targets are not met then he would lose the pay as well as the time and efforts put into the job consequently, the pay must be higher. The REMCO uses executive remuneration data from companies to make their own assessment of appropriate external relativities to benchmark their executives' pay levels. Disclosure makes this data available and each company aiming to reward its executive at the median or upper quartile which mounts autonomous pressure on the executive remuneration levels on all companies. The media, newspaper and magazines always list the remuneration of the top-earning executives, and with this

²¹¹ Edward Iacobucci, 'The Effects of Disclosure on Executive Compensation' (1998) 48(4) U Tor LJ 489, 503.

²¹² *ibid.*

²¹³ *ibid.*, 505.

information executives use it to establish their respective expectations and negotiating stances.²¹⁴

Shift to incentive pay

Principle D.1 of the UKCGC 2012 recommends that ‘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 as to link reward to corporate and individual performance’. This means that the bulk of a director’s pay should derive from performance-related components. Executive fixed pay on the contrary has risen in recent years from about £500,000 in 2000 to £800,000 in 2010.²¹⁵ The performance-related elements of executive directors’ remuneration should be stretching and designed to promote the long-term success of the company. As discussed above under the component of remuneration package, the forms of performance-related pay are worth many times the base salary. Annual bonuses could be worth 200% or more and long-term incentive plans 700% or more of base salary.²¹⁶ In the UK presently, there is a greater focus on LTIPs of the pay package. This is a measure to reduce the principal agent problem that might arise if executive are paid cash only. The focus on LTIPs is to get the executive to align their interest with that of the shareholders and maximise company profitability. The success of this scheme will depend on the quality of their implementation in practice. Their successful implementation will also depend on the quality of their design, which in turn is influenced by the capacities and experience of the executive.²¹⁷ LTIP introduces variability and hence uncertainty about the level of remuneration executives. The drive to link executive remuneration to company performance through the use of performance-related payments has resulted in the increase of average FTSE 100 executive bonus from about £300,000 in 2000 to £1 million in

²¹⁴ Productivity Commission, ‘Executive Remuneration in Australia’ (2009) Report No. 49, Final Inquiry Report, Melbourne, pg 97.

²¹⁵ Luke Hildyard, Huge Executive Salaries are Vital to UK Competitiveness (2013) NEF, pg 4, http://highpaycentre.org/files/NEF_mythbuster.pdf assessed 11 March 2014.

²¹⁶ High Pay Centre, ‘It’s How You Pay it: Making Sense of the Complicated World of Executive Pay’ (2012), pg 7 http://highpaycentre.org/files/hpc_03.pdf assessed 11 March 2014.

²¹⁷ Productivity Commission, ‘Executive Remuneration in Australia’ (2009) Report No. 49, Final Inquiry Report, Melbourne, pg 99.

2010, whilst long term incentive plans have risen from £200,000 to £1.4 million over the same period.²¹⁸

Peer benchmarking

Most companies today set executive pay benchmarking with other companies in the same industry (benchmarking is discussed in more detail in chapter 4). This practice is regarded as generating a ratchet effect that leads to continued growth in the level of pay. The company awards its executives a level of remuneration above median pay in their relevant peer group to signal to the market that the executive is of a high-quality. The REMCO relies on RCONs for advice on peer benchmarking. The REMCO are expected to offer a remuneration package with reference to the company's industry, size, performance, as well as the pay package should be able to attract, retain and motivate the executives. A remuneration package that effectively considers all of these elements is very difficult and the REMCO often than not strive more to retain the executives by offering them very attractive remuneration packages rather than putting more emphasis on the performance of the company. For example, in March 2014, the Co-Operative Bank ignored the poor performance and losses of the company, and was ready to offer their CEO a pay package of £3.6 million which contained a retention payment of £1.5 million.²¹⁹ One reason for this difficulty could be the fact that the market for executive is scarce and considering the present day complexity of executive duties, companies try more to retain their executives and putting the shareholder interest secondary.

The board of directors tend to determine executive pay with regard to executives of their peer companies, by upwardly adjusting the pay of the underpaid executives. This is done with the intention of providing pay package that can “attract, motivate and retain” an executive. For this reason the pressure to adjust pay would be stronger when executives are underpaid relative to other peer firms.²²⁰ In most cases the REMCO benchmarks pay levels across companies and industries with whom the firm

²¹⁸ Luke Hildyard, *Huge Executive Salaries are Vital to UK Competitiveness* (2013) NEF, pg 4, http://highpaycentre.org/files/NEF_mythbuster.pdf assessed 11 March 2014.

²¹⁹ James Salmon and Ted Thornhill, ‘Co-op in Chaos as Chief Executive Euan Sutherland Walks Out Days After £3.6million Pay Pot is Leaked as he Brands the Bank 'Ungovernable'’ MailOnline 11 March 2014.

²²⁰ Taekjin Shin, ‘Peer Comparisons of CEO Pay: Fair Pay or Power Play?’ (2008) http://www.ocf.berkeley.edu/~tshin/chapter4_ceo_11032008.pdf assessed 14 January 2011.

competes for talent. Even though the REMCO benchmark with the intention of ‘attracting, motivating and retaining’ directors, executive benchmarking has contributed largely to the continuous rise of executive remuneration. Benchmarking has the tendency of rising executive pay, as where the company is below pay level of their counterparts in their peer group with same size, talent, executive characteristics and industry, they turn to receive pay rise that are larger both in percentage terms and monetary terms.²²¹

The REMCOs may select peer groups with companies that have a higher executive remuneration. In a situation where a company benchmark against other companies that offer higher remuneration packages the effect will inevitably be a rise in the remuneration levels. One disadvantage of benchmarking is the existence of a wide range of market data and competitive pay levels giving executives more chance to influence their pay. At first sight, it seems that this is a sensible way of setting a total value for a remuneration package. Unfortunately over reliance on competitive pay data has resulted in upward spiral in executive remuneration.²²² Because salaries below the 50th percentile and often labelled “below market” while those between the 50th and 75th percentile are considered “competitive”, remuneration surveys have tended to “ratchet up” base salaries.

Conclusion

Executive remuneration packages have grown in complexity and size over the last three decades. Remuneration packages have moved from simple combination of base salary and benefits to a complex package that includes more elements (e.g. base salary, annual bonus, long-term incentive plans, pension schemes and benefits). Severance payment is not a component of the remuneration package per se, but its influence on pay package considering that it is agreed upon on the date of the executive appointment, makes it very important to be considered as a component of the remuneration package. The growth has been reflected in the responsibilities of the executives and consequently on the size of the pay package as well. The complexity of the modern remuneration package makes it more difficult for the shareholders to

²²¹ John Bizjak, Michael Lemmon and Lalitha Naveen, ‘Does the use of Peer Groups Contribute to Higher Pay and Less Efficient Remuneration?’ (2008) 90(2) JFE 152-168.

²²² Martin Conyon, Paul Gregg and Stephen Machin, ‘Taking Care of Business: Executive Compensation in the United Kingdom’ (1995) 105(430) EJ 704, 706.

comprehend executive pay and this may hinder their ability to hold the directors to account over it. This may also give the directors the opportunity to make benefits as they are the custodians of vital information needed for the appropriate designing of the remuneration package.

The increase in executive remuneration is influenced by a number of factors. Privatisation is seen as the first and primary driver of executive remuneration in the UK during the 1990s. Even though, privatisation is no longer the modern day driver of executive remuneration levels, other drivers of executive remuneration are just building on its effect. Disclosure requirements, executive labour market and globalisation are the most influential drivers of modern remuneration levels. The regulation of executive remuneration will not be effective if the remuneration package and the drivers of remuneration are not taken into consideration. The next chapter will discuss the methods used in this thesis to examine to understand how executive remuneration is determined and how some of these drives influence the pay setting process

Chapter 2: Research Methodology

Introduction

To understand the discussions and conclusion made in this thesis, this chapter will provide a description of the research design and methods are used to answer the aforementioned research questions. The study adopts a mixed method approach (which includes doctrinal, qualitative and quantitative analyses) which is all discussed in detail below. This chapter is divided into two sections. First, the research design will be explained and second, the research methods will discussed.

Research paradigm

Research design is an accepted set of theories, procedures, and assumptions about how researchers look at the world.²²³ It is important to discuss the research paradigms as they are related to the selection of research methodologies. Three different research paradigms have been adopted in this study to be able to answer the research question.

The first research paradigm is the legal realist approach of knowledge. Legal realism is an approach in thinking and studying the results of the application of the law.²²⁴ It is not only concerned with the origin and basis of the law, but also with its application and results. Furthermore, according to legal realist, law cannot be understood in an autonomous vacuum: law can only be understood as law in action, and this means paying due attention to law's sociological, political, economic and even psychological aspects. The legal realist advocates empirical approaches to understanding law. Based on this research paradigm the regulation of executive remuneration in the UK by the Companies Act 2006 and the UKCGC- will be discussed and empirical methods (qualitative and quantitative) will be used to investigate its impact on the companies and the public at large.

The second research paradigm is the constructivist approach of knowledge. Constructivism is the notion that knowledge lies in the minds of individuals, who

²²³ Roger Wimmer and Joseph Dominick, *Mass Media Research* (Cengage Learning 2013) 117.

²²⁴ Kevin Mackey, *The Triumph of Legal Realism* (2004) Digital Commons at Michigan State University College of Law 3.

construct what they know as the basis of their own experiences.²²⁵ The role of the researcher in this approach is to ‘attempt to understand individual construction of knowledge and ways in which individuals construct meaning’.²²⁶ Adopting this approach, this study relies on the participants’ experience and practice in relation to executive remuneration benchmarking. Executive remuneration benchmarking is an important determinant of executive remuneration levels. This benchmarking exercise is carried out by the RCONs. There exist no guideline on the method and factors to consider in benchmarking executive remuneration. Therefore, in order to understand the process involved in the benchmarking executive remuneration, the experience of the RCON need to be relied upon.

The third research paradigm is the positivist approach of knowledge. Positivist believes that reality can be observed and described from an objective viewpoint.²²⁷ Positivists hold that all phenomena should be understood through the employment of scientific method and aims to create a theoretically neutral language of observation by stripping hypothesis and theories of subjective content.²²⁸ For a positivist researcher, reality is objective and exists apart from the researcher. The role of the researcher in this approach is to use the research to generate laws and theories, test, support or reject theories.²²⁹ Adopting this approach, this study will be testing hypothesised relationships on executive remuneration (discussed later in the chapter).

Research design

A research design is a plan of the methods and procedures that is used by the researcher to collect and analyse the data needed to answer the research question(s).²³⁰ In this section the various methods used in this study will be discussed. A mixed method approach is used to discuss the existing law and corporate governance mechanisms on executive remuneration determination (using a legal doctrinal approach); evaluate the law and makes possible recommendations using an empirical (qualitative and quantitative) research approach. The evaluation of the law would be

²²⁵ Maggi Savin-Baden and Claire Howell Major, *Qualitative Research: The Essential Guide to Theory and Practice* (Routledge 2013) 29.

²²⁶ *ibid.*

²²⁷ Roger Wimmer and Joseph Dominick, *Mass Media Research* (Cengage Learning 2013) 117.

²²⁸ Hary Collins, *Creative Research: The Theory and Practice of Research for the Creative Industries* (AVA Publishing, 2010) 38.

²²⁹ Roger Wimmer and Joseph Dominick, *Mass Media Research* (Cengage Learning 2013) 118.

²³⁰ Paurav Shukla, *Essentials of Marketing Research: Part 1* (Ventus Publishing 2010) 26.

based on empirical, legislative and case law evidence. The justification for the use of mixed method approach will now be discussed.

Justification of mixed method approach

To understand the determination of executive remuneration it is important to assess the effectiveness of its regulation. The doctrinal approach is used to describe, explain and interpret the law, its administration and evaluate the effectiveness of the law. It lies at the basis of the role of law in executive remuneration determination and is the core legal research method. This study seeks to evaluate whether in practice ‘the rules’ of the law are complied with or effective in achieving any of the goals which underpins the setting of executive remuneration package. It is in this respect that an empirical mixed method approach is adopted as it aims to understand the law, lay the groundwork for reform, build up a set of generalisations about the law, support doctrinal method and contribute to the legal theory.²³¹ Priest commenting on mixed methods approach in legal studies said:

It is no longer sufficient to defend legal doctrine on the mere grounds that a rule is a rule, or that the doctrine derives from time immemorial. Rather, it is necessary to show that the doctrine has a beneficial effect on the society, is an expression of an important public value, or otherwise serves the public interest.²³²

The purpose of evaluating the law is to assess its effectiveness and to identify any gaps that may need attention. Traditional doctrinal research can benefit from a better clarification of the research question it seeks to answer by using empirical methods.²³³ Empirical methods build the theoretical understanding of the law as a social and political phenomenon and contribute to the development of social theory. In this research, for example, the qualitative analysis on how RCONs benchmark executive remuneration, would inform policy makers on executive remuneration benchmarking and its effect on remuneration determination process, and consequently remuneration levels.

²³¹ Peter Cane and Herbert Kritzer, *The Oxford Handbook of Empirical Legal Research* (Oxford University Press 2010) 979.

²³² George Priest, ‘The Growth of Interdisciplinary Research and Industrial Structure of the Production of Legal Ideas: A Reply to Judge Edwards’ (1993) 91 Mich. L. Rev. 1929, 1931.

²³³ JM Smits, *The Mind and Method of the Legal Academic* (Edward Elgar Publishing 2012) 115.

Watkins and Burton²³⁴ argued that legal scholarship must entail a sociological understanding of law which would involve a study of the law in practice from a stand point outside the legal system using scientific or social science methodologies. Using empirical investigation to determine the link between executive pay and company performance; and method of executive remuneration benchmarking will help inform policy makers on the determination of executive remuneration in the UK. It is therefore on this premise that this study adopted the mixed method approach to enable the researcher answer the research question. The mixed methods adopted in this study will now be discussed.

The doctrinal research method

Doctrinal research is research which provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty and, perhaps, predicts future developments.²³⁵ Doctrinal research in simple terms is the research which asks what the law is in a particular area.²³⁶ It consists of either a simple research directed at finding specific statement of the law or a more complex and in depth analysis of legal reasoning.²³⁷ The researcher's main objective is to describe the body of law, how it applies and provides an analysis of its application.²³⁸ This research demonstrates what the law and corporate governance mechanisms are in regards to executive remuneration (the determination of executive remuneration in particular) in the UK. Doctrinal research determines what the law is in terms of legislation and case law, but the application of the law is a contentious issue justifying the adoption of empirical methods (qualitative and quantitative methods).

Doctrinal research method is characterised by the study of legal texts and it is often described colloquially as 'black-letter law'. Doctrinal law is based on authority and hierarchy and the objective is to base any statement about what the law is on primary authority (legislation). Secondary sources such as journal articles or textbooks may be used in supporting a particular interpretation. The databases that are used in this study

²³⁴ Dawn Watkins and Mandy Burton, *Research Methods in Law* (Routledge 2013) 18.

²³⁵ Terry Hutchinson and Kylie Burns 'The Impact of "Empirical Facts" on Legal Scholarship and Legal Research Training' (2009) 43(2) *The Law Teacher* 153, 160.

²³⁶ Wing Hong Chui, *Research for Law* (Edinburgh University Press 2007) 18.

²³⁷ Adilah Abd Razak, 'Understanding Legal Research' (2009) *Integration and Dissemination* 19 at 20.

²³⁸ Wing Hong Chui, *Research for Law* (Edinburgh University Press 2007) 19.

would include relevant legislation on executive remuneration (e.g. the CA 2006). Furthermore, the UKCGC, case-law, textbooks and journals that cover the subject matter are used and cited where relevant. These sources will be used to identify and examine the regulations on executive remuneration determination, its application by companies and its implication on the remuneration levels.

Quantitative method

Quantitative research methods are one of the social science's approaches for research which has been used in different academic disciplines such as sociology, psychology and legal studies. It is used to test or verify appropriateness of existing theories to explain the phenomena under study.²³⁹ Quantitative research deals largely with numbers, statistics and reports its findings objectively – the researcher assumes a neutral position in this study. Quantitative methods will be used in this study to analyse relationships and test the hypothesis set below.

Hypothesis

Past studies in the UK investigating the link between executive remuneration and company performance have mixed results.²⁴⁰ These differences in findings maybe attributed to the use of different variables²⁴¹ in assessing the relationship between pay and performance. There exists a gap in knowledge as to why there exist inconsistencies in the findings of past studies which this study intends to find out. The study will also determine the effect of different performance variables on the pay for performance link.

Furthermore, limited (if any) research has been done to investigate the link between pay and performance on a company to company basis²⁴² to establish why the constant weak relationship. The individual company's method of measuring company performance is vital to the understanding of the link between pay and performance. Following the implied requirement of the law and the UKCGC recommendation,

²³⁹ Wing Hong Chui, *Research Methods for Law* (Edinburgh University Press 2007) 48.

²⁴⁰ Discussed in detail in chapter 5.

²⁴¹ Including performance measures, different components of the remuneration package, different time frames – discussed in detail below.

²⁴² Taking into account the performance measures used by the company to measure company performance

executive remuneration should be linked to company performance, thus following hypothesis is made:

H1: It is hypothesised that there is a significant positive relationship between executive/CEO remuneration and company performance.

Company size has been proven by past research as an important determinant of the level of executive remuneration as executive pay tends to increase with increase in firm size.²⁴³ Company size can increase as a result of expansion of the business, acquisitions or mergers which could be as a result of the good performance of the company. Assuming that growth in company size indicates good performance of the company, a strong relationship would be expected between company size and company performance²⁴⁴ which could in turn be used to justify the increase in executive remuneration. Thus the hypothesis:

H2: it is hypothesised that there is a significant positive relationship between executive/CEO remuneration and company size.

Several variables²⁴⁵ can be used to determine the size of a company. Depending on the variable used to determine the size of a company, it might not necessarily indicate that the company is performing well. This could therefore suggest that in such cases, the increase in executive remuneration due to the increase in company size is unjustified. The performance of the company and the growth of the company are used by companies to justify executive remuneration. It is important to investigate if company size is strongly related to company performance as to justify increase in executive pay based on these factors. If growth in company size increases executive remuneration and good company performance also increases executive remuneration then a significant relationship between size and performance to will be expected to justify pay levels. Thus the hypothesis:

²⁴³ Peter Kostiuk, 'Firm Size and Executive Compensation' (1990) 25 JHR 90,104.

²⁴⁴ Past studies have confirmed that there exist a strong relationship between company size and executive remuneration, e.g. Peter Kostiuk, 'Firm Size and Executive Compensation' (1990) 25 JHR 90-105.

²⁴⁵ e.g. market capitalisation, total revenue, total assets etc. – terms defined and explain later under this section.

H3: it is hypothesised that there is a significant positive relationship between company size and company performance.

The researcher will investigate these hypothesis from a positivist stance (as explained above) adopting a quantitative method of research.

Data sample

The sample population for this study was the FTSE 100 companies listed in 2010. This sample population was chosen because they are usually the ones in the spotlight on executive remuneration issues. The researcher classified the one hundred companies under different sectors as demonstrated in the table below.

Table 1: 2010 FTSE 100 companies classified into their various sectors

Sector	Companies (plcs)
Aerospace	BEA Systems, Roll-Royce
Catering, information, support, publishing, Testing and Security	Capita Group, Compass Group, Intercontinental Hotel Group, Whitbread, G4S, Experian, Reed Elsevier, Intertek Group, Serco Group
Consumer goods, Brewery, Beverages and computer software	SABMiller, Reckitt Benckiser, Sage Group, Diageo, Autonomy Corporation
Engineering	Amec, Smiths Group, GKN, IMI, Petrofac, Weir Group
Financial services and banking	Barclays Bank, Lloyds TSB banking group, HSBC, ICAP, Legal and General, Man Group, Prudential, Royal Bank of Scotland, Standard Chartered Bank, Standard Life, Alliance Trust, Investec Bank
Generator hire	Aggreko
Insurance	Admiral Group, Aviva, Old Mutual, Royal & sun Alliance
Investment	Resolution, Schrodes
Microprocessors	ARM Holdings
Mining	Eurasian Natural Resources, Rio Tinto Group, BHP Billiton, Antofagasta, Anglo American, Lonmin, Vandanta Resources, Xstrata, Fresnillo, African Barrick Gold, Kazakhmys
Pharmaceuticals, chemical and medical device	GlaxosmithKline, Johnson Mattley, Shire, Smith & Newpew, Astrazeneca
Real estate and property	British Land, Land Securities, Hammerson, Capital Shopping Centers
Retail, packaging, distribution and clothing	Associated British Food, Mark and Spencer, WM Morrison Supermarket, Rexam, J. Sainsbury, Tesco,

	Next, Kingfisher, Bunzl, Burberry
Telecommunication and communication	Vodafone, BT Group, British Sky Broadcasting, WPP Group, Inmarsat
Tobacco	British America Tobacco, Imperial Tobacco
Transportation, Aviation	Carnival, Tui Travel, International Airlines Group, Invensys
Utility and energy	BG Group, International Power, Royal Dutch, Scottish & Southern Energy, Severn Trent, United Utilities, British Energy Group, National Grid, Tullow Oil, Cairn Energy, Centrica, Essar Energy

Five sectors were chosen to provide an effective cross-section of industries. These sectors were financial, retail, mining, pharmaceutical and utility sectors. From each sector, five companies were chosen to be studied. Three sectors (pharmaceutical, financial and utility) out of the five were chosen for particular reasons. The financial sector was chosen due to the financial crisis the sector suffered over recent years (2008-2009 banking crisis). Part of the reason for the crisis was attributed to excessive executive remuneration.²⁴⁶ The pharmaceutical sector was chosen because one of its companies was the first²⁴⁷ to see its executive remuneration report voted against by the shareholders.²⁴⁸ The utility sector because the debate on executive remuneration has its roots in the privatization of utility companies in the 1990.²⁴⁹ The retail and mining companies were chosen at random from the rest of the sectors to provide the researcher with a cross section of sectors for comparison. This resulted in a sample size of twenty-five companies chosen from the one hundred companies that made the FTSE 100 listing of 2010.

All the one hundred companies could not be included in the study because the volume of data would have been with no sufficient time to collect, analyse and write-up the thesis. To make selection manageable, 1996 was chosen as the start date because it is the year in which most companies started disclosing executive remuneration by

²⁴⁶ Nathan Dong, 'Excessive Financial Services CEO Pay and Financial Crisis: Evidence from Calibration Estimation' (2014) 27 *Journal of Empirical Finance* 75-96.

²⁴⁷ First in the history of UK corporate governance.

²⁴⁸ GlaxoSmithKline remuneration report voted down in 2003.

²⁴⁹ Justine Simpson and John R Taylor, *Corporate Governance Ethics and CSR* (Kogan Page Publishers 2013) 139.

components²⁵⁰ providing data for the study. Data collection stopped at 2011 because the researcher needed a cut-off date to allow time to collect and analyse the data.

The annual report and accounts for each company were obtained from the company's website for the years 1990-2011. Five out of the 25 companies were formed through mergers at some point within the study period. These companies include GlaxoSmithKline plc, ICAP plc, Lonmin plc, Scottish & Southern Energy plc and AstraZeneca plc indicating that the data for these companies did not go as far back as 1996. Below is a table representation of the five sectors and the companies that were selected.

Table 2: 25 selected 2010 FTSE 100 companies classified into sectors

Company	Pharmaceutical Sector	Utility Sector	Retail Sector	Financial Sector	Mining Sector
1	GlaxoSmith Kline plc	Severn Trent plc	Tesco plc	HSBC plc	Antofagasta plc
2	Shire plc	Scottish and Southern Energy plc	J. Sainsbury plc	Barclays plc	Rio Tinto plc
3	Johnson Matthey plc	United Utilities plc	WM Morrisons plc	ICAP plc	Lonmin plc
4	Smith and Nephew plc	National Grid plc	Kingfisher plc	Legal & General plc	Xstrata plc
5	AstraZeneca plc	Cairn Energy plc	Mark and Spencer plc	Prudential plc	BHP Billiton plc

Out of the 25 companies 19 was analysed and discussed. The six companies out of the 25 companies that are not analysed were: GlaxoSmithKline plc, BHP Billiton plc, Xstrata plc, AstraZeneca plc, Rio Tinto plc and, Antofagasta plc. These six companies

²⁵⁰ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee 1995) Para. 5.8.

were from the Pharmaceutical and Mining Sector. These companies were not proceeded with because of the inconsistent disclosure of information in annual reports and accounts. Their remuneration figures were disclosed in dollars with no indication of the exchange rate used at the time. For GSK, the annual report and account indicated that the dollar to pounds exchange rate considered was the average exchange rate of the year. Exchange rate changes on a daily basis and to get the average for the year was a difficult task, as a result the companies were excluded from the analysis. These companies were not replaced with other companies from the same sector, or replaced the sector with another because the reason for their exclusion demonstrate an example of inconsistencies in executive remuneration disclosure methods discussed in chapter 6.

Data collection

The executive remuneration data was obtained from the annual report and accounts.²⁵¹ The act of selecting the required data from the company's annual report and accounts is a method that had been used in the past by McKnight and Tomkins²⁵² and Buck et al.²⁵³ This method of data collection has an advantage over data obtained from a database in that the researcher determines the information needed and is able to carry out any statistical calculation using methods which the researcher desires. Whereas, with data obtained from a database information is predetermined by the data provider and limited only to one or two calculations. This method therefore, allows the researcher to utilise data in a way which best fits into the research design of the study.

The selected companies do not have the same fiscal year. Some of the companies have fiscal year beginning in April and ending in March, while others run from January to December or, November to December which is typical of UK firms. This difference in accounting years can cause a problem when comparing companies and results. There was no attempt on standardising the fiscal year as it would have been difficult because some companies may defer their fiscal year to a later date in the accounting year, or bring forward their accounting year to an earlier date.

²⁵¹ Notably the remuneration report.

²⁵² P.J, McKnight and C, Tomkins, 'The Implications of Firm and Individual Characteristics on CEO Pay' (2004) 22 Eur Manage J 27-40.

²⁵³ T, Buck, A, Bruce, B.G.M., Main and H, Udueni, 'Long Term Incentive Plans, Executive Pay and UK Company Performance' (2003) 40 JOMS 1709-1727.

Company performance is measured by the variables total shareholder return (TSR), earnings per share (EPS) and return on assets (ROA). TSR is the total return on investment achieved for shareholders during the review period.²⁵⁴ This is the net stock price change plus the dividends paid during a particular period. It measures share price growth and dividends. Stock price represents the cost of one share of the company. Data for the calculation of TSR which include: share price at the start of period, share price at the end of period and dividend paid under the period, was obtained from the annual report and accounts. EPS is earnings available to the shareholder²⁵⁵ divided by the number of common shares outstanding (shares of the company that has been issued and are in the hands of the public).²⁵⁶ Data for the calculation of EPS (diluted and basic) were obtained from the annual reports and accounts. Return on equity (ROE) is another profitability performance measures which assess the rate of return on the ownership interest or shareholders' equity of the common stock. It is a measure that shows how much profit a company has made from the money shareholders invested in the company.²⁵⁷ Data for ROA, market capitalisation, total assets and total revenue were obtained from the Bloomberg database. There are several performance measures that can be used to measure company performance. However, each performance measure has a limitation and the limitations of the three performance measures used in this study are acknowledged.²⁵⁸ In order to understand how the statistical analysis were done, it is important to understand the variables used in the calculations.

Definition of variables

For the purpose of this study, executive remuneration, company performance and company size are defined using different variables. The increase or decrease in the levels of executive remuneration will depend on the increase or decrease of company performance and company size meaning that executive remuneration is a dependent variable as it depends on company performance and company size. Company size and

²⁵⁴ Jane King and Mary Carey, *Personal Finance: A Practical Approach* (Oxford University Press 2013) 131.

²⁵⁵ Excluding preferred shareholders as they receive fixed dividend amount.

²⁵⁶ Pamela Peterson Drake, Frank J Fabozzi, CFA, *Analysis of Financial Statements* (John Wiley & Sons 2012) 156.

²⁵⁷ William Hettinger and John Dolan-Leitlinger, *Finance without Fear: A Guide to Creating and Managing a Profitable Business* (Inst for Finance & Entrepren 2011) 156.

²⁵⁸ A few performance measures and their limitations are discussed in chapter 5.

company performance are the independent variables as their increase or decrease does not depend on the increase or decrease in levels of executive remuneration.

Dependent variables

Dependent variables are variables whose values are determined by other variables. For example, the levels of executive remuneration (dependent variable) are determined by the performance of the company (independent variable). Three variables of directors' remuneration were obtained from the annual report and accounts (particularly from the remuneration report). These are total remuneration, total cash remuneration and performance-related pay.

- Total cash pay includes, base pay and benefit pay.
- Performance related pay includes annual bonuses, LTIPS and share options.
- Total remuneration includes base pay, benefits, cash bonus, deferred bonuses; LTIPs pay and, share options (which are basically total cash plus performance-related pay).

In this study loss of office pay is not included in the pay package as it is not a constant payment and only given to directors who are leaving the company. Also, pension payment is not included as it is regarded as personal savings.

Independent variables

An independent variable is a variable whose change does not depend on the other e.g. performance does not depend on executive remuneration. There are two sets of independent variables used in this study – company performance and company size. Company performance is the independent variable which can be measured by using TSR, EPS and ROA.²⁵⁹ TSR is chosen for this study because it is the total return on investment achieved for shareholders. It is an important measure considering that the main purpose of performance-related pay is to align the interest of the directors with those of the shareholder. TSR was also chosen based on its long term potential. The stock price at the start of the period and the stock price at the end of the period were obtained from Bloomberg data stream. Dividends were hand collected from the

²⁵⁹ These variables are explained in details in chapter 5, pp177-181.

annual reports. ROA was chosen because it does not have the shortcomings of Return on equity which is the commonly used financial performance measure. ROA values were obtained from Bloomberg data stream. EPS values were obtained by adding values of basic EPS to values of diluted EPS²⁶⁰ obtained from Bloomberg data stream. EPS was chosen because it the most important measurement and indicator of financial performance of a company that is universally accepted because it drives the share price of a company.

The second independent variable used in this study is company size. Company size could be measured using a variety of variables which includes total sales, total employee heads, market capitalisation, total assets etc. Three variables for measuring company size adopted by this study include market capitalisation, total asset and total revenue. Market capitalisation was chosen as it is a common variable used by most companies to determine company size. Total asset is often rarely (as compared to total revenue) used by companies and academia to determine company size. Using these three variables would allow the study to investigate whether they all demonstrate the same relationship with executive remuneration. These variables would now be discussed in turns below.

Market capitalisation is the total value of the company based on its current share price multiplied by the number of outstanding shares.²⁶¹ Outstanding shares are the company's shares currently held by its shareholders and restricted shares are shares owned by the company. A company's outstanding shares can increase if the company issues more shares. Market capitalisation depends on the share price of the company at a particular time. The share price of the company can decrease or increase at any given period. Therefore, depending on the share price volatility (constant changes in share price) the market capitalisation of a company (the worth of the company) can significantly increase with the increase of share price without an increase in the number of shares. If the company issues new shares and the share price is at its best for the period, it would lead to a significant increase in market capitalisation. Measuring company size by market capitalisation would therefore indicate a

²⁶⁰ Diluted EPS represents the earnings per share a business would have generated considering all dilutive securities (e.g. share options and convertible debt).

²⁶¹ M Ranganatham, *Investment Analysis and Portfolio Management* (Pearson Education India 2006) 148.

significant increase in the company size. For example, Shire plc at the beginning of the financial year in 2011 had a share price of £15.35 and at the end of the financial year the share price had increased to £22.43 per share. This increase in share price for the company would indicate a significant growth in the size of the company. However, the fall in the share price of the company at any given time would result into the decrease in market capitalisation consequently, a decrease in the size of the company. This share price volatility pose a weakness to the use of market capitalisation as an effective measure of company performance. Total assets represent the total value of the entire assets (tangible and intangible) of the company. Tangible assets are assets that can be physically seen and touch such as machinery and intangible assets are those that cannot be felt such as patent and copyrights. The value of total assets will fluctuate depending on whether the company is acquiring or disposing of the assets and the effect will be a change in company size. Total assets are presented in the balance sheet of the company's annual reports and account. It takes into account all the properties of the company and not the debt and liabilities of the company. Total asset could be presumed as a better indicator of company size than market capitalisation because market capitalisation depends on share price that is not determine by the company but the selling or buying of assets is a decision of the company and also a better indicator of directors performance.

Total revenue as discussed above, is money the company makes over a period of time before expenses are deducted. Depending on how much money the company makes over a particular period and its expenses, this will affect the size of the company either positively or negatively.

Data analysis

A statistical package for the social science (SPSS) is used to analyse the relationships between executive pay and company performance; executive pay and company size; and company size and company performance. SPSS is a computer application that provides statistical analysis of data and allows for analytical reporting. This method of data analysis was chosen because it was relatively easy to learn and the ease of obtaining results after loading all the data on to the system. By using this program quantitative data is analysed quickly, eliminating long hours of calculations and

mistakes that comes with it.²⁶² In determining the relationships between executive pay and company performance, executive pay and company size and company size and company performance, Pearson's correlation coefficient will be used in the calculations to determine the strength of the relationships between these variables. Pearson's correlation coefficient represents the linear relationship between two variables. A linear relationship represents a relationship in which any given change in one variable (independent variable) should always produce a corresponding change in the other variable (the dependent variable). This means for example that, for a linear relationship between company performance and executive pay, a one per cent increase in company performance should also result in a one per cent increase in executive pay. Pearson correlation coefficients will be calculated to examine the linear relationship between CEO remuneration, company performance, and company size.

The correlation coefficient takes on values ranging between +1 and -1. A 0 value indicates no linear relationship. For example that, if the correlation coefficient obtain for the relationship between executive pay and company performance is 0, it means that there is no relationship between the two suggesting that they are independent of each other. A Pearson's correlation coefficient of +1 indicates a perfect positive linear relationship. This means that as one variable increases in value, the other variable also increases in value through an exact linear rule. For example, if the correlation coefficient obtained is +1 for the relationship between executive pay and company performance, it means that there is a perfect positive relationship between the two (e.g. if company performance increases by ten percent, executive pay will also increase by exactly ten percent). A Pearson correlation coefficient between 0.5 – 0.99 will indicate a strong positive relationship. Correlation coefficient between 0.3 – 0.499 will indicate a positive moderate relationship and a correlation coefficient between 0.01 – 0.299 will indicate a positive weak relationship.

A Pearson's correlation coefficient of -1 indicates a perfect negative linear relationship. This means that as one variable increases in its values, the other variable decreases in its values through an exact linear rule (e.g. if company performance increases by ten percent, executive pay will decrease by exactly ten percent). A

²⁶² Alan Bryman and Duncan Cramer, *Quantitative Data Analysis with SPSS Release 10 for Windows: A Guide for Social Scientists* (Routledge 2002) 15.

Pearson correlation coefficient between -0.5 – -0.99 will indicate a strong positive relationship. Correlation coefficient between -0.3 – -0.499 will indicate a positive moderate relationship and a correlation coefficient between -0.01 – -0.299 will indicate a positive weak relationship. The table below sets out Pearson’s correlation coefficient values and what the values mean.

Table 3: Pearson’s Correlation Coefficient table and meaning

Pearson’s correlation coefficient	Meaning
+1	Perfect positive relationship
0.5 to 0.99	Positive strong relationship
0.3 to 0.5	Positive moderate relationship
0.1 to 0.3	Positive weak relationship
0	No relationship
-0.1 to -0.3	Negative weak relationship
-0.3 to -0.5	Negative moderate relationship
-0.5 to -0.99	Negative strong relationship
-1	Perfect negative relationship

Pearson’s correlation coefficient is adopted as the most suitable because the data is continuous and not ranked or grouped.²⁶³ Total cash pay, total variable pay and total pay are the variables for executive remuneration. Market capitalisation, total revenue and total asset are the variables for company size. Total shareholder return, return on asset and earnings per share are the variables for company performance. The objective of linking pay to performance is to ensure that executive remuneration is linked to the company’s performance. Following this objective, it would therefore mean that executive remuneration will be expected to increase when the company makes profits and decrease/remain the same when the company profits decreases or remains the same.

²⁶³ Ranked or grouped data is suitable to be analysed using either Kendall or Spearman correlation coefficients.

Qualitative methods

Qualitative study is research that focuses on understanding the naturalistic setting or everyday life, of a certain phenomenon or person.²⁶⁴ Qualitative researchers study things in their natural settings, collecting, analysing and interpreting data in an attempt to make sense about a phenomenon in terms of the meaning people bring to them.²⁶⁵

The main objective of this research is to examine the regulation of executive remuneration determination in the UK. The qualitative study is aimed at understanding how RCONs influence executive pay setting process and what factors they take into account in benchmarking executive pay. The CA 2006, under the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, part 3, s22, requires all quoted companies to disclose the names of any remuneration adviser (consultants) used, whether they provide any other services to the company, and how their advice was assessed as objective by the company. Consultants advise companies on the setting of executive remuneration by comparing (benchmarking) the remuneration of executives across companies. This practice has become common amongst quoted companies in the UK, but there exists no best practice or guidelines on the criteria for benchmarking. This therefore implies that only the consultants know what criteria they employ in executive benchmarking which this study sets to investigate. Past academic literature on RCONs focused on their influence on the remuneration levels²⁶⁶, but no study has investigated the criteria for benchmarking. Qualitative method is used because the only way of getting information is by interviewing the consultants.

The key criteria in a qualitative study as identified by Maxwell²⁶⁷, is the activities of collecting and analysing data, developing and modifying theory, elaborating or refocusing the research question, and identifying and dealing with validity threats

²⁶⁴ Helle Neergaard and John P Ulhio, *Handbook of Qualitative Research Methods in Entrepreneurship* (Edward Elgar Publishing 2007) 383.

²⁶⁵ *ibid.*

²⁶⁶ Ruth Bender, 'Paying For Advice: The Role of the Remuneration Consultant in UK Listed Companies' (2011) 64 *Vand. L. Rev.* 361-396; Ruth Bender, *Executive Compensation Consultants* (2011) Executive Compensation and Corporate Governance Conference Paper; Martin Conyon, 'Executive Compensation Consultants: Empirical Evidence from the United States and United Kingdom' (2007) ESSEC Business School and the Wharton School, Working Paper.

²⁶⁷ Joseph A Maxwell, *Qualitative Research Design: An Interactive Approach: An Interactive Approach* (SAGE 2012) 2.

(factors that affect research findings). This study involved the collecting of data from the RCONs by interviews, analysing and interpreting the data to help answer the research question. Different studies²⁶⁸ have identified differences between qualitative and quantitative research approaches, but the one key issue that distinguishes the two is in the methods of data collection. Qualitative method allows for data to be collected which cannot be obtained from quantitative studies.²⁶⁹ Qualitative research study ‘things’ in their natural settings, attempting to make sense of, or interpret phenomena in terms of meanings people bring to them.²⁷⁰ For this study the nature of data required to understand the executive benchmarking process is dependent on the information collected from the RCONs. This research design was greatly affected by access to the participants which will be discussed in detail below.

Sampling

For this study the purposeful sampling approach was adopted. Purposeful sampling is a strategy in which particular persons are selected deliberately to obtain information that cannot be obtained from other methods.²⁷¹ This approach is used where the researcher already knows something about the specific people, allowing the researcher to deliberately select people that are seen as likely to produce the most valuable data. They are selected with a specific purpose in mind, and that purpose reflects the particular qualities of people and their relevance to the topic under investigation.²⁷² The advantage that this approach possesses over others is that, it is more concerned with the appropriateness, purpose and access to good information than representation and random probability statistical sampling.²⁷³ Random statistical sampling is a characteristic of quantitative research intended to produce results that may be generalized to a larger population; whilst purposeful sampling is a characteristic of qualitative research intended to draw emphasis on appropriate information that elicit a

²⁶⁸ For example, Michael Q Patton, *How to use Qualitative Methods in Evaluations* (Sage 1987); H Russell Bernard, *Research Methods in Anthropology* (Rowman Altamira 2011).

²⁶⁹ Dimitra Hartas, *Educational Research and Inquiry: Qualitative and Quantitative Approaches* (Continuum 2010) 27.

²⁷⁰ R Murray Thomas, *Blending Qualitative and Quantitative Research Methods in Theses and Dissertations* (Corwin Press 2003) 1.

²⁷¹ Maggi Savin-Baden and Claire Howell Major, *Qualitative Research: The Essential Guide to Theory and Practice* (Routledge 2013) 314.

²⁷² Denscombe Martyn, *The Good Research Guide: For Small-Scale Social Research Projects: for Small-scale Social Research Projects* (McGraw-Hill International 1 Aug 2010) 35.

²⁷³ Rebecca Marschan-Piekkari and Catherine Welch, *Rethinking the Case Study in International Business and Management Research* (Edward Elgar Publishing 2011) 177.

detail understanding of a particular phenomenon.²⁷⁴ It allows for small samples to be studied intensively with each one generating a large amount of information. This approach enables the researcher to limit the sample to participants that would provide appropriate information relevant to answer the research question, and exclude participants that do not fit the criteria of selection. Finally, the sampling approach allows for possible analytical generalisations but not statistical generalisation because the sample size is generally small.²⁷⁵

For this study, a guide as to the sample population was obtained from the 25 companies chosen for this study as they disclose their RCONs in the company's annual reports and accounts (particularly in their remuneration report). From the twenty-five companies' remuneration reports, nineteen consultancy firms were identified. It was realised that seventeen out of the twenty-five companies used one or more consultancy firms from the 'Big Four'.²⁷⁶ Out of the nineteen consultancy firms identified, five were US based and the rest fourteen were UK based or had branches in the UK. A random list of fifty consultants was shortlisted from the 14 consultancy firms based in the UK.

The subject matter of this study covers consultancy firms that engage in executive remuneration benchmarking. This is because the aim of the study is to understand the process of benchmarking, the factors chosen and why they are considered for selecting comparator companies. The RCONs were the appropriate people for this study because they maintain proprietary databases which collect comparative data on pay levels and structures in different industries and sizes of business. This information supplemented by surveys conducted by the consulting firms, are used in comparing market levels of pay. From this information, the RCON would then advise the REMCO on comparators they should use in determining executive pay.²⁷⁷ The RCONs are experts in the field of benchmarking and their advice have considerable influence on the level of pay. It means that only the RCONs will possess this type of

²⁷⁴ Susan Jones, Vasti Torres and Jan Arminio, *Negotiating the Complexities of Qualitative Research in Higher Education: Fundamental Elements and Issues* (Routledge 2013) 207.

²⁷⁵ Maggi Savin-Baden and Claire Howell Major, *Qualitative Research: The Essential Guide to Theory and Practice* (Routledge 2013) 314.

²⁷⁶ The Big Four consultancy firms are made up of Deloitte, KPMG, Ernst & Young and PricewaterhouseCoopers.

²⁷⁷ Ruth Bender, 'Executive Compensation Consultants' (2011) Executive Compensation and Corporate Governance Conference Paper 5.

information, and may not give people access to this data because of commercial confidentiality- consequently the interviews required.

Pilot study

A pilot study is a study that takes place before the actual study to determine the feasibility and limitations of the study.²⁷⁸ This includes conducting a preliminary study on a limited scale before the original study is carried out in order to gain some primary information, on which the main research would be planned and formulated.²⁷⁹ In this study the purpose of the pilot study was to get primary information on the methods of benchmarking, and also to test whether the methodology adopted for the study would yield desirable results. Due to lack of access to participants for the study, one participant was used as a pilot study. Out of the six willing participants, only one agreed to a face-to-face interview and the rest choose telephone interviews for convenience. The participant who agreed on a face-to-face interview was used as a pilot. It was explained to the participant on the reasons of considering the interview as a pilot and consent was given to the interview by the participant. A pilot study was undertaken to identify the factors that are considered when benchmarking, which elements of the pay package that were considered for benchmarking and what they considered was the effect of benchmarking on executive remuneration. The importance of doing a pilot study is that it helps in identifying problems in research methodology, data gathering technique and also important in determining the questions which could be used in the interviews.²⁸⁰ The pilot study was conducted to evaluate the suitability of the interview questions in achieving the research aim. An unstructured open-ended interview was held with one RCON for the pilot study. From the pilot study, it was clear that the research design was suitable and would yield desirable results for the study which was to investigate the method employed in benchmarking executive remuneration.²⁸¹ Information from the pilot study was used in the final analysis as excluding the pilot study would result in too small a sample in

²⁷⁸ James Mauch, Namgi Park, *Guide to the Successful Thesis and Dissertation: A Handbook For Students And Faculty* (CRC Press 2003) 136.

²⁷⁹ Sam Daniels and Aroma Sam, *Research Methodology* (Gyan Publishing House 2011) 137.

²⁸⁰ Graeme Ruxton, Nick Colegrave, *Experimental Design for the Life Sciences* (Oxford University Press 2011) 18-19.

²⁸¹ Sam Daniels and Aroma Sam, *Research Methodology* (Gyan Publishing House 2011) 137.

the main study.²⁸² In qualitative research, some or the entire pilot can be included in the main study were excluding the pilot would result in too small a sample.²⁸³ This interview identified different factors considered in benchmarking, why they are considered and also which elements of the remuneration package are considered in the benchmarking process. This then set a platform on which the rest of the interviews were conducted as well as served as probes for the interviews where necessary.

Access to participants

The selection of interview participants was based on the information that was published on each consultancy firm's website. The participants were identified from the firm's websites by job role (RCON), name, emails and their office telephone numbers. The first problem encountered was that some of the firm's websites were not up to date and therefore had the names of persons that had left the firm. Invitation letters, information sheets and consent forms, were dispatched to the randomly selected 50 consultants by post. These invitations yielded two positive responses and 4 negative responses. Despite the low rate in responses, Pirkko & Silk²⁸⁴ said response rate in qualitative study can range from one to one hundred participants depending on ease of getting access to the participants. Where access to participants is very limited/or restricted one or more key informant would be enough to provide the required information.²⁸⁵ Therefore, two responses obtained were considered as good response because RCONs are key informants on executive remuneration benchmarking. One face-to-face interview and one telephone interview appointments were booked with the two participants.

Follow-ups on the other 44 invitations were made via email and the results was a further 4 positive responses with 5 negative responses. The four positive responses were all booked for telephone interviews as the interview participants' chose telephone interview option as being most convenient for them. Telephone interviews as oppose to face-to-face interviews allows data to be collected faster and at a lower

²⁸² Edwin Van Teijlingen and Vanora Hundley, 'The Importance of Pilot Studies' (2001) 35 *Social Research Update* 1, 2.

²⁸³ *ibid.*

²⁸⁴ Pirkko Markula and Michael Silk, *Qualitative Research for Physical Culture* (Palgrave Macmillan 2011) 93.

²⁸⁵ Chris Gratton and Ian Jones, *Research Methods for Sports Studies* (Taylor & Francis 2010) 170.

cost than a face-to-face interview.²⁸⁶ However, it is not easy to establish a rapport with the interviewee and the interviewee may find it easier to terminate the interview before it finishes or refuses to respond to some questions without facing the interviewer.²⁸⁷ Also there is the inability of the interviewer to observe the body language of the interviewee.²⁸⁸ The advantage of the face-to-face interview was that it allowed the interviewer to observe the body language of the interviewee. Judith Sturges²⁸⁹ compared interview transcripts of face-to-face interviews and telephone interviews and found no significant differences in the interviews. In this study, telephone interviews were in retrospect the only possible way of getting the interviews, consequently, both the face-to-face interview and the telephone interviews to collect data for the study.

A further attempt to increase the chances of recruiting more participants, the researcher followed-up the invitations by telephone. The researcher proposed to send questions generated from the pilot study to the participants by email for them to go over it and then decide on whether or not to participate in the study. This attempt yielded 28 negative responses with reasons such as ‘no time’, ‘your study brings no benefit to our firm’²⁹⁰ or ‘the firm is not interested in your study’.²⁹¹ Three consultancy firms (with a total of nine randomly selected RCONs) requested evidence of other firms had agreed to participate in the research before they would decide whether or not to participate. The evidence they requested for included the name of the firm and the consultant who would be participating. The researcher could not meet these demands as the requested information was treated as confidential.

All efforts to contact the remaining sixteen consultants proved unsuccessful as they were either out of the country, left the firm, gone on sick leave or were on maternity leave.²⁹² As an alternative means of recruiting more participants, the researcher

²⁸⁶ James Neelankavil, *International Business Research* (M.E. Sharpe 2007) 215.

²⁸⁷ PradipKumar Sahu, *Research Methodology: A Guide for Researcher in Agricultural Science, Social Science and Other Related Fields* (Springer 2013) 66.

²⁸⁸ James Neelankavil, *International Business Research* (M.E. Sharpe 2007) 216.

²⁸⁹ Judith Sturges, ‘Comparing Telephone and Face-to-face Qualitative Interviewing: A Research Note’ (2004) 4(1) *Qualitative Research* 107-118

²⁹⁰ Response from six potential participants.

²⁹¹ Eight negative responses for being too busy and having no time to grant an interview, seven responses for the firm not are interested.

²⁹² For example, 2 potential participants was out of the country, one on sick leave, one on maternity leave and fourteen had left the firms.

contacted one of the willing participants recommend willing participants. This approach yielded no positive result as the participant classed the topic under investigation as 'sensitive'. Despite the high negative response rate, the six participants were all that were willing to help thereby acknowledging the limitation of this study (insufficient data). This study acts as a basis for further study in the area.

Unstructured questions

The study adopted an unstructured (open-ended) interview approach which allows for an in-depth collection of data. Interviews are a purposeful conversation between the researcher and the participants where the researcher focuses on the participants' experiences as the participants express in their own words.²⁹³ The main area which the study aimed to cover is on the methodology of benchmarking thereby exploring the factors used in selecting comparator companies and why, and the nature of advice the consultants offer to the REMCO and how it affects the pay setting process. Unstructured interviews allow the interviewer to use the immediate context to ask questions instead of relying on predetermined questions. This approach is suitable in a research where the researcher knows very little about the problem under investigation to uncover important issues that can guide the interview.²⁹⁴ The lack of best practice on executive remuneration benchmarking and absence of past studies on the subject justifies the use of unstructured interviews. Unstructured interviews would enable researcher to uncover information that would not be exposed if using structured or semi-structured interviews. Unstructured interview allows the researcher to ask a question to which the interviewee freely responds to. The interviewer probes and responds to points made by the interviewee that seems relevant to the study.²⁹⁵ Responses from the interviewee in an unstructured interview most often leads to further questions. This method helps the researcher to gain access to the participants' world in order to understand their interpretation and motivation.²⁹⁶ This method was chosen because it represents the best way of understanding participants' thoughts and experiences on the benchmarking. Unstructured question interview is informal and

²⁹³ V Minichiello, R Aroni, E Timewell and L Alexander, *In-depth Interviewing: Principles, Techniques and Analysis* (, 2nd edn. Addison Wesley Longman1995) 61.

²⁹⁴ Karin Klenke, *Qualitative Research in the Study of Leadership* (Emerald Publishing 2008) 126.

²⁹⁵ Susan Jones, Vasti Torres and Jan Arminio, *Negotiating the Complexities of Qualitative Research in Higher Education: Fundamental Elements and Issues* (Routledge 2013) 135.

²⁹⁶ V Minichiello, R Aroni R, E Timewell and L Alexander, *In-depth Interviewing: Principles, Techniques and Analysis* (2edn. Addison Wesley Longman 1995) 61.

conversational in nature thereby creating a relaxed research atmosphere. This relaxed research atmosphere could be replicated in telephone interviews because some interviewees find it easier to discuss sensitive issues on the phone where they cannot see the interviewer. A mixed of face-to-face and telephone interviews was used as it was the only way the interviews could be obtained. Interviews were the appropriate method for this study because the participants were the key informants for the study.²⁹⁷

Data recording procedures

Permission was obtained from the participants, both face-to-face and telephone interview participants for the interviews to be recorded and the data used in the thesis. A digital recorder was used to record the interviews and later transfer to a computer where the file was password protected. The interviews were transcribed by the interviewer on a word-for-word basis and the transcripts sent to the interviewees for verification. One transcript was sent back from one interviewee with amendments and confirmation and the other five were silent. A follow-up on the five was done via emails and the five interviewees confirmed that they were happy with what they said and did not have to go through the transcripts. The one major reason that they gave for not looking over the transcript was their busy schedule thus having no time to go through the transcripts.

Ethical Issues

Ethical approval was obtained for this study from the University of Portsmouth Business School ethics committee (Reference no: E176). The primary concern was confidentiality of the participants and they were assured that their identities would remain anonymous. This concern arose because within a firm, only a few individuals are involved in this specialty and they deal with commercially sensitive data – meaning that the consultancy firm as well as the consultants needed to be anonymous. The study could mean the RCON revealing confidential information from their clients which could result in them losing their clients. Thus there was a need for confidentiality and anonymity in this study. This situation therefore influenced how

²⁹⁷ Due to the lack of secondary material on the subject matter.

the results have been presented by simply naming them consultant 1 to 6 without including any further information.

Interviews with respondents were voluntary and based on informed consent and anonymity was assured by the interviewer. For an interview participant to give informed consent, the interviewer must make clear how extensive they plan to use their participant's own words in the final report of the research.²⁹⁸ In this study, it was explained to the participants that their interviews would be used extensively in the thesis, word-for-word quotes will be used, and made-up names (e.g. consultant 1, 2, etc.) would be used. The consent letter included contact information of the researcher, should the interview participant have questions or concerns about the research. Informed consent may be given by individuals capable of such consent either in a written format, verbally or audio-taped.²⁹⁹ To fulfil this requirement of informed consent, consent letters (indicating the interviewee's voluntary participation and consent to the use of the information given) were sent to the respondents together with the invitation letter (inviting the interviewee to take part in the study) and information sheets (giving the interviewee all the relevant information about the study and their right under the study).³⁰⁰ One respondent signed the consent form and the rest five respondents who were interviewed over the phone gave their consent at the beginning of the interview. The consent of these five respondents are held in an audio-taped form on the researcher's laptop and placed under a password locked folder. Assuring the respondents that no personal data (other than name and position) was collected and that none of the respondents would be identified in the thesis; and the University of Portsmouth Business School Ethical conditions, caused the respondents deliver information willingly. One of the respondents gave information using phrases that were very revealing of his identity which were not included in the thesis write-up. In this study, there were no identified conflicts because the researcher is independent of the participants and their consultancy firms. All of the respondents were informed of the researcher's aims and objectives, and their right to withdraw before the interviews were analysed.

²⁹⁸ Irving Seidman, *Interviewing as Qualitative Research: A Guide for Researchers in Education and Social Sciences* (Teachers College Press 2012) 75.

²⁹⁹ Karin Klenke, *Qualitative Research in the Study of Leadership* (Emerald Publishing 2008) 50.

³⁰⁰ Copies of the invitation letter, consent form and the information sheet are attached in the appendices.

Data analysis

Data analysis involves organising and interrogating data in ways that allow researchers to see patterns, identify themes and develop explanations which will help to answer the research question.³⁰¹ In order to identify themes and develop explanations, this study adopted content analysis and thematic analysis to analyse the data. Content analysis is the analysis of the frequency and patterns of use of terms or phrases in the data. Farmer³⁰² defines content analysis as a method that is used to determine the presence of certain words, themes and concepts within a document and to analyse this presence in an objective and systematic manner. The method of data analysis was chosen because the coding scheme can be clearly set out to enable replication and follow-up studies on the subject. Furthermore, this method of analysis will enable the researcher to track changes in the frequency of use of different factors considered in executive remuneration benchmarking with further research in future.³⁰³ However, this study acknowledges the weakness of using this method of data analysis. The frequency counting in content analysis may not reflect the structure or underlying phenomenon. A point/factor that is not mentioned or mentioned less frequently in an interview is considered less important in content analysis which may in fact be an important point.³⁰⁴ For this reason, thematic analysis was also used in this study to minimise the weaknesses of content analysis.

Thematic analysis is a method for identifying and analyse patterns, or themes within a data.³⁰⁵ This method of analysis is used when dealing with the individual experiences of the research participant. The basic unit of thematic analysis is the identification of a descriptive pattern and its significance that can be used to answer the research question.³⁰⁶ The data used for thematic analysis is the same data used for content analysis (e.g. the interview transcript). The method of coding is the same for both methods. Combining both methods in the analysis of the research data is important as

³⁰¹ Amos Hatch, *Doing Qualitative Research in Education Settings* (SUNY Press 2010) 148.

³⁰² Lesley Farmer, *Using Qualitative Methods in Action Research: How Librarians Can Get to the why of Data* (Library of Congress Cataloguing 2011) 110.

³⁰³ Alan Bryman and Emma Bell, *Business Research Methods* (3rd edn. Oxford University Press 2011) 305.

³⁰⁴ Roger Watson, Hugh McKenna, Seamus Cowman and John Keady, *Nursing Research: Designs and Methods* (Elsevier Health Sciences 2008) 94.

³⁰⁵ Emily Finch and Stefan Fafinski, *Criminology Skills* (Oxford University Press 2012) 385.

³⁰⁶ Jeffrey Longhofer, Jerry Floersch and Janet Hoy, *Qualitative Methods for Practice Research* (Oxford University Press 2012) 48.

it enables the researcher to better interpret the data (e.g. what factors considered in benchmarking, why they are considered and how they affect executive remuneration determination process) in order to answer the research question. Common terminologies that are used in qualitative data analysis (content analysis and thematic analysis inclusive) are defined below to aid the understanding of this study's data analysis.

Table 4: Key terms used in qualitative research methods³⁰⁷

Term	Meaning
Theme	A recurring pattern that conveys something significant about somebody's experience on a particularly subject matter
Clustering	The process of comparing and contrasting quotes and connecting or separating quotes with similar meaning
Tag	A label that is attached to a selection of data to identify its meaningful piece of information
Category	The collection, organisation and banding together of similar data and themes

Analysing data using content analysis and thematic analysis follows ordered steps:

1. Reading the interview transcripts over and over to become familiar with the data
2. Search for, identify and label themes in each case
3. Connecting and ordering themes by independently clustering the raw data themes into meaningful categories that seems to connect and fit together
4. Cross-checking that the categories gives the same meaning and idea and used by the research participant
5. Display the themes on a table in a hierarchical nature.³⁰⁸

In coding the data for this study, each interview transcripts was analysed. The coding provided the structure for analysing and interpreting the data. No computer software was used for coding as the researcher found it easy to code manually given that only

³⁰⁷ Andrew Sparkes and Brett Smith, *Qualitative Research Methods in Sport, Exercise and Health: From Process to Product* (Routledge 2013) 117.

³⁰⁸ *ibid*, 118.

six interviews were made. It would have been more demanding and time consuming for the researcher if computer software were to be used as trainings would have been required. The codes were developed from the interview data and the interpretation of the themes as described by the participants.

Some factors considered when benchmarking were identified from the interview transcripts that help answer the research questions. These factors varied with consultants. These factors were classified into various categories that are exclusive and exhaustive of each other. Some of the key words identified during the coding process had one or more synonyms (e.g. objective had synonyms like unbiased, transparent, robust, best, fair, impartial etc.). These words were noted and all the key words and synonyms put together and considered as same. This is important in this method of data analysis as the strength and importance of a word is determined by the number of times (frequency) it is being said by the respondent. Examples of key words identified and their synonyms for all categories are identified on the table below.

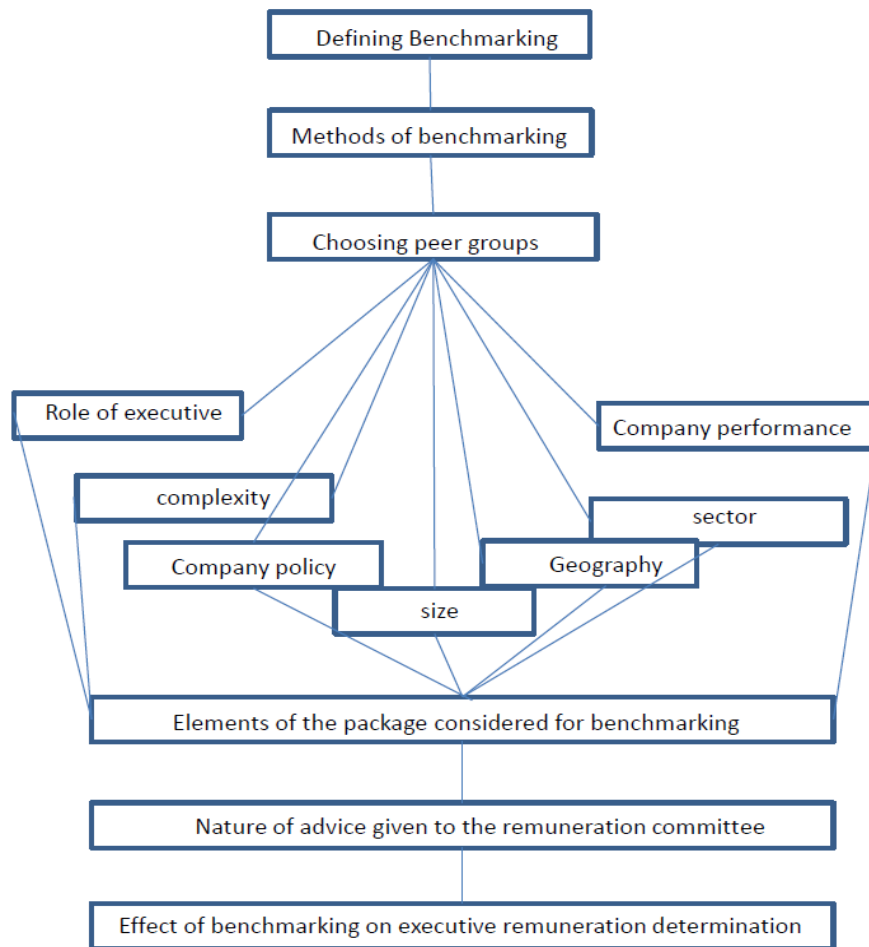
Table 5: Key words and synonyms identified in the interviews

Category	Key words describing the category	Synonyms of the words used
Size	<ul style="list-style-type: none"> – Total revenue – Market capitalisation – Total employee heads – Company complexity – Company turnover 	None
Company remuneration policy	<ul style="list-style-type: none"> – Median quartile – Top quartile – Lower quartile – Position in the market 	None
Sector	<ul style="list-style-type: none"> – Across sector – Same sector 	<ul style="list-style-type: none"> – Similar – specific
Nature of advice from the consultant	<ul style="list-style-type: none"> – objective 	<ul style="list-style-type: none"> – suggestive – unbiased – transparent

		<ul style="list-style-type: none"> – robust – best – fair – impartial
Company performance	– company profitability	None
Peer group selection	<ul style="list-style-type: none"> – specific – general 	None
Elements of remuneration package considered for benchmarking	<ul style="list-style-type: none"> – total – element on element basis 	– all elements
Geography	<ul style="list-style-type: none"> – global – domestic 	<ul style="list-style-type: none"> – multinational – international – overseas – foreign
Effect of benchmarking	<ul style="list-style-type: none"> – decrease pay – increase pay – renders pay setting transparent 	None
Role of the executive	– role of executive	None

After coding the data, the last step in content analysis and thematic analysis is the representation of the information in a hierarchical manner as demonstrated by the chart below. The full meaning of elements and theory will be discussed in chapter 4 under results and discussion.

Figure 5: Flow chart indicating the process of executive remuneration benchmarking



Conclusion

This chapter has outlined the methods used in this study to answer the research question. The study has used a mixed method approach which includes doctrinal, qualitative and quantitative research methods. All the methods have been based on different research philosophies which include realism, positivism and constructivism. A combination of the findings obtained from each method is used to answer the research question. Data collection for the study was from companies' annual reports and account, Bloomberg data stream and interviews. Variables used have been defined and data analysis specified. The findings of this study are discussed across the rest of the chapters depending on which research method the chapter adopts.

Chapter 3: Corporate Governance **Reports and Codes**

Introduction

Corporate governance is the system by which companies are directed and controlled.³⁰⁹ Financial scandals in the 1980-1990s in the UK undermined confidence in the quality of financial reporting and the ability for external auditors to provide sufficient assurances on the financial situation of companies. This lack of accountability and transparency prompted policy makers to consider corporate governance as a means of controlling and monitoring company dealings. The last two decades have seen the introduction and revision of reports and codes in corporate governance in which issues of executive remuneration have also been addressed. All these corporate governance codes aimed at pursuing transparency and accountability in the determination and disclosure of executive remuneration and other corporate governance issues at large. One of the major issues in corporate governance since the early 1990s is executive remuneration. This was and still is, because of public and investors' concerns over the rapid growth of executive remuneration and the apparent lack of link between executive remuneration and company performance.³¹⁰ Executive remuneration in the UK is regulated by the law³¹¹ and corporate governance codes also contain a notable number of key recommendations. This chapter will discuss the evolution of corporate governance codes and their recommendations on executive remuneration and related provisions only. The principal recommendations will be discussed further in subsequent chapters.

Evolution of corporate governance mechanisms

The development of corporate governance mechanisms on executive remuneration in the UK started in the early 1990s. The concerns and criticism of excess growth in executive pay with no apparent link to company performance was one of the issues the Cadbury Report sought to address.

³⁰⁹ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992) para. 2.5.

³¹⁰ Kevin Keasey and Mike Wright, 'Issues in Corporate Accountability and Governance: An Editorial' (1993) 23(41) A & BR 291, 291.

³¹¹ notably, the relevant provisions in the Companies Act 2006, discussed in chapter 6

The Cadbury Report 1992

The Committee on the Financial Aspects of Corporate Governance was chaired by Sir Adrian Cadbury in response to three inter-related (accountability, financial reporting and auditing) areas of concern in the then existing corporate arrangements which included public concerns about the rapid growth of executive remuneration not linked to company performance.³¹² The committee published its final report in December 1992 which included a Code of Best Practice. The Code of Best Practice was appended to the Yellow Book (the forerunner to the Listing Rules), and the ‘comply or explain’ rule (discussed later in this chapter) was made a requirement for all listed companies.³¹³

The Code of Best Practice contained the main provisions of the report. The Cadbury Report addressed the issue of executive remuneration in three out of its nineteen recommendations; Cadbury advocated a sharp break to what was the traditional UK corporate practice of executive remuneration setting process of which directors determining their own pay package. The most important recommendation the committee made was for the board to appoint a REMCO consisting of wholly or mainly NEDs.³¹⁴ The responsibility of the REMCO was to make recommendations to the board on the remuneration of the executives in all forms. This recommendation marked a big change in the process of determining executive remuneration. This raised the issue of conflict of interest as executives were considered as awarding themselves pay that did not correspond to the company’s performance. The Cadbury Report recommended that executives should be precluded from taking part in decisions relating to their own pay.³¹⁵ The REMCO was allowed to draw advice from outside if necessary.³¹⁶ The company’s board were recommended to disclose the membership of the REMCO in the annual account and report. The REMCO was to put the interest of the shareholder first at all times and in all their decision making

³¹² S Girma, S Thompson and PW Wright, ‘Corporate Governance Reforms and Executive Compensation Determination: Evidence from the UK’ (2007) 75(1) *The Manchester School* 65, 66.

³¹³ Listing rules of the London Stock Exchange (The Yellow Book) para. 12.43a.

³¹⁴ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992) para 4.42.

³¹⁵ *ibid.*

³¹⁶ *ibid.* The advice provided by remuneration consultant is discussed in detail in chapter 4)

processes.³¹⁷ By recommending that executive remuneration be determined by a REMCO, Cadbury sought to strengthen the role and independence of NEDs.³¹⁸ NEDs are appointed on a part-time basis, to the board of a company and are involved in the management but are not employees of the company.³¹⁹ Furthermore, by recommending the establishment of the REMCO, the Cadbury Report was seeking to make the process of determining executive remuneration more transparent and less subject to the influence of the executives.³²⁰ The spirit of the Cadbury Report was not intended to reduce the level of executive remuneration and/or the growth rate of executive remuneration;³²¹ rather Cadbury's objective was to encourage executive remuneration to be more transparent and more closely related to company performance.³²² Transferring the pay-setting responsibilities to the REMCO dominated by NEDs was believed to better align shareholders' and executives' interests more closely and so link pay more directly to performance.

The Cadbury Committee recommended that the total emolument of the chairman and highest paid director be disclosed with separate figures representing their salary and performance related elements in the annual report.³²³ Given that disclosure was also a legal requirement, the Cadbury committee went further than the Companies Act 1985 to recommend that disclosure should be done on the various elements of the pay package as opposed to the a single figure for the highest paid director required by the Companies Act. The committee recommended companies to disclose and explain the performance criteria and all relevant information on stock options, stock appreciation right and pension.³²⁴ The names of the chairman and the highest paid director were not required to be disclosed and the remuneration of the other executives were not required to be disclosed either. The aim of this recommendation was to make

³¹⁷ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992) para 4.44.

³¹⁸ Steve Thompson, 'The Impact of Corporate Governance Reforms on the Remuneration of Executives in the UK' (2005) 13(1) *Corporate Governance* 19, 20.

³¹⁹ A, Mohd-Suliman, 'Strengthening the independence criteria – a comparison of the UK, Malaysia, Hong Kong and Singapore' (2010) 21(7) *ICCLR* 239, 239.

³²⁰ Sourafel Girma, Steve Thompson and Peter Wright, 'Corporate Governance Reforms and Executive Compensation Determination: Evidence from the UK' (2007) 75 *The Manchester School* 65, 69.

³²¹ *ibid* at 70.

³²² Steve Thompson, 'The Impact of Corporate Governance Reforms on the Remuneration of Executives in the UK' (2005) 13(1) *Corporate Governance* 19, 21.

³²³ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992) para. 4.40.

³²⁴ *ibid*.

executive remuneration determination more transparent as disclosing the figures and how they came about, would enable the shareholders to either criticise or accept the remuneration process.

Companies were bound by contract to pay huge sums of money to an underperforming executive that was forced to leave the company before the expiry of his contract. The purpose of this recommendation was to limit the size of payoff that companies offered to executives that were forced to leave the company.

However, the report rejected a proposal to give the shareholders an opportunity to determine matters such as executive pay at an annual general meeting.³²⁵ The committee did not see how such a complex issue could be determined by shareholder by saying ‘... A directors’ remuneration is not a matter which can be sensibly reduced to a vote for or against; where the vote to go against a particular remuneration package, the board would still have to determine the remuneration of the director concerned’.³²⁶ However, the law rejected this approach and now provides shareholders with a binding vote (discussed in chapter six).³²⁷

Although, the recommendations of the Cadbury Committee were voluntary, their endorsements by the London Stock Exchange caused many listed companies in the UK to comply with its provisions very rapidly.³²⁸ A study by Conyon³²⁹ found out that in 1993, 94% of British quoted companies had a REMCO. Girma et al³³⁰ study on the relationship between CEO cash remuneration and firm performance over the period of 1981 – 1996 found that the rate of increase in CEO remuneration slowed down after the Cadbury Report, indicating that Cadbury Report did have an impact on

³²⁵ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992) para. 4.43.

³²⁶ *ibid.*

³²⁷ Companies Act 2006 (The Enterprise and Regulatory Reform Act 2013) s439A.

³²⁸ Martin J Conyon, ‘Institutional Arrangement for Setting Directors’ Compensation in UK Companies’ (1997) in K Keasey, S Thompson and M Wright, *Corporate Governance: Accountability, Enterprise and International Comparisons* (Oxford, 2005) 105.

³²⁹ Martin J Conyon, ‘Corporate Governance Changes in UK Companies Between 1988 and 1993’ (1994) 2 *Corporate Governance* 87-99.

³³⁰ Sourafel Girma, Steve Thompson and Peter Wright, ‘Merger Activity and Executive Pay’ (2002) CEPR Discussion Paper No. 3255. <http://dspace.cigilibrary.org/jspui/bitstream/123456789/19111/1/Merger%20Activity%20and%20Executive%20Pay.pdf?1> assessed 14 November 2013.

the executive remuneration determination process. However, Girma et al³³¹ in another study on the impact of Cadbury Report on executive remuneration determination found out that, the Cadbury Report had very little impact on the pay-setting process as a whole. Girma et al³³² findings suggested that executive remuneration remained less sensitive to company performance and depended more on company size. However, a study by Guest³³³ found out that the Cadbury Report influenced the pay setting process, with an increase in the number of NEDs leading to an increase in the correlation between executive pay and company performance. Past studies on the impact of Cadbury Report on executive remuneration setting process yielded mixed findings. However, Cadbury Report recommendation of separating a REMCO that would be responsible for the determination of executive remuneration marked a significant change in the executive remuneration determination process. Despite the recommendations made by the Cadbury Report and the changes it effected, growing public concern on executive remuneration issues led to the Greenbury Report 1995.

Greenbury Report

After the Cadbury Report 1992, executive remuneration became a hot political issue with the media and newspapers³³⁴ highlighting executives' lengthy service contracts, substantial perks and large pay increases without a proportionate increase in company performance. This public debate fuelled by media stories on executive remuneration gave birth to the Greenbury Report 1995. Pension Funds who were major investors in listed companies wanted to see a greater link between pay and performance. A particular target of criticism was the pay of directors in privatized industries.³³⁵ The rallying point was Cedric Brown's (the then chairman of British Gas plc) 75% pay rise as there was no justifiable link between his pay increase and company performance and the fact that the company was making many employees redundant at the same time. A committee under the chairmanship of Sir Richard Greenbury was setup under the instigation of the Confederation of British Industry (CBI) and reported

³³¹ Sourafel Girma, Steve Thompson and Peter Wright, 'Corporate Governance Reforms and Executive Compensation Determination: Evidence from the UK' (2007) 75(1) *The Manchester School* 65-81.

³³² *ibid*, 80.

³³³ Paul Guest, 'Board Structure and Executive Pay: Evidence from the UK' (2010) 34 *Camb J Econ* 1075, 1075.

³³⁴ For example, 'Derailing the Gravy Train' (1995) *Sunday Times* January 22nd.; D. Cohen, 'Executive Gluttony Under Attack' (1994) *Financial Times* November 26/27th at 3; 'Fat Cats in the Dock' (1995) *Economist* March 4th.

³³⁵ Case Study: The Case of British Gas (1996) 4 *Corp. Gov.:Inter. Rev.* 21, 22-23.

in 1995. The committee's goal was to identify good practices in determining executive remuneration and prepare a code of such practice for use by UK companies.³³⁶ The committee's findings were documented in the Greenbury Report which incorporated a Code of Best Practice on director's remuneration. The Greenbury Code of Best Practice was divided into four sections: the RC, disclosures, remuneration policy and service contracts and remuneration. The committee's objective was to provide possible answers to concerns on the process of determination executive remuneration and greater transparency. The key themes in the Code of Best Practice were alignment of executives' interests with those of the shareholders to improve company performance, full disclosure and responsibility. The Greenbury Report's Code of Best Practice was endorsed by the listing rules of London Stock Exchange requiring a compliance or non-compliance statement in the annual report and accounts of the company.

Unlike the Cadbury Report which recommended that the REMCO should consist wholly or mainly of NEDs, the Greenbury Report recommended that the REMCO should comprise exclusively of NEDs³³⁷ who have no personal interest in the matters of the company, no potential interest and with no day-to-day running of the company's business.³³⁸ This recommendation was intended on making the REMCO independent of the executives to enhance their objectiveness in the determination of executive remuneration. The Greenbury Report went further to recommend that the REMCO should be made up of at least three NEDs or at least two NEDs in the case of small companies.³³⁹ The REMCO would report to the shareholders each year on the remuneration policy, including full disclosure of elements in the remuneration of individual directors. This recommendation was to give the shareholders information on the executive pay setting process as a means of encouraging accountability and transparency.

The report recognised the importance for companies offering wages that are high enough to attract suitable executives that are capable of running the company and

³³⁶ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee, 1995) para. 1.2

³³⁷ *ibid*, para. 4.8

³³⁸ *ibid*, A4

³³⁹ *ibid*, para. 4.11.

cautioned the REMCO to be careful to avoid paying more than is necessary.³⁴⁰ This recommendation was justified on the basis that there exists a market for executive talent, meaning that companies who do not offer attractive pay packages will not attract, recruit and retain executives of high calibre to run the company. This meant that the REMCO had to consider the pay structure and practices of other companies when setting executive remuneration levels. This recommendation seemed weak as the REMCO was given the chance to set the pay at a level they desire and justify it as being the right package to attract, retain and motivate a quality director.³⁴¹

The Greenbury Report recommended that directors' contracts be reduced from three years to one year as a means of preventing excessive golden handshakes.³⁴² This recommendation also recognised that removing a director before the expiry of his office can amount to breach of contract for which compensation will need to be paid for each year remaining on the contract. This recommendation simply express what was stated in the CA 1985/2006. The rationale for recommending a reduction of director's service contract was to prevent directors from entrenching themselves by making it prohibitively expensive to remove from office. The report added that a notice period of two years could still be reasonable in some circumstances.³⁴³

Furthermore, the Greenbury Report recommended executive pay structure to be made up of multiple elements which included base salary, benefits in kind, annual bonus, share options, other long-term incentive schemes and pension rights.³⁴⁴ All bonus schemes, share options and long term incentive schemes were to depend on satisfactory performance and needed shareholder approval. Annual bonuses were to be rewarded based on some financial performance measures.³⁴⁵ Long term performance schemes were to encourage the long term success of the company subject to challenging performance criteria.³⁴⁶ Performance measures were to be applied relative to what other companies in the same industry are applying.³⁴⁷ The

³⁴⁰ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee, 1995) para. 6.5.

³⁴¹ Coyle Brian, *Corporate Governance* (3edn. London 2004) 217.

³⁴² Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee 1995) para7.13.

³⁴³ *ibid*, para. 7.15

³⁴⁴ *ibid*, para. 6.14

³⁴⁵ *ibid*, para. 6.19

³⁴⁶ *ibid*, para. 6.38

³⁴⁷ *ibid*, para. 6.39

Greenbury Report failed to provide guidelines on what was to be considered as satisfactory performance, leaving the subject to the discretion of the REMCO.³⁴⁸ Share option schemes for directors were to be linked to long term corporate performance and not to be offered at a discount.

The Greenbury Committee was keen on ensuring that executive remuneration be linked to company performance and was not bothered about the levels of pay so long as they were justified on the basis of company performance:

A key concern should be to ensure, through the remuneration system, that directors share the interest of shareholders in making the company successful. Performance-related remuneration can be highly effective in aligning interest in this way. In many companies therefore, there will be a case for high gearing of performance-related to fixed pay...The gearing which suits one company may be quite unsuitable for another.³⁴⁹

The Greenbury Report was the first to recommend that parts of the executive remuneration package be tied to performance as a means of aligning the interest of the executives with that of the company and the shareholder.

The Report recommended extensive disclosure on remuneration matters which went notably further than the disclosure requirements in the CA 1985³⁵⁰ and the Cadbury Report as a means of ensuring accountability to shareholders and reassuring the public. This was intended to give the shareholders reasonable information to enable them to assess the company's general policy on executive remuneration and the entire remuneration package of individual directors.³⁵¹ The remuneration of each named director with details of the various components of the pay package (which include base salary, annual bonus, benefit, share options, long term incentive plans and compensation for loss of office) to be disclosed.³⁵² The report recommended that explanation and justification be provided whenever any element of remuneration other

³⁴⁸ Coyle Brian, *Corporate Governance* (3edn. ICSA Publishing Limited, 2004) 219.

³⁴⁹ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee 1995) para. 6.16

³⁵⁰ Companies Act 1985, s 232.

³⁵¹ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee 1995) para. 5.2-5.3

³⁵² *ibid*, para 6.14

than the basic salary was pensionable.³⁵³ All notice periods of more than twelve months were to be disclosed and explained together with the names of the directors in the annual report. The REMCO was to write a report which was to be included or annexed to the annual report and account of the company on behalf of the board. The report had to provide information on the remuneration policy and the actual remuneration packages including share options and pension entitlement earned of each named executive, and how the executive remuneration was benchmarked with other companies.³⁵⁴ Despite the extensive disclosure requirement, the report did not set a standardised format on how the companies should disclose this information. This left the companies to adopt disclosure format that they deemed satisfactory and thus creating a variation in disclosure format amongst companies.³⁵⁵ Furthermore, the Report did not require shareholders to approve the general remuneration policy which meant that companies submit the amount of information the liked.

Despite these recommendations on executive remuneration, the Report failed to consider what would be its effect on pay levels. It was argued that the availability of substantial information in the annual reports and accounts on executive remuneration encouraged pay comparisons amongst executives that resulted in pay rises.³⁵⁶ A study by Gregg et al³⁵⁷ examined the relationship between executive pay and company performance for a large sample of UK companies over the period 1994-2002. Their findings suggested that there existed a weak relationship between executive remuneration and company performance. This finding meant that the Greenbury Report like the Cadbury Report failed to strengthen the link between executive pay and company performance. Executive remuneration continued after Greenbury Report 1995 to hit headline news as pay continued to rise faster than average earnings with little relationship to the company's performance.

³⁵³ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee, 1995) para. 6.44

³⁵⁴ *ibid.*, para. 5.4

³⁵⁵ Discussed in detail in chapter 6.

³⁵⁶ Martin Conyon, Simon Peck, Laura Read and Graham Sadler, 'The Structure of Executive Compensation Contracts: UK Evidence' (2000) 33 LRP 478-503.

³⁵⁷ P, Gregg, S, Jewell and I, Tonk, 'Executive Pay and Performance in the UK 1994-2002' (2005) CMPO Working Paper Series No. 05, Discussion paper No 657, http://www2.lse.ac.uk/fmg/workingPapers/discussionPapers/DP657_2010_ExecutivePayandPerformanceintheUK.pdf assessed 24 August 2011.

Hampel Report and the Combined Code

A review of the implementation of the Cadbury and Greenbury Reports took the form of the 'Committee on Corporate Governance' chaired by Sir Ronald Hampel. The committee published its findings in 1998. The committee suggested that the recommendations of Cadbury, Greenbury and Hampel be integrated into a single Code of Corporate Governance.

The Hampel Report covered director's remuneration as well as operations of the board, accountability and audit, relations with institutional shareholders and the responsibilities of institutional shareholders. The important contribution of this committee was the avoidance of a prescriptive approach to corporate governance. It emphasized the need to maintain principles-based, voluntary approach to corporate governance rather than a regulated approach.³⁵⁸ The committee recommended principles of good governance and the reduction of the regulatory burden on companies. It recognised that good governance will largely depend on individual companies and favoured shareholder involvement in company affairs. However, Hampel did not advance the debate on executive remuneration rather it re-iterated the provisions of the Greenbury Report. Remuneration packages should be structured so that rewards are linked to individual or company performance.³⁵⁹ The committee warned that while setting remuneration level in comparison with other companies, caution should be taken to avoid ratcheting-up remuneration by the uncritical uses of comparisons.³⁶⁰ The report emphasised that parts of the remuneration package that are tied to individual and corporate performance should not only be achievable but challenging.³⁶¹ The REMCO was required to use informed judgment in devising scheme appropriate for specific circumstances of their company and to explain their reasoning with the shareholders. The committee also recommended that notice period should be one year or less. Like the Cadbury Report, the Hampel Report did not believe that director's remuneration should be a matter for shareholders to vote on at the AGM. Reiterating the recommendation of Greenbury Report on the disclosure requirement, Hampel recognised that disclosures were often too excessively detailed

³⁵⁸ The Committee on Corporate Governance, *The Report of the Committee on Corporate Governance* (Gee Publishing 1998) para. 1.11-1.12.

³⁵⁹ *ibid* para. 4.2.

³⁶⁰ *ibid* A.4.4.

³⁶¹ *ibid* B.4.7.

to the point of obscuring essential features of remuneration packages which only experts can understand. It therefore advocated a simplified form of disclosure by the companies to be accessible for the non-experts to understand.³⁶² The committee also pointed out that full disclosure of individual executives total emoluments led to an upward pressure on remuneration in a competitive field.³⁶³

The recommendations of the Cadbury, Greenbury and the Hampel Reports were consolidated in the Combined Code 1998. The code was appended to the listing rules with a requirement for companies to provide a statement for compliance or non-compliance. The code also required instances of non-compliance to be explained. The recommendations of the Code were the same as those of the Greenbury Report on executive remuneration with the exception that the Code recommended that the board should report to the shareholders on remuneration matters rather than the REMCO as recommended by the Greenbury Report. The Code was appended to the listing rules and operated on 'comply or explain' basis.

Higgs Report

The Higgs Report focused on the effectiveness of NEDs. Following the recommendation of the Greenbury Report, Higgs recommended that the REMCO should comprise of at least three members, all of whom should be independent NEDs.³⁶⁴ Most importantly Higgs recognised that one of the roles of NEDs was to set the levels of executive remuneration. The Higgs Report recommended that the REMCO has delegated responsibility for setting remuneration for executive directors, senior executives, and the chairman and should be responsible for appointing remuneration consultants.³⁶⁵

Unlike its predecessors, the Higgs Report highlighted certain relationships and factors which could compromise independence. The Higgs Report recommended that the independence of the REMCO could be compromised if they have been former employees of the company five years after their employment ended or persons who still have business dealings with the company. The Higgs Report reinforces the notion

³⁶² The Committee on Corporate Governance, *The Report of the Committee on Corporate Governance* (Gee Publishing 1998) para. 4.16.

³⁶³ *ibid* A.4.5.

³⁶⁴ Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (2003) para. 13.11.

³⁶⁵ *ibid*.

of independence by recommending that the board identifies in its annual report its independent NEDs explaining why they are considered independent.³⁶⁶ The test of the independence of NEDs was an important recommendation to support the accountability and transparency of the executive pay setting process. In addition to the already existing recommendations on executive remuneration in the Combined Code, the Higgs Report recommended that the number of meetings the board and its committees hold a year must be disclosed in the annual report and accounts including the attendance records of individual directors.³⁶⁷ Higgs recommended that the remuneration of NEDs should reflect the workload, complexity and responsibility involved. They could also be part paid by shares, and were allowed, subject to shareholders' approval, to own shares in the company.³⁶⁸ The Higgs Report 2003 led to the amendments of the Combined Code to incorporate its recommendations.

The Combined Code (2003, 2006 and 2008 updates)

The Code emphasised the importance of independent NEDs on the REMCO that they bring objective judgement to their role. Following the recommendation from the Higgs Report, the Code recommended that the board should determine relationships that are likely to affect the judgment of independent NEDs and state its reasons for regarding a non-executive as independent where there exist factors that could affect his/her judgement.³⁶⁹ It went further from the Combined Code 1998 to recommend that a significant proportion of the executive remuneration should be structured so as to link rewards to corporate or individual performance.³⁷⁰ Furthermore, it also recommended that the remuneration of NEDs should not include share options.³⁷¹ The Code cautioned that where the executive directors or senior management were involved in advising or supporting the RC, care should be taken to recognise and avoid conflicts of interest.³⁷² Directors' eligibility for annual bonuses and long term award schemes were subject to satisfactory performance and required all new long

³⁶⁶ Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (2003) para. 9.11.

³⁶⁷ Greenbury Committee, *Directors Remuneration: The Report of a Study Group Chaired by Sir Richard Greenbury* (Gee 1995) para. 4.8.

³⁶⁸ Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (2003) para. 12.27.

³⁶⁹ FRC, *The Combined Code on Corporate Governance* (FRC 2003) A.3.1.

³⁷⁰ *ibid*, B.1.

³⁷¹ *ibid*, B.1.3.

³⁷² *ibid*, B.2.3.

term schemes proposed to be approved by shareholders.³⁷³ It also recommended the performance evaluation of the REMCO by the board annually. The Combined Code 2006 recommended that the chairperson of the company could serve on the REMCO where he/she was considered independent at the time of appointment. Apart from these few changes all the provisions remained the same. The Combined Code 2008 contained the same recommendations on executive remuneration as the Combined Code 2006.

The Walker Review

Despite the updates on the Combined Codes, executive remuneration continued to be in the spotlight with constant increase in executive pay with little or no relationship with the company's performance.³⁷⁴ Coupled with the banking crisis of 2007 and 2008 in the UK in which the government had to save five banks from collapsing led to the Walker Review.³⁷⁵ This committee was set up by the government chaired by Sir David Walker to look at corporate governance in the banking sector.

One significant problem that contributed to the banking crisis was the excessive risk taken by the banks. It was argued that excessive executive remuneration by the use of bonus payments encouraged excessive risk taking by the executives.³⁷⁶ Pay arrangements in the financial industry provided reward to some staff in the bank entitled to bonus payment as an integral part of their pay package, encouraged recklessness in respect of valuation of assets and the calculation of profits.³⁷⁷ Executive bonus rewards were linked to short-term performance rather than the long-term performance recommended by the Combined Code. The Walker Review considered amongst other issues whether an incentive and bonus remuneration scheme encourages risk taking in the banking sector. The main changes of Walker Review was to ensure that performance related remuneration is linked to long term success and that the remuneration incentives are compatible with risk policies and

³⁷³ FRC, *The Combined Code on Corporate Governance* (FRC 2003) Sch. A.

³⁷⁴ P, Gregg, S, Jewell and I, Tonks, 'Executive Pay and Performance: Did Bankers Cause The Crisis?' (2012) 12(1) IRF 89-122.

³⁷⁵ Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (1999).

³⁷⁶ Stephen Bloomfield, *Theory and Practice of Corporate Governance: An Integrated Approach* (Cambridge University Press 2013) 144.

³⁷⁷ Lucian Bebchuk, 'Executive Pay and the Financial Crisis' (2012) <http://blogs.worldbank.org/allaboutfinance/executive-pay-and-the-financial-crisis> assessed 26 November 2013.

systems. The Walker Review recommended that the REMCO should have a sufficient understanding of the company's approach to pay and employment conditions to ensure that it is adopting a coherent approach to remuneration in respect of all employees.³⁷⁸

Similar to the Combined Code 2008 where REMCO were allowed to determine the remuneration policy and packages for board-level executives, the Walker Review recommended an extension of the role of the REMCO to cover firm-wide remuneration policy. This was to ensure that the committee had appropriate oversight of the overall remuneration policy of the entity with particular focus on the risk dimension relevant to performance conditions, deferment and claw-back. The Walker Review recognised that reward by bonuses which had been locked into the structure of corporate governance by the Greenbury Report might be an unsuitable way of rewarding the executives.³⁷⁹

The Walker Review recommended that the REMCO should oversee the remuneration policy and outcomes in respect of all 'high end' employees.³⁸⁰ The REMCO report should confirm that performance objectives are linked to compensation for this 'high-end' group.³⁸¹ The REMCO report should confirm the review of remuneration arrangements for the "high end" group, satisfaction with the link between performance objectives remuneration structure; and disclose the principles underlying performance objectives and remuneration structures. The total remuneration of the 'high end' group, in bands, indicating numbers of executives in each band should be disclosed.³⁸² Despite calls for disclosure of salaries of high-earning individuals, Walker does not require banks to name high earners due to issues of privacy – commercial confidentiality. Rather an anonymous disclosure of salary packages in excess of £1m. Disclosure of high-end employees (whether board members or not) falling into bands from £1-£2.5m, £2.5-£5m, and £5m upwards, with details provided of the main elements of salary, cash and deferred bonus, performance-related long-

³⁷⁸ Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (1999) recommendation 28.

³⁷⁹ Stephen Bloomfield, *Theory and Practice of Corporate Governance: An Integrated Approach* (Cambridge University Press 2013) 144.

³⁸⁰ Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (1999) recommendation 29.

³⁸¹ *ibid*, recommendation 30.

³⁸² *ibid*, recommendation 31-32.

term awards and pension contribution. The £1m benchmark represents a shift from the earlier proposal for disclosure of pay that exceeds the median of a company's executive directors.³⁸³ At least half of variable remuneration should be in the form of long term incentive scheme with half of the reward vesting after not less than three years and the remainder after five years. Short term bonus awards should be paid over three year period, with not more than one-third in the first year. Walker uses this deferral of incentive payments as the risk adjustment mechanism to align rewards with performance. It recommends claw backs should be used in cases of material misstatement and misconduct.³⁸⁴

The Walker Review recommended that the REMCO should seek advice from the board risk committee³⁸⁵ on specific risk adjustments to be applied to performance objectives.³⁸⁶ The Review sought for more ways of linking executive remuneration to company performance by recommending that the chairman of the REMCO should stand for re-election the following year should the non-binding resolution on a REMCO report attracts less than 75 per cent of the total votes cast.³⁸⁷ The REMCO report should state whether any executive board member has the right to receive enhanced benefits beyond those already disclosed and whether the committee had exercised its discretion during the year to enhance benefits.³⁸⁸ The recommendations of the Walker Review were principally aimed at the financial industry and a review of this report led to the UKCGC 2010.

The UK Corporate Governance Code 2010 and 2012

A review of the Walker Review, by the Financial Reporting Council, FRC³⁸⁹ led to a new code with a change of name from the Combined Code to the UKCGC. Parts of

³⁸³ Chris Warren-Smith and Stephen Elam, 'Walker Review' (2010) 4th February <http://www.inhouselawyer.co.uk/index.php/banking-and-finance/7717-walker-review> assessed 26 November 2013.

³⁸⁴ Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (1999) recommendation 33.

³⁸⁵ The board risk committee is a committee of the board chaired by a NED and made up of a majority of NEDs, whose responsibility is to assess the risk involved in the implementation of the company's strategy on a day-to-day basis (Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (1999) para. 6.11).

³⁸⁶ Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (1999) recommendation 35.

³⁸⁷ *ibid*, recommendation 36.

³⁸⁸ *ibid*, recommendation 37.

³⁸⁹ The body established by the government to oversee the operation of the Code.

the Walker Report that applied to all companies were incorporated into the UKCGC, and those that applied only to the banking sector were left as example of best practice. The recommendations of the UKCGC apply to a wide range of companies, but only listed companies must comply or explain regardless of whether they are incorporated in the UK or elsewhere. The Code made some key changes relating to executive remuneration. The Code recommended that remuneration of NEDs should not include any performance-related elements or stock options as these tend to jeopardise their independence.³⁹⁰ It also recommends that the performance-related elements of executive director's remuneration should be designed to promote the long-term success of the company.³⁹¹ Furthermore, the Code recommends that remuneration and incentive schemes should be subject to non-financial performance criteria where appropriate and compatible with the company's risk policies and systems; it also makes clear that companies should give consideration to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct.³⁹² The UKCGC 2012 contains the same provisions on executive remuneration as the UKCGC 2010. These provisions are contained in section D and schedule A of the Code.

The UK Corporate Governance Code 2014

A review of the UKCGC 2012 led to the publication of the UKCGC 2014 released on the 17 September 2014. The Code has made a few changes in relation to executive remuneration. These changes will only apply to the companies with accounting periods beginning on or after 1st October 2014. The Code recommends that executive directors' remuneration should be designed as to promote the long-term success of the company which was a supporting principle under the 2012 Code to a main principle.³⁹³ This principle is emphasising on the importance of linking executive remuneration to company performance because executive pay is presumed to lack a link between pay and performance. The principle has dropped the statement that 'levels of pay should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully'. This may be because of the excessive pay packages that some newly hired executive receive as 'golden hello'

³⁹⁰ FRC, *The UK Corporate Governance Code* (FRC 2010) D.1.3.

³⁹¹ *ibid*, D.1.

³⁹² *ibid*, Schedule A.

³⁹³ FRC, *The UK Corporate Governance Code* (FRC 2014) D.1.

when they first join the company. The REMCO will be faced with a new task of determining an appropriate balance between fixed and performance-related, immediate and deferred remuneration.³⁹⁴ They should in future set remuneration incentives to be compatible with risk policies and systems.³⁹⁵ The REMCO should consider requiring (a change from should be encouraged) directors to hold shares for a period after the vesting or exercised.³⁹⁶ Shares granted or other forms of deferred remuneration should not vest or be paid or exercised in less than three years and longer periods may be appropriate.³⁹⁷ The new Corporate Governance Code 2014 will still operate on a comply-or-explain rule.

The ‘Comply-or-Explain’ Rule

The ‘comply-or-explain rule only applies to listed companies. This rule was first put forward in the Cadbury Report Code of Best Practice 1992 as a practical means of establishing a single code of corporate governance whilst avoiding an inflexible ‘one size fits all’ approach.³⁹⁸ The Yellow Book (predecessor to the Listing Rules)³⁹⁹ required all listed companies to state in their report and accounts whether they complied with the provisions of the code or give reasons for any areas of non-compliance. The main objective of the rule of comply-or-explain was to allow for flexibility in the application of the rules set out in the code. This rule has been maintained since Cadbury and makes up one of the listing rules on the London Stock Exchange.⁴⁰⁰ Not all companies covered by the code are expected to follow all the recommendations of the code. That is, where individual rules do not fit the particular company, a deviation from the recommendation is allowed if explained. The UKCGC 2012 states clearly that: ‘...an alternative to following a provision may be justified in particular circumstances if good governance can be achieved by other means which

³⁹⁴ FRC, *The UK Corporate Governance Code* (FRC 2014) Schedule A

³⁹⁵ *ibid.*

³⁹⁶ *ibid.*

³⁹⁷ FRC, *The UK Corporate Governance Code* (FRC 2010) Schedule A.

³⁹⁸ D Seidl, P Sanderson and J Roberts, ‘Applying ‘Comply-or-explain’: Conformance with Codes of Corporate Governance in the UK and Germany’ (2009) Working Paper <http://www.cbr.cam.ac.uk/pdf/WP389.pdf> assessed 8 December 2013.

³⁹⁹ Listing rules of the London Stock Exchange (The Yellow Book) para. 12.43a.

⁴⁰⁰ FSA, *The Listing Rule* (FSA 2007) para. 9.8.6(6).

the company should explain clearly and carefully to shareholders...⁴⁰¹ A departure from the Code does not automatically mean a breach of the Code.⁴⁰²

Academic studies that have examined the rule demonstrate that companies are not adequately explaining the reason for non-compliance or not giving reasons at all. Grant Thornton's⁴⁰³ review of corporate governance found that the recommendation on REMCO had one of the highest levels of non-compliance.⁴⁰⁴ Grant Thornton's findings indicated that 6.7% companies of their sample failed to meet up with the recommendations on the composition of the REMCO. Fourteen companies still had an executive chairman on their REMCO. While non-compliance is not automatically a breach of the code, 82% of the companies failed in their explanation to identify whether or not the non-compliance was temporal or would last longer into the future. Only 22% of the companies explaining their non-compliance discussed the impact of the non-compliance on the shareholders or refer to an action taken to ensure an appropriate measure to redress the deviation.⁴⁰⁵ Compliance with the Code on the composition of the REMCO is very low in most companies thereby impairing their responsibility of setting appropriate pay levels.⁴⁰⁶

Conclusion

Corporate Governance has made and revised recommendations on the determination of executive remuneration. It is more principle based than rule based offering a degree of flexibility with relatively low cost. Despite the various recommendations of corporate governance codes on issue of executive remuneration, executive remuneration stills remain a hot topic in corporate governance. There are still gaps in corporate governance mechanisms that need to be addressed on issues of executive

⁴⁰¹ FRC, *The UK Corporate Governance Code* (FRC 2012) para. 3.

⁴⁰² *ibid.*, para. 4.

⁴⁰³ Grant Thornton, 'Governance Steps up the Gear' Corporate Governance Review 2013 <http://www.grant-thornton.co.uk/Documents/FTSE-350-Corporate-Governance-Review-2013.pdf> assessed 9 January 2014.

⁴⁰⁴ The other two recommendations FRC, *The UK Corporate Governance Code* (FRC 2012) B.1.2 and A.2.1.

⁴⁰⁵ Grant Thornton, 'Governance Steps up the Gear' Corporate Governance Review 2013, pg 10.

⁴⁰⁶ This is supported by the study of L MacNeil and X Li, 'Comply or Explain': Market Discipline and Non Compliance with the Combined Code' (2006) 14(5) CGIR 486-496; D Seidl, P Sanderson and J Roberts, 'Applying 'Comply-or-explain': Conformance with Codes of Corporate Governance in the UK and Germany' (2012) 17(3) *Journal of Management and Governance* 791-826; Grant Thornton, 'Governance Steps up the Gear' Corporate Governance Review 2013 <http://www.grant-thornton.co.uk/Documents/FTSE-350-Corporate-Governance-Review-2013.pdf> assessed 9 January 2014.

remuneration. The Corporate Governance Code recommends that a significant proportion of executive remuneration package be performance based with challenging performance criteria. However, the Code does not give guidelines as to what performance measures to be used; therefore giving the companies the liberty to choose performance measures that they think is satisfactory. As will be discussed in chapter 5, companies use a wide array of performance measures and there is very little uniformity. The flexibility of comply or explain rule, still offers some companies safe heaven as the code does not punish for less or inadequate explanation. Executive remuneration continues to rise as FTSE 100 Chief Executives pay increased on average pay package of £4.3 million in 2012, up from £3.9 million in 2011⁴⁰⁷ This pay increase justification are neither based on individual nor company performance but based on ‘attracting, motivating and retaining’ qualified executives. The UKCGC 2012 recommends pay to be tied to individual and corporate performance (discussed in chapter 5) as well has recommends the REMCO to offer remuneration that is sufficient to attract, motivate and retain quality executives. This points out to the flaws in corporate governance that still requires attention. The next chapter will discuss the REMCO and their role in the executive pay setting process.

⁴⁰⁷ High Pay Centre, ‘High Pay Centre Condemns Latest Executive Pay Increase’ 10th June 2013.

Chapter 4: The Remuneration Committee

Introduction

The UKCGC⁴⁰⁸ recommends that companies should set up a REMCO that will be responsible for the determination of executive remuneration. This would involve determining the company's overall remuneration policy, sets the salaries and other remuneration components of executives' pay, and develop short and long term incentive schemes for top managements. The purpose of this recommendation was to stop executives from determining their own pay thereby encouraging accountability and transparency in the executive remuneration setting process.⁴⁰⁹ The REMCO is seen as a key agent in the strategic human resource management process of choosing a remuneration package and, arranging and making sure it is calibrated in a way that incentivises the executives towards taking decisions and actions necessary to improve the company's strategy.⁴¹⁰ The recommendation for UK companies' boards to appoint REMCOs was first made by the Cadbury Report in 1992.⁴¹¹ To better understand the REMCO and executive pay setting process, this chapter will be divided into two parts. Part one will examine the REMCO and the pay setting process, and Part two will discuss RCONs and their influence on the REMCO's pay setting process.

Part 1: The Remuneration Committee

The REMCO is a subcommittee of the board made up of at least three, or two (in the case of smaller companies) independent NEDs who are responsible for setting the pay of the executive directors of the company.⁴¹² This part of the chapter will be divided into the following sections. The first section will examine the appointment, composition, the role of the REMCO and the sources of information required by the REMCO are discussed. Secondly, the independence of the REMCO will be considered and its effect on pay setting process will be discussed. Third, the factors

⁴⁰⁸ FRC, *The UK Corporate Governance Code* (FRC 2012) D.2. (1&2).

⁴⁰⁹ S Ogden and R Watson, 'Remuneration Committees and CEO Pay in the UK Privatized Water Industry' (2004) 2 *Socio-Economic Review* 33, 34.

⁴¹⁰ BGM Main, C Jackson, J Pymm and V Wright, 'The Remuneration Committee and Strategic Human Resource Management' (2008) 16(3) *CGIR* 225,231.

⁴¹¹ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992) para. 4.42.

⁴¹² FRC, *The UK Corporate Governance Code* (FRC 2012) D.2.1.

that the REMCO take into account when determining pay will be examined. Fourth, the theories that influence the REMCO's decision making process will be discussed. Finally, the effect of the REMCO on executive remuneration levels will be considered.

Appointment, Composition and Role of the Remuneration Committee

Members of the REMCO are suggested by the nomination committee⁴¹³ but the final decision lies with the board of directors as it is their responsibility to appoint board members.⁴¹⁴ The UKCGC⁴¹⁵ recommends that there should be a formal, rigorous and transparent procedure for the appointment of new directors to the board, and the appointment has to be on the basis of merit, objective criteria, gender, skills, knowledge and experience.⁴¹⁶

The prime role of the REMCO is to determine and monitor the remuneration of the company's executive directors. The importance of REMCO was echoed by Main and Johnson who stated that:

The complexities of present day remuneration packages demand a degree of expert knowledge and specialised information. If pay is to be linked to performance then it seems wise to give some attention to this details, and it also seem wise that the dominant perspective on such matters comes from those who most obviously represent the shareholders, i.e. the Board and the non-executive in particular.⁴¹⁷

The REMCO's role is not to reduce executive pay, but to provide a forum within which directors will determine the appropriate design of reward structures for senior executives and align management with company interest.⁴¹⁸ This could be achieved by designing remuneration packages that will align the interest of the directors with that of the company and its members with the success factor central to the company's

⁴¹³ Nomination committee is a sub-committee of the board that is responsible for appointing members of the board.

⁴¹⁴ Brain Coyle, *Corporate Governance* (3edn. The Basingstoke Press Ltd 2005) 86.

⁴¹⁵ FRC, *The UK Corporate Governance Code* (FRC 2012) B.2.

⁴¹⁶ *ibid*, para B.2.2.

⁴¹⁷ BGM Main and J Johnson, 'Remuneration Committee and Corporate Governance' (1993) 23(1) A & BR 351, 352.

⁴¹⁸ Martin Conyon and Simon Peck, 'Board Control, Remuneration Committees, and Top Management Compensation' (1998) 41(2) *The AMJ* 146, 148.

business strategy.⁴¹⁹ Remuneration policies are usually revised annually to confirm that the original choices are still consistent with the company's contemporaneous situation and the evolving views of shareholders. This would include the review of previous awarded incentive schemes with reference to the company's performance, to be able to design future incentive schemes. REMCOs are expected to judge where to position the company relative to other companies, assess the wider pay situation both within and without the company, and construct an appropriate remuneration package for the executives.⁴²⁰ In setting individual remuneration packages, the committee should consider all components including base salary, annual bonuses, benefits and incentive schemes such as stock options or grant (incentive plan include developing criteria for top executive performance-related remuneration). Performance-related components should be contingent on achieving performance conditions that are geared towards the long term performance of the company.⁴²¹ However, the role of the REMCO in determining remuneration packages that aligns the interest of the management with that of the company has been criticised and questioned by past academic studies. O'Reilly et al's⁴²² study on executive pay and social comparison suggested that the REMCO's role of aligning management interest with that of the company was not effective. They found out that average pay of the committee members had a positive effect on CEO pay. This was explained on the basis that some of the REMCO were setting executive pay based on the levels of pay they receive in the companies where they are executives which in turn push up pay levels. Main et al⁴²³ in their study found that executives tend to take initiative more in terms of making new pay arrangements than the REMCO. Although, the management may propose new pay arrangements and the REMCO reviews them, it is expected of the REMCO to make the proposals and consult the management not the opposite.⁴²⁴ The REMCO has been criticised to be ineffective in their role and are seen as negotiating

⁴¹⁹ BGM Main, C Jackson, J Pymm and V Wright, 'Questioning the Remuneration Committee Process' (2007)

<http://homepages.ed.ac.uk/mainbg/Files/questioning%20the%20remuneration%20committee%20process%20-%202021%20feb%202007.pdf> assessed 16 December 2010.

⁴²⁰ FRC, *The UK Corporate Governance Code* (FRC 2012) para. D.1.

⁴²¹ Brain Coyle, *Corporate Governance Essentials* (ICSA Publishing Limited 2008) 100.

⁴²² Charles O'Reilly III, Brian Main and Graef Crystal, 'CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories' (1998) 33(2) *Admin Sci Quart* 257, 271

⁴²³ Brain G.M. Main, Richard Belfied and Katherine Turner, 'Is there a Negotiation Process in UK Remuneration Committees?' (2011) Research Paper Retrieved 21st December, 1, 13.

⁴²⁴ FRC, *The UK Corporate Governance Code* (FRC 2012) D.1.

pay with the executives rather than critiquing the proposals from the executives.⁴²⁵ The make-up of the REMCO (mostly executives and former executives of other companies)⁴²⁶ impacts on decision making which tends to favour a negotiation of remuneration proposals than a critiquing.⁴²⁷

The REMCO can only do their job effectively if it has access to relevant sources of information and advice. Being a sub-committee of the board, they have access to any information that is available to the board and so will have access to detailed information relating to the company's finances and directors' performance. The UKCGC⁴²⁸ recommends that the REMCO should consult the chairman and/or the chief executive about their proposals relating to the remuneration of other executive directors. Furthermore, the REMCO should be responsible for appointing any consultants in respect of executive director remuneration, and to be cautious when executive directors or senior management are involved in advising or supporting the REMCO.⁴²⁹

Companies tend to use remuneration advisers such as the RCONs, the company's CEO and chairman, the human resource function and the shareholders and their representative bodies, to get information and support on how to set executive pay. These advisers provide the REMCO with useful information to enable them to determine executive pay packages. The quality of the information they provide to the REMCO can determine the appropriateness of the remuneration package.

The human resource department are invaluable source of information and support to the REMCO in the determination of executive remuneration. However, scepticism has been expressed by Main et al⁴³⁰ of the possibility that the human resource personnel might be taking over the pay setting process or acting as agents on behalf of the executives. The human resource department of the company has a strong influence on the pay setting process because they design, propose and set company policy; and are

⁴²⁵ Brain GM Main, Richard Belfied and Katherine Turner, 'Is there a Negotiation Process in UK Remuneration Committees?' (2011) Research Paper Retrieved 21st December 1, 13.

⁴²⁶ Discussed in detail in the next section.

⁴²⁷ The independence of the remuneration committee would be discussed in detail in the next section.

⁴²⁸ FRC, *The UK Corporate Governance Code* (FRC 2012) D.2.

⁴²⁹ *ibid.*

⁴³⁰ Brain GM Main, Richard Belfied and Katherine Turner, 'Is there a Negotiation Process in UK Remuneration Committees?' (2011) Research Paper Retrieved 21st December 1, 17.

also involved in setting top executive remuneration policy.⁴³¹ One of the respondents in Main's study said 'in the past there's been an unconscious takeover by the human resources director in preparing REMCO proposals...we have now shifted it from human resources writing and proposing and letting the REMCO approve, to a joint recommendation with the REMCO chair steering'.⁴³² In the majority of the sample data (8 out of 15 respondents) the human resources department was seen to be taking the lead in the proposals on executive pay arrangements.⁴³³ Furthermore, the human resource personnel do have an effective relationship with the managing director of the company that is based on high trust relationships.⁴³⁴ This places the human resource personnel in a difficult situation when they try to mediate between the executives and the REMCO. Based on the fact that the human resource personnel appointment to the board is largely the responsibility of the board, they may tend to favour the executives in pay decisions.

The independence of the remuneration committee

The REMCO's independence is considered a key element in control of executive remuneration.⁴³⁵ The on-going debate on executive remuneration poses considerable problems for the REMCO in the determination of acceptable executive remuneration packages. This is because the REMCO is responsible for making sure that pay awards are regarded as legitimate. The effective delivering of the REMCO's role has been criticized on the grounds that they are not completely independent from the board, consequently affecting their decision in the pay setting process. The REMCO's perceived lack of independence from the board has attracted criticism that they are unable to resist the influence of the executives on their decision making.⁴³⁶

In addition to the independent NEDs, the Code also recommends that the chairman of the company may also be a member of the REMCO (but not chair) if he was

⁴³¹ Brain GM Main, Richard Belfied and Katherine Turner, 'Is there a Negotiation Process in UK Remuneration Committees?' (2011) Research Paper Retrieved 21st December 1, 17.

⁴³² *ibid*, at 16.

⁴³³ *ibid*, 17.

⁴³⁴ James Kelly and John Gennard, 'The Role of Personnel Directors on the Board of Directors' (1996) 25(1) PR 7, 21.

⁴³⁵ Brain GM Main, Richard Belfied and Katharine Turner, 'Is there a Negotiation Process in UK Remuneration Committees?' (2011) Research Paper Retrieved 21 December 1, 3.

⁴³⁶ Brenda Hannigan, *Company Law* (Oxford University Press, 2012) 125.

considered independent at the time of his appointment.⁴³⁷ However, a study by Main et al⁴³⁸ found that in most companies the CEO is always present at REMCO's meetings. They argued that it is important for the CEO to be present in REMCO meetings because it would be difficult to design acceptable remuneration arrangements without engaging with the CEO and hence the executive team.⁴³⁹ They further pointed out that the CEO withdraws from the meeting when the CEO's pay is being discussed.⁴⁴⁰ The UKCGC⁴⁴¹ recommends that the REMCO should consult the chairman and/or the CEO about their proposal relating to the remuneration of other executive directors. This implies that the Code recognises the importance and encourages the presence of the CEO at some of the REMCO meeting but not when their pay is being discussed. A survey conducted by the High Pay Centre⁴⁴² found out that out of 96 companies of the FTSE 100, 2012 listing, 33% of FTSE 100 companies had a current CEO on the REMCO. The NEDs are expected to bring independent judgment and experience to the deliberations of the board on various issues and in particular on the determination of executive pay.⁴⁴³ The REMCO would need to be independent from the company, particularly from the executives to be able to carry out their responsibilities objectively. The UKCGC⁴⁴⁴ does not provide a definition for 'independence' but rather gives guidelines for determining independence of NEDs which requires members of the REMCO:

- Not to have been employee of the company or group within the last five years
- Not to have or has had within the last three years, any material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company
- Not to have received or receives additional remuneration from the company apart from director's fee, participates in the company's share option or

⁴³⁷ FRC, *The UK Corporate Governance Code* (FRC 2012) D.2.1.

⁴³⁸ Brain GM Main, Richard Belfied and Katherine Turner, 'Is there a Negotiation Process in UK Remuneration Committees?' (2011) Research Paper Retrieved 21st December, 1-35.

⁴³⁹ *ibid.*, 12.

⁴⁴⁰ *ibid.*

⁴⁴¹ FRC, *The UK Corporate Governance Code* (FRC 2012) D.2.

⁴⁴² High Pay Centre, *The New Closed Shop: Who's Deciding on Pay?* (High Pay Centre 2012) 7.

⁴⁴³ The Committee on the Financial Aspect of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992) para. 2.1.

⁴⁴⁴ FRC, *The UK Corporate Governance Code* (FRC 2012) B.1.1

performance-related pay scheme, or is a member of the company's pension scheme

- Not to have close family ties with any of the company's advisers, directors or senior employees
- Not to hold cross-directorship or has significant links with other directors through involvement in other companies and bodies
- Not to represent a significant shareholder; or
- Not to have served on the board for more than nine years from the date of their first election or be over seventy years of age.⁴⁴⁵

Furthermore, if a NED does not meet any of these criteria, the board should explain why it considers the NED independent. The NEDs are legally and commercially seen as an important guarantee of integrity and accountability of companies.⁴⁴⁶ It is assumed that the interest of those who invest in the company will be safeguarded by the presence of NEDs by setting directors' pay to reflect on the company's performance.⁴⁴⁷ As a means of diluting the number of executives from other companies sitting on the REMCO of another company, BIS⁴⁴⁸ suggested more diversity in the REMCO members that it should include people from outside the traditional corporate sphere (e.g. from academia, public sector etc.) who will lend relevant and valuable expertise whilst bringing fresh ideas to the committee.⁴⁴⁹ This diversity on the board will also avoid the 'escalation' in self-interest of executives thereby, causing them to put the interest of the company first. However, the discussion paper did not consider how such arrangements could be realised, or the legal status of the committee members who are not fully NEDs. To increase diversity on the REMCO, companies could recruit knowledgeable individuals from the various backgrounds only to participate on executive remuneration setting, but they would have to be legally responsible to the company for their responsibilities in the same magnitude as the NEDs. This would ensure that the committee members act carefully when making decisions. Some FTSE 100 companies already have members from a

⁴⁴⁵ K Keasey and R, Hudson, 'Non-executive Directors and the Higgs Consultation Paper – Review of the Role and Effectiveness of Non-executive Directors' (2002) 10(4) JFRC 368-369.

⁴⁴⁶ A Zattoni and F Cuomo, 'How Independent, Competent and Incentivized should Non-executive Directors be? An empirical Investigation of Good Governance Code' (2010) 21(1) Brit J Manage 63, 64.

⁴⁴⁷ *ibid.*

⁴⁴⁸ *ibid.*, 27.

⁴⁴⁹ *ibid.*, 27.

diversified background as demonstrated by the study of High Pay Centre. It revealed that out of the 366 NEDs who sit on the REMCO of the FTSE 100 companies, 37 members did not come from a business or financial intermediation background. Two members worked for BBC, 20 were civil servants, 3 were lawyers, 1 was a film producer, 4 were academics and 7 were accountants.⁴⁵⁰ However, the effect of this diversification is insignificant as most REMCOs are still predominantly made up of current executives of other companies.

Ideally, the REMCO should be made up of independent NEDs who are fully conversant with the company and who have a good knowledge of executive remuneration practices.⁴⁵¹ The independence of the NEDs has been criticised firstly, on the grounds that the appointments of the NEDs are still largely in the hands of the board as a whole even though the nomination committee are supposed to make the appointment process more transparent and independent.⁴⁵² Furthermore, the articles of many companies (including the Model Articles⁴⁵³) allow the board to appoint a director, indicating that the board still ultimately appoints the NEDs. In some cases NEDs are appointed by the management and this makes them susceptible to management as they owe their pay to the executives.⁴⁵⁴ NEDs feel a sense of divided loyalty as they attempt to fulfil their fiduciary duty to the company while maintaining an amicable relationship with the executives under whose opinion they are appointed to the board.⁴⁵⁵ The effect of this on executive pay would be an increase in pay levels as the NEDs try to please the executives and protect their position on the board.⁴⁵⁶

Secondly, NEDs only work part-time for the company devoting about one or two days a month to the company whilst the executive directors work full time and are responsible for the day-to-day running of the company.⁴⁵⁷ The NEDs are faced with limited time and may be unable to grasp fully the intricacies of executive pay setting

⁴⁵⁰ High Pay Centre, *The New Closed Shop: Who's Deciding on Pay?* (High Pay Centre 2012) 8.

⁴⁵¹ Ruth Bender, 'The Platonic Remuneration Committee' (2012) SSRN <http://ssrn.com/abstract=1782642> 1 at 9.

⁴⁵² David Kershaw, *Company Law in Context: Text and Materials* (Oxford University Press, 2012) 292.

⁴⁵³ The Companies (Model Articles) Regulations 2008, Part 2, reg 17(1)(b).

⁴⁵⁴ R Esen, 'Managing and Monitoring: The Dual Role of Non-executive Directors on UK and US board' (2000) 11(6) ICCLR 202, 205.

⁴⁵⁵ *ibid.*

⁴⁵⁶ *ibid.*, at 211.

⁴⁵⁷ L Roach, Card & James' *Business Law for Business, Accounting, & Finance Students* (Oxford University Press 2012) 561.

process and the information upon which performance is to be judged without involving the executive directors.⁴⁵⁸ In large quoted companies, the company's internal resources and financial terms are complex and hard to understand for persons who are not actively involved in the day-to-day running of the company. This is one beneficial factor for members of the REMCO to be active directors of other companies as they understand what it takes to run a company. The NEDs need to understand the company and its functioning to be able to adequately design a remuneration scheme that will reflect on the performance of the company.⁴⁵⁹ The amount of information needed by the NEDs to be able to make informed decisions is enormous and requires time and expertise to understand the information given.⁴⁶⁰ This is a weakness on the independence of NEDS as the management can manipulate and edit the information to favour the executives.⁴⁶¹ The information could be delayed and may reach the NEDs at a stage too late for effective action to be taken.⁴⁶² In most cases, company executives' control (to a large extent) the quality, timing and volume of information given to the NEDs.⁴⁶³

Thirdly, UK NEDs do not have sufficient incentives to monitor the executives as their fee is such that they may not be sufficiently motivated.⁴⁶⁴ The NEDs fee is independent of the company's performance and is also much less than what they might earn as an executive elsewhere.⁴⁶⁵ This leaves the NEDs with little incentive to devote time and effort required to fulfil their responsibilities or oppose the policies of the executive and top management. Zattoni and Cuomo⁴⁶⁶ argued that if NEDs were well paid they would have little incentive to oppose the pay policy of executives, and

⁴⁵⁸ K Keasey and R, Hudson, 'Non-executive Directors and the Higgs Consultation Paper – Review of the Role and Effectiveness of Non-executive Directors' (2002) 10(4) JFRC 361, 367.

⁴⁵⁹ A Zattoni and F Cuomo, 'How Independent, Competent and Incentivized should Non-executive Directors be? An Empirical Investigation of Good Governance Code' (2010) 21(1) Brit J Manage 63, 65.

⁴⁶⁰ T Long, V Dulewicz and K Gay, 'The Role of the Non-executive Director: Findings of an Empirical Investigation into the Differences between Listed and Unlisted UK boards' (2005) 13(5) Corporate Governance 667, 671.

⁴⁶¹ A Sykes, 'Overcoming Poor Value Executive Remuneration resolving the manifest conflicts of interest' (2002) 10(4) Corporate Governance 256, 298.

⁴⁶² *ibid.*

⁴⁶³ R Esen, 'Managing and Monitoring: The Dual Role of Non-executive Directors on UK and US board' (2000) 11(6) ICCLR 202,204.

⁴⁶⁴ Giles Proctor and Lilian Miles, *Corporate Governance* (Cavendish Publishing 2002) 28.

⁴⁶⁵ *ibid.*

⁴⁶⁶ A Zattoni and F Cuomo, 'How Independent, Competent and Incentivized should Non-executive Directors be? An Empirical Investigation of Good Governance Code' (2010) 21(1) Brit J Manage 63, 66.

if they are not well paid NEDs may be insufficiently incentivized to devote time and effort to the job. It is therefore unclear what can incentivize NEDs to motivate them to do their job effectively taking into account the criteria for independence.⁴⁶⁷

Fourthly, NEDs frequently have economic and social ties with the management and may not be prepared to take decisions contrary to the executive's wishes.⁴⁶⁸ This is because they themselves are often former executives or executives of other companies with some of them sitting on the REMCOs of more than two companies, so they will sympathize more with the executives. Their experience as executive in other companies gives them the knowledge and skills needed by board members to set goals, negotiate pay, and hold executives accountable for their performance. These characteristics make the NEDs to identify more with the interest of the executives than those of the company and shareholders.⁴⁶⁹ Due to the choice of NEDs to have this skill set, there is a tendency of recruiting NEDs from a relatively limited talent pool and potentially contribute to the insufficient challenge on remuneration issues by the REMCO.⁴⁷⁰ A survey conducted by the High Pay Centre⁴⁷¹ on 96 companies of the FTSE 100 companies in 2012 indicated that:

- 33% of FTSE 100 companies have a current lead (CEO) executive on the REMCO.
- 9% of FTSE 100 companies have a current FTSE 100 lead executive on the REMCO.

This result demonstrates the composition of the REMCO of some companies and the potential danger it can have on the pay setting process which will be setting less challenging performance conditions on performance related elements of the pay package contrary to the UKCGC's recommendation. It is worth re-iterating here that the UKCGC operates on a 'comply or explain' basis⁴⁷² which requires the companies to disclose their compliance or non-compliance providing explanations where they did not comply. Where the company did not comply as demonstrated by the findings

⁴⁶⁷ A Zattoni and F Cuomo, 'How Independent, Competent and Incentivized should Non-executive Directors be? An Empirical Investigation of Good Governance Code' (2010) 21(1) *Brit J Manage* 63, 66.

⁴⁶⁸ David Kershaw, *Company Law in Context: Text and Materials* (Oxford University Press 2012) 245.

⁴⁶⁹ BIS, *Executive Remuneration: Discussion Paper* (BIS 2011) 26.

⁴⁷⁰ *ibid.*

⁴⁷¹ High Pay Centre, *The New Closed Shop: Who's Deciding on Pay?* (High Pay Centre 2012) 7.

⁴⁷² Discussed in chapter 3.

above, the shareholder would be expected through the annual general meeting to hold the directors to account for the non-compliance. The survey also pointed out that some companies' (e.g. Reckitt Benckiser) REMCO s are made up wholly of current and former executives of other companies.⁴⁷³ This survey demonstrates that although the NEDs might be regarded as independent in their focal company having no direct interest on the levels of executive pay, they may be indirectly interested as they are executives of other companies.⁴⁷⁴ Being executives in other companies, Sykes⁴⁷⁵ argues that the NEDs would have a generic interest in high remuneration without exerting performance requirements. This is because they are aware that giving the executives high remuneration level will reflect back on their pay levels in their own company where they are executives through remuneration benchmarking. Given this position the NEDs therefore find themselves in a sympathetic position rather than assertive and dynamic position.⁴⁷⁶ The High Pay Centre pointed out that because the REMCO is made up of NEDs who are often executives in other companies, they are part of the high pay culture and what would constitute excessive pay to a majority of people might seem reasonable to the REMCO.⁴⁷⁷ The effect of this position would be an inability to objectively question excessive executive remuneration.⁴⁷⁸ Consequently, executive remuneration would continue to increase in a sequence with the REMCO of most companies not wanting the executive of their companies to be earning less than their counterparts in other companies, thus tending to make recommendations that would increase remuneration levels.⁴⁷⁹

The lack of independence of the NEDs therefore places doubts on the REMCO as an effective body in the setting of executive remuneration. Despite the widespread adoption of REMCO s by listed companies, this lack of independence is demonstrated by the continuous increase in executive pay levels over the past two decades with no apparent link to company performance.

⁴⁷³ High Pay Centre, *The New Closed Shop: Who's Deciding on Pay?* (High Pay Centre 2012) 7.

⁴⁷⁴ *ibid.*

⁴⁷⁵ A, Sykes, 'Overcoming Poor Value Executive Remuneration Resolving the Manifest Conflicts of Interest' (2002) 10(4) CGIR 256, 257.

⁴⁷⁶ Giles Proctor and Lilian Miles, *Corporate Governance* (Cavendish Publishing 2002) 28.

⁴⁷⁷ High Pay Centre, *More For Less: What has Happened to Pay at the Top and does it Matter?* (High Pay Centre 2011) 43-45.

⁴⁷⁸ BIS, *Executive Remuneration: Discussion Paper* (BIS 2011) 26.

⁴⁷⁹ *ibid.*

Theories that affect the decision making process

Several different theories suggest how individuals on REMCOs set the executive remuneration level. A detailed discussion on the various theories that affect the REMCO's decision making is outside the scope of this thesis but four theories would be briefly discussed. These theories include social comparison theory, demographic characteristics, labour market theory and human capital theory. These theories are discussed below.

Social comparison/identity theory

The process by which the REMCO deliberate on remuneration setting is subject to social psychological processes that affect most group decision making.⁴⁸⁰ They make ambiguous decisions such as setting executive remuneration where use of social information is highlighted.

Social identity theory suggests that people classify themselves and others into social categories and then identify more with members of their own category than with members outside that category.⁴⁸¹ The presence of the executives of other companies on the REMCO of another may exert influence over the remuneration process as corporate executives tend to be a relatively homogenous, cohesive collection of individuals.⁴⁸² This cohesion may lead to a general propensity to support peer executives in board decisions and particularly in remuneration packages.⁴⁸³ The gap between the executive interest and company's interest (Agency Theory) is very significant such that the REMCO cannot ignore it. Unfortunately, due to social identity, the REMCO identifies themselves with the social category of the executives rather than the shareholders whose interests they are supposed to promote. The REMCO (being executives of other companies) may review and recommend a remuneration package that is more consistent with their preference as executives than with those of shareholders.⁴⁸⁴ Studies found out that executive remuneration is highly

⁴⁸⁰ Savo Kovacevic, 'Understanding Board Remuneration Committees' (2009) A Submission to the Productivity Commission 1, 19. http://www.pc.gov.au/__data/assets/pdf_file/0010/89470/sub043.pdf assessed 13 June 2014.

⁴⁸¹ Charles O'Reilly III, Brain Main and Graef Crystal, 'CEO Remuneration as Tournament and Social Comparison: A Tale of Two Theories' (1988) 33(2) Admin Sci Quart 257, 261.

⁴⁸² High Pay Centre, *The New Closed Shop: Who's Deciding on Pay?* (High Pay Centre 2012) 9.

⁴⁸³ B D Singh, *Compensation and Reward Management* (2edn. Excel Books India 2012) 269.

⁴⁸⁴ *ibid*, pg 211

related to the remuneration of NEDs serving on REMCOs. This echoes the benchmarking strategy of determining executive pay package⁴⁸⁵ discussed later in this chapter. This theory does not take into account individual and company performance when setting executive remuneration indicating that the effect of this theory on executive remuneration levels would be an increase in executive remuneration levels with no corresponding link to company performance.

Social identity theory also suggests that gender similarity or dissimilarity can be used to predict the treatment of others. This means that men and women are more comfortable with individuals of the same gender at adulthood. This points out that the REMCO could treat executives with whom they feel more comfortably favourably. Research on this aspect of gender similarity has yielded mixed results with O'Reilly et al⁴⁸⁶, Michael N. Young⁴⁸⁷ supporting the positive effect of gender similarity, while Graves et al⁴⁸⁸, found a negative effect of the gender similarity.

Furthermore, considering the nature of responsibility of the REMCO (and how difficult it can be to make decisions on executive remuneration) their experience as executives of other companies does have a significant impact upon the decision they make. They tend to identify with the problems encountered by other executives. This similar experience provides the executives and the REMCO with a shared language that facilitates their interaction.⁴⁸⁹

Demographic characteristics

Demographic similarities provide an important basis for group membership. Similarity in demographic characteristics such as age, gender, tenure, education and race has been proven to influence outcomes within executive work teams. Generally individuals with the same or similar demographic characteristics seem more inclined

⁴⁸⁵ Crystal S Graef, 'Why CEO Remuneration is so High' (1991) California Management Review, 34(1), 9-29; Hambrick DC & Finkelstein S, 'The Effect of Ownership Structure on Conditions at the Top: The Case of CEO Pay Rises' (1995) 34 SMJ 707-717.

⁴⁸⁶ Charles O'Reilly III, David Caldwell and William Barnett, 'Work Group Demography, Social Integration and Turnover' (1989) 34(1) Admin Sci Quart 21-37.

⁴⁸⁷ Michael N. Young and Ann K. Buchholtz, 'Firm Performance and CEO Pay: Relational Demography as a Moderator' (2002) 14 (3) Journal of Managerial Issues 296-313.

⁴⁸⁸ Graves M. Laura and Powell N. Gary, 'The Effect of Sex Similarity on Recruiter's Evaluation of Actual Applicants: A Test of the Similarity – Attraction Paradigm' (1995) 48(1) Personnel Psychology 85-98.

⁴⁸⁹ *ibid.*

to work in favour of each other than those with dissimilar demographic characteristic.⁴⁹⁰ These characteristics lead to perceived similarity in attitudes and values which tends to lead to interpersonal attraction, then positive treatment of each other.⁴⁹¹ Executives may prefer demographically similar board of directors (e.g. most boards are made up of a majority of men than women⁴⁹² and members of the board may prefer men to women), and by extension board committees whose members are more likely to support management initiatives. Increase in demographic similarity between executives and members of the REMCO may be associated with increase in executive remuneration and decrease in performance related remuneration.⁴⁹³ A study by Young and Buchholtz⁴⁹⁴ on the effect of relational demography on the link between CEO remuneration and company performance found out that demographic similarity (tenure) between the CEO and the REMCO resulted in a weak relationship between CEO pay and company performance. This finding suggest that because of social cohesion between the executives and the REMCO is likely to result in higher guaranteed salaries with less emphasis on performance related pay. Considering that members of the REMCO might also be executives of other companies, the REMCO tends to have similar experience and background with the executive of the focal company, consequently providing the executive s with very attractive remuneration packages.⁴⁹⁵

Another demographic characteristic that may affect the determination of executive pay is the age of the executive. Executive age is important in pay setting process because the intellectual capability of the executive is enhanced due to education, knowledge and experience gained from the position over the years.⁴⁹⁶ Members of the

⁴⁹⁰ Michael N Young and Ann K Buchholtz, 'Firm Performance and CEO Pay: Relational Demography as a Moderator' (2002) XIV (3) *Journal of Managerial Issues* 296, 297; Zenger R. Todd and Barbara S. Lawrence, 'Organisational Demography: The Differential Effects of Age and Tenure Distribution on Technical Communication' (1989) 32 *AMJ* 353-376.

⁴⁹¹ Michael N Young and Ann K Buchholtz, 'Firm Performance and CEO Pay: Relational Demography as a Moderator' (2002) XIV (3) *Journal of Managerial Issues* 296, 299; Charles O'Reilly III, David Caldwell and William Barnett, 'Work Group Demography, Social Integration and Turnover' (1989) 34(1) *Admin Sci Quart* 21, 22.

⁴⁹² High Pay Centre, *The New Closed Shop: Who's Deciding on Pay* (High Pay Centre 2012) 8.

⁴⁹³ Anne Tsui, Terri Egan and Charles O'Reilly III, 'Being Different: Relational Demography and Organisational Attachment' (1991) 1 *ACAD MANAGE PROC* 183-187.

⁴⁹⁴ Michael Young and Ann Buchholtz, 'Firm Performance and CEO Pay: Relational Demography as a Moderator' (2002) 14(3) *Journal of Management Issues* 296-313.

⁴⁹⁵ *ibid.*

⁴⁹⁶ David Day, *The Oxford Handbook of Leadership and Organisations* (Oxford University Press 2014) 571.

same age group share a wealth of experience, beliefs and attitude that provides them with a common bond. Members of the REMCO who are of the same age as the executives tend to treat the executives more favourably regarding remuneration issues than those who are either younger or older.⁴⁹⁷ The executives are expected to manifest a willingness to accept additional exposure to risk and favour long-term success of the company because of the knowledge and experience they have amassed over the years in the executive job role. On the contrary, remuneration pay levels increase with age but company's performance does not always increase with age.

Labour Market Theory

The labour market theory suggests that there is a limited pool of talented individuals who have the ability to run large companies successfully and therefore are paid more than others.⁴⁹⁸ This implies that the level of executive remuneration could be determined by the operation of a competitive executive labour market. This competitive nature of the labour market implies that executives could move to better rewarded employments should the current company not pay more than other companies.⁴⁹⁹ The REMCO use this argument to justify the pay levels awarded to executives on the grounds that they are required to offer pay packages that are sufficient to attract, retain and motivate executives.⁵⁰⁰

Human Capital Theory

The efficiency and productivity of an executive is influenced by his accumulated knowledge and skills (otherwise known as human capital). The amount of human capital an executive possesses influences his productivity which in turn influences his earnings.⁵⁰¹ A high human capital will be a function of more knowledge (education) and/or skills (work experience) an executive has. Education has been found to

⁴⁹⁷ David Day, *The Oxford Handbook of Leadership and Organisations* (Oxford University Press 2014) 571.

⁴⁹⁸ Ian Gregory-Smith and Brian G.M. Main, 'Testing the Participation Constraint in the Executive Labour Market' (2013) http://homepages.ed.ac.uk/mainbg/Files/jobmoves2013_08_27.pdf 1, 2 assessed 22 June 2014.

⁴⁹⁹ High Pay Centre, *The New Closed Shop: Who's Deciding on Pay?* (High Pay Centre 2012) 10.

⁵⁰⁰ FRC, *The UK Corporate Governance Code* (FRC 2012) D.1.

⁵⁰¹ JA Otten, 'Theories on Executive Pay. A Literature Overview and Critical Assessment' (2008) MPRA Paper No. 6969 1, 8.

influence managerial executive remuneration positively.⁵⁰² Furthermore, executives with higher human capital tend to be paid more as they are, in theory, perceived to perform their job better.⁵⁰³

Factors taken into account when determining executive remuneration

The factors considered in determining an executive remuneration package are crucial to the realisation of a 'desired' remuneration package (a desired remuneration package which will be closely linked to company performance). The public debate on executive remuneration is for pay levels to be linked to company performance and for the pay inequality gap between executives and other employees of the company to be reduced. The UKCGC makes limited recommendations on the factors that the REMCO should consider in determining pay, which is for companies to consider individual and corporate performance,⁵⁰⁴ although it does not recommend how performance should be measured. The Code also recommends that pay should be set as to attract, retain and motivate the executives.⁵⁰⁵ This principle of the Code is vague, therefore leaves the REMCO with significant discretion in setting pay. The CA 2006 does not make provision on how executive remuneration should be determined. Considering the complex nature of executive remuneration packages, the REMCO are therefore confronted with the question of what is appropriate in determining executive pay.⁵⁰⁶ A number of research studies⁵⁰⁷ have been conducted in this area but none has come up with defined criterion on how and what should be the appropriate determinants of executive remuneration package. The work of Gomez-Mejia and Wiseman⁵⁰⁸ looked at how, when and what to pay executives as remuneration in

⁵⁰² James Johnson and Michael W. Danson, 'Chief Executive Officer Remuneration in Britain: A Regional Perspective' (1995) 29(8) RS 791, 791.

⁵⁰³ Ian Gregory-Smith and Brian G.M. Main, 'Testing the Participation Constraint in the Executive Labour Market' (2013) http://homepages.ed.ac.uk/mainbg/Files/jobmoves2013_08_27.pdf 1, 2 assessed 22 June 2014.

⁵⁰⁴ FRC, *UK Corporate Governance Code* (FRC 2012) D.1.

⁵⁰⁵ *ibid.*

⁵⁰⁶ Stuart Ogden and Robert Watson, 'Executive Pay and the Search for Legitimacy: An Investigation into how UK Remuneration Committees Use Corporate Performance Comparisons in Long-term Incentive Pay Decisions' (2008) 61(5) HR 711, 712.

⁵⁰⁷ For example, Ruth Bender, 'The Determination of Directors' Remuneration in selected FTSE 350 Companies' (2004) PhD Thesis, University of Warwick; Stuart Ogden and Robert Watson, 'Executive Pay and the Search for Legitimacy: An Investigation into how UK Remuneration Committees Use Corporate Performance Comparisons in Long-term Incentive Pay Decisions' (2008) 61(5) HR 711, 712.

⁵⁰⁸ Luis Gomez-Mejia and Robert M. Wiseman, 'Reframing Executive Remuneration: An Assessment and Outlook' (2007) 23(3) *Journal of Management* 291-374.

which they considered various criteria (such as company size, sector etc.) but did not come up with defined criteria to follow by companies when determining executive. A study carried out by Bender⁵⁰⁹ examined how companies determine pay, considered the effect of market value, industry and the company size on the remuneration package, but again did not define the criteria followed in the act of determining executive remuneration.

The lack of uniform rules and criteria on the determination of executive remuneration implies that the REMCO needs to exercise value judgments in making their decision. The factors taken into account by the REMCO when setting executive remuneration are many and complex. Some of the factors include the company's business, culture and values, stakeholder interest, company performance, and the company's policy on executive pay.

The company's business

The understanding of the company's business is essential for the REMCO when setting executive remuneration packages. This would include understanding the size of the company, the company's sector and the complexity of the company. Each of these factors would be discussed in turn.

Company size

Company size has an important role in the determination of executive pay with numerous studies indicating that executive pay tends to increase with company's size.⁵¹⁰ The size of the company can affect all aspects of remuneration such as base salary, annual bonus design, performance measures and the type of long-term incentive plans that are appropriate. The executive's job in a large company is considered to be more complex and has more responsibilities than those in a smaller company, thus justifying higher pay. The marginal productivity (the change in company performance as a result of executive performance) of an executive varies

⁵⁰⁹ Ruth Bender, 'The Determination of Directors' Remuneration in Selected FTSE 350 Companies' (2004) Thesis.

⁵¹⁰ Peter F. Kostiuk, 'Firm Size and Executive Remuneration' (1990) 25(1) JHR 90; O'Reilly Charles, Main. Brian, and Crystal Graef, 'CEO Remuneration as Tournament and Social Comparison: A Tale of Two Theories' (1998) 33(2) Admin Sci Quart 257-274; O'Reilly Charles and Brian. Main, 'Setting the CEOs Pay: Economic and Psychological Perspectives' (2005) Stanford Research Paper No. 1912 <http://ssrn.com/abstract=804584> assessed 23 February 2011

directly with the size of the company he manages, thus the larger the size, the higher the marginal productivity.⁵¹¹ This principle however, seems to be applied more to the executives than to all the workforce of the company. This is because the percentage increase in executive pay levels does not correspond to the percentage increase in the wages of average employees of the company.⁵¹²

Companies develop a hierarchical structure and they tend to pay those at the top more than their subordinates.⁵¹³ Larger companies have more hierarchical management levels, they also have increased numbers of layers of management and their executives may receive a higher remuneration than that of a small company.⁵¹⁴ However, not all companies of the same size and sector have same rewards for layer of management (e.g. Sainsbury plc and Marks & Spencer plc) are from the same sector with almost the same size (size measured by market capitalisation, £6.97bn for Marks & Spencer, and £6.3bn for Sainsbury). The pay level for the CEO of Sainsbury was far more than that of the CEO of Marks & Spencer. Furthermore, the number of management levels increases with company size. Consequently, companies that attempt to ensure adequate pay differentials between hierarchical levels are likely to pay more.

Company sector

A sector could be defined as a collection of companies with similar characteristics. Companies in the same sector tend to have some similarities like common organisational routines, similar markets and are subject to comparable external influences.⁵¹⁵ The company's sector has an important factor in the determination of executive remuneration as it represents the demarcation of the managerial labour market with the relative supply and demand of executives in an industry.⁵¹⁶ Company sector is important in determining executive remuneration as it provides important reference for the REMCO in terms of social comparison. Managers tend to compare

⁵¹¹ Naresh C Agarwal, 'Determinants of Executive Remuneration' (1981) 20(1) IR 36 at 36.

⁵¹² BBC News, 'Pay Gap Between Executives and Employees is 'Widening' (2013) November 18th.

⁵¹³ William Pride, Robert Hughes and Jack Kapoor, *Foundation of Business* (Cengage Learning 2012) 116.

⁵¹⁴ Jay Fattorusso, 'UK Executive Pay: The Special Case of Executive Bonuses' (2006) Doctoral Thesis, Loughborough University 1, 47.

⁵¹⁵ Sydney Finkelstein, 'Why is the Industry Related to CEO Remuneration?: A Managerial Discretion Explanation' (2009) 3 TOJ 42, 42.

⁵¹⁶ *ibid*, at 44

their remuneration with others and usually the most relevant comparison would be with their peers of other companies in the same sector indicating that the sector pay practices may be influential in the executive pay setting.⁵¹⁷ Finkelstein's⁵¹⁸ study on the effect of company sector on the executive remuneration discovered that executive remuneration is heavily influenced by the company's sector in which the company competes. The REMCO's understandings of the industry and the position of the company within the industry is significant to the setting of executive remuneration levels. This is because different industries have different remuneration policies.⁵¹⁹ This labour market effects would be unlikely to be sector-based if executive labour market operated within such boundaries (within industries). However, this fact has been branded by Harris and Helfat⁵²⁰ as irrelevant on the basis that some companies tend to appoint executives from other companies in completely different industries. Finally, in the executive labour market, premiums paid to external successors are unaffected by the sector, implying that the demand and supply of executives in an industry has little bearing on pay levels.⁵²¹

Corporate complexity

Corporate complexity is an important factor taken into account when setting executive remuneration because companies with more complex structures tend to pay executives more due to the amount of responsibilities they carry out. Basu and Media⁵²² defined business complexity as the condition of having several interdependent and interconnected stakeholders, information technology systems and organizational structures. Stakeholders include employees, customers, partners, suppliers, regulators, investors, media and competitors. Organizational structures include divisions, subsidiaries and joint ventures (e.g. a complex company would include Barclays bank that had 1268 subsidiaries, joint ventures and associates of the company by 31st

⁵¹⁷ Dawn Harris and Constance Helfat, 'Specificity of CEO Human Capital and Remuneration' (1997) 18 SMJ 895, 895.

⁵¹⁸ Sydney Finkelstein, 'Why is the Industry Related to CEO Remuneration?: A Managerial Discretion Explanation' (2009) 3 TOJ 42, 54.

⁵¹⁹ Jay Daniels Fattorusso, 'UK Executive Pay: The Special Case of Executive Bonuses' (2006) Doctoral Theses 1, 94.

⁵²⁰ Dawn Harris and Constance Helfat, 'Specificity of CEO Human Capital and Remuneration' (1997) 18 SMJ 895, 895.

⁵²¹ *ibid.*

⁵²² Chirantan Basu and Demand Media, 'Definition of Complexity in Business' <http://smallbusiness.chron.com/definition-complexity-business-21640.html> assessed 18 July 2013.

December 2012).⁵²³ A relatively simple company would include Fresnillo plc with 14 subsidiaries and associates of the company.⁵²⁴ Therefore, complexity of a company is the result of growth in the business, new technologies, new regulations, more employees to manage, global nature of the business and the interconnection with other businesses. Some executives have a more demanding job than others, consequently they might demand a higher premium in the managerial labour market because their talents are relatively scarce, and the demand for their services is high⁵²⁵. A company with multinational operations tend to pay their executives more than a company with a single operation. Company diversity may signify greater executive discretion and higher executive pay.⁵²⁶

Company performance

Company performance is a vital factor to be considered in the determination of executive remuneration, as recommended by the UKCGC.⁵²⁷ The Code recommends that a significant proportion of the remuneration package should be structured so as to link rewards to corporate and individual performance.⁵²⁸ The REMCO therefore should determine remuneration elements that will boost the company's performance as well as the individual executive's performance. The REMCO would have to set performance targets and performance measures relevant to the company and designed to promote the success of the company. There exist a number of performance targets and measures that the REMCO can use to set and reward the executive based on individual and company performance (discussed in detail in chapter 5).⁵²⁹ These performance factors are important as every stakeholder would want an executive who will guide the company towards success by virtue of his ability, expertise, experience, motivation, authority, accountability and then be rewarded accordingly.⁵³⁰ The use of appropriate performance targets will enable the REMCO to ensure that directors'

⁵²³ List of Barclays Bank plc subsidiaries 2012, <http://www.sec.gov/Archives/edgar/data/312069/000119312513105055/d497934dex81.htm>.

⁵²⁴ Chirantan Basu and Demand Media, 'Definition of Complexity in Business' <http://smallbusiness.chron.com/definition-complexity-business-21640.html> assessed 18 July 2013.

⁵²⁵ *ibid.*

⁵²⁶ Tammy Berry, John Bizjak, Michael Lemmon and Lalitha Naveen, 'Organisational Complexity and CEO Labor Markets: Evidence from Diversified Firms' (2006) 12 *Journal of Corporate Finance* 797, 798.

⁵²⁷ FRC, *The UK Corporate Governance Code* (FRC 2012) D.1.

⁵²⁸ *ibid.*

⁵²⁹ See chapter 5.

⁵³⁰ Robert AG Monks and Nell Minow, *Corporate Governance* (5edn. John Wiley & Sons 2012) 299.

remuneration is perceived as appropriate and fair. Performance measures will also provide the REMCO with essential underpinning when it comes to determining short and long-term incentives. In order to obtain the desired performance from the executives, it is crucial that the performance targets and measures are selected carefully to promote the success of the company. The REMCO needs to understand the past performance record of the company and future prospects of the company to be able to set the performance-related pay of the executives.

Market Forces

The REMCO need to understand the market and the market data as they are important input into their deliberations on the remuneration decisions. Market forces represent the economic factors affecting the price of, demand for, and the availability of a commodity (in this case the executives)⁵³¹. Market forces are assumed to lead to optimal pay levels and structures; remunerating executives for the risks they are willing to take to manage the corporation in the interest of the shareholders.⁵³² The market data defines the parameters of normality and the boundaries of what is reasonable remuneration. Executive remuneration cannot deviate significantly from what the market deem as appropriate otherwise underpaid executives would likely move to competitors companies who are happy to pay at the market rate⁵³³. The REMCO needs to ensure that the executives remain loyal to the company by offering levels of pay comparable, or better, to the external labour market. By offering the executives' pay that is at the market rate, executive turnover of a company will be reduced.⁵³⁴

Stakeholder interests

The term stakeholder can refer to any individual or group on which the activities of the company have an impact.⁵³⁵ This includes shareholders, employees, and providers of credit to the company, customers, suppliers, government and the local community.

⁵³¹ Oxford Dictionaries, <http://www.oxforddictionaries.com/definition/english/market-forces> assessed 13 June 2014.

⁵³² Jordan Otten, 'Theories on Executive Pay: A Literature Overview and Critical Assessment' (2007) <http://mpa.ub.uni-muenchen.de/6969/1/theorizingexecutivepay.pdf> assessed 14 March 2011.

⁵³³ High Pay Centre, *The New Closed Shop: Who's Decision on Pay* (High Pay Centre 2012) 9.

⁵³⁴ Mahmoud Ezzanmel and Robert Watson, 'Market Comparison Earnings and the Bidding-up of Executive Remuneration: Evidence from The United Kingdom' (1998)41(2) AMJ 221, 223.

⁵³⁵ Christine A Mallin, *Corporate Governance* (4edn. Oxford University Press 2013) 69.

The UKCGC⁵³⁶ recommends companies to be sensitive to pay and employment conditions elsewhere in the group when determining pay. The law also requires quoted companies to include in their remuneration report a statement of how pay and employment conditions of employees of the company was taken into consideration when determining executive pay.⁵³⁷ The REMCO should therefore take into account the pay gap between executives and other employees of the company when determining executive remuneration, even though this does not seem to be the case when determining executive pay. An example would be the pay inequality between executives and other employees of the company (e.g. in 2014 CEOs of FTSE 100 companies were paid 130 times more than their average employee)⁵³⁸. Although shareholders come under stakeholders of the company, they have a privilege over the rest of the stakeholders as they are the recipient of the residual free cash flow after creditors are paid. Shareholders would like companies to strive more for the enhancement and maintenance of long-term success of the company which will maximise shareholder value whilst trying to take into account the wider stakeholder interest at the same time.⁵³⁹ The wider stakeholder group have their independent interests that they want to protect⁵⁴⁰ and the REMCO needs to take into consideration this interest in determining executive remuneration.

Company culture and values

Every company has distinctive cultures and values which communicate what is important, and what behaviour is acceptable in the company. Kelchner and Media⁵⁴¹ said:

The culture refers to the values and attitudes of employees in the business or organization. In a business with an unhealthy culture, employees act as individuals, performing their duties to meet their own needs, such as a pay

⁵³⁶ FRC, *The UK Corporate Governance Code* (FRC, 2012) D.1.

⁵³⁷ The Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Part 2, reg. 4.

⁵³⁸ Iuke Hildyard, 'FTSE 100 Bosses Now Paid an Average 130 times as Much as Their Employees' (2014) High Pay Centre August 18th.

⁵³⁹ Christine A Mallin, *Corporate Governance* (4edn. Oxford University Press 2013) 36.

⁵⁴⁰ Excluding preferred shareholders as they receive fixed dividend amount.

⁵⁴¹ Luanne Kelchner and Demand Media, 'Importance of a Healthy Corporate Culture' (2014) Houston Chronicle <http://smallbusiness.chron.com/importance-healthy-corporate-culture-20899.html> assessed 13 June 2014.

check or health benefits. A healthy corporate culture values each employee in the organization regardless of his job duties, which results in employees working as a team to meet the company's and their own personal needs. Healthy corporate culture improves the performance of a business in a number of areas.

For example, the culture and values of John Lewis Partnership is based on trust which is incorporated in their work practice and has gained the partnership a good corporate reputation.⁵⁴² These distinctive cultures are established by the founders of the company and further affected by the personality and transforming activities of the founders inheritors.⁵⁴³ Company cultures and values are strongly influenced by the characteristics of the sector in which the company operates.⁵⁴⁴ Companies within the same sector often share certain cultural elements that are required for the long term survival of the company.

These values are widely shared and reflected in daily practice and relevant to company purpose and strategy.⁵⁴⁵ These values and cultures are frequently reflected in the sector's pay practices, which includes types of benefits available or the design of incentives (long term or short term incentive). For example, company values that are purely profit driven might offer their executives more rewards as they might be likely based on short term performance of the company rather than long term success of the company. Nash et al's⁵⁴⁶ study of the impact of culture on CEO compensation found out that cultural factors are significant determinants of CEO compensation. Consequently, the REMCO must be familiar with the values and culture of the company to be able to determine a remuneration package that will reflect on the company's performance.

⁵⁴² John Lewis Partnership, <http://www.johnlewispartnership.co.uk/en.html> assessed 13 June 2014.

⁵⁴³ P, Hyde and B, Williamson, 'The Importance of Organisational Values. Part 3: Choosing and Implementing Organisational Values' (2000) 68 Focus on Change Management 10, 10.

⁵⁴⁴ George Gordon, 'Industry Determinants of Organisational Culture' (1991) 16(2) AMR 396-415.

⁵⁴⁵ *ibid*, 399.

⁵⁴⁶ Robert Nash, Ajay Patel and Steve Bryan, 'Culture and CEO Compensation' (2012) San Diego Meeting Paper <http://ssrn.com/abstract=2023530> assessed 13 June 2014.

Current remuneration arrangements

The REMCO would also have to consider the remuneration report of the company for the previous year which will contain (i) information on the compliance with the law and corporate governance codes; (ii) the overall remuneration philosophy which includes the positioning of the total remuneration relative to the market, long-term and short-term incentive arrangement, the benefit policy and any changes planned for the current year; (iii) directors contract details including severance arrangements, notice period, remuneration for loss of office and any arrangements for changes in control; (iv) details of individual director's remuneration for the past three to five years including base salary, long-term incentive plans, bonuses, pensions, share options and any special arrangements for individual directors and why they exist, and; (v) the RCONs that were used, how they were appointed and the advice they offered. This document would provide the REMCO with necessary information for them to make informed judgment on future remuneration policy for the company.

Executive Pay Benchmarking

The UKCGC recommends that the REMCO should be sensitive to pay and employment conditions elsewhere in the group (sector), especially when determining annual salary increases.⁵⁴⁷ Most quoted companies set executive pay by comparing executive pay levels with executives of other companies. This practice is regarded as generating a ratchet effect that leads to continues growth in the level of pay and also increases the inequality gap between directors and rank and file employees.⁵⁴⁸ The REMCO rely on RCONs on advice on peer benchmarking.⁵⁴⁹ More on executive remuneration benchmarking is discussed later in the chapter.

The effects of the remuneration committee on executive pay

The adoption of REMCOs reflects the complexity of modern day remuneration packages, unlike the simple pay packages in the 1980s that were made up of only base salary and bonus as the main components.

⁵⁴⁷ FRC, *The UK Corporate Governance Code* (FRC 2012) D.1.

⁵⁴⁸ L Goh and A Gupta, 'Executive Compensation, Compensation Consultants, and Shopping for Opinion: Evidence from the UK' (2011) 25(4) JAAF 608-644.

⁵⁴⁹ Executive remuneration benchmarking is examined in Part II of this chapter.

Evidence on the adoption of REMCOs was provided by the study carried out by Conyon⁵⁵⁰ which revealed that, between 1988 and 1993, the percentage of UK quoted companies with RCs had risen from 54 per cent to 94 per cent. Conyon and Peck⁵⁵¹ in 1998 found out that nine out of ten companies reported REMCOs indicating that most companies were using the REMCO to determine executive pay rather than allowing the executives to set their own pay.⁵⁵²

The absence of a REMCO within a company would suggest that the executives are writing and signing their own contracts. The CA 2006 does not require companies to set up a REMCO; it states that if a committee has consider matters relating to directors' remuneration, then members of such committee should be disclosed in the remuneration report.⁵⁵³ This implies as a strict matter of the law the executives are still setting their own pay as they are not required by law to set up a REMCO.

Despite the justification of having REMCO to determine executive pay, past research has provided a mixed results as to the committee's effectiveness. Early studies on REMCO by Main et al.⁵⁵⁴ found out that executives of companies without a REMCO were paid 24% more than executives whose board had REMCO. This indicated that REMCOs has an important and positive role in controlling boardroom remuneration. Conyon⁵⁵⁵ examined the existence of REMCO and directors remuneration and found that the presence of the REMCO was associated with lower growth in director remuneration thereby supporting the findings of Main et al. There are strong theoretical reasons for expecting the REMCO to exert an influence on top executive pay for the interest of the company and its stakeholders at large. In their role to act as independent arbiters of executive remuneration, they also have to respond competitively towards market pressure and design a remuneration contract that

⁵⁵⁰ Martin Conyon, 'Corporate Governance Changes in UK Companies Between 1988 and 1993' (1994) 4(2) CGIR 87-93.

⁵⁵¹ Martin Conyon and Simon Peck, 'Board Control, Remuneration Committee, and Top Management Remuneration' (1998) 41(2) AMJ 146-157.

⁵⁵² S, Kovačević, "Remuneration Committees in the Spotlight: Explaining executive pay" (2008) 22nd AIRRANZ Conference Melbourne, <http://www.mngt.waikato.ac.nz/departments/Strategy%20and%20Human%20Resource%20Management/airaanz/proceedings/melbourne2008/ref/S.%20Kovacevic.pdf> assessed 18 January 2011.

⁵⁵³ Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8. Pt. 3, para 22(1)(a).

⁵⁵⁴ BGM, Main, C, O'Reilly, and J, Wade, 'The CEO, the Board of Directors and Executive Remuneration: Economic and Psychological Perspective' (1995) 4 ICC 293-332.

⁵⁵⁵ Martin Conyon, 'Corporate Governance and Executive Compensation' (1997) 15(4) IJIO 493-509.

ensures executive have an incentive to behave consonantly with shareholder interest.⁵⁵⁶ Contrary to the findings of Main et al. and Conyon above, Main and Johnston⁵⁵⁷, Conyon and Peck⁵⁵⁸, Dalton R. Dan et al⁵⁵⁹ found little evidence to support the fact that the REMCO tailored executive pay to produce incentive effects that are beneficial to the company and its shareholders. Studies demonstrating the ineffectiveness of the REMCO have more evidence than those that demonstrate its effectiveness. This is further supported by a study carried out by the High Pay Centre⁵⁶⁰ demonstrating that the composition of the REMCO may be part of the reasons of its ineffectiveness. The high pay that executives receive due to the presence of the REMCO could be attributed to the lack of independence of the REMCO from the executives.⁵⁶¹ Ezzamel and Watson⁵⁶² found that with the presence of the REMCO, directors who were underpaid relative to the market had their pay increased, but directors who were overpaid received no parallel downward adjustments. They suggested that a kind of opportunistic relationship existed between the executive and NEDs who sit on each other's committees and thereby bid up executive earnings.⁵⁶³ This study was supported by O'Reilly et al⁵⁶⁴ who suggested that executive pay is driven by expectations stemming from social norms in which individuals base their judgments on a self-referential point (personal preferences, situation and circumstances). Their study suggested that the REMCO perhaps set executive remuneration level based initially on their own level⁵⁶⁵ which ends up with higher pay levels. They found that the average salary of the REMCO members (in relation to their own executive jobs) had a positive effect on executive pay. This means that the REMCO is not having the desired effect on the setting of executive remuneration,

⁵⁵⁶ JD, Fattorusso, 'UK Executive Pay: the Special case of Executive bonuses' (2006) thesis <https://dspace.lboro.ac.uk/dspace-jspui/bitstream/2134/2294/3/PhDTHESISJayFattorusso.pdf> assessed 28 October 2010.

⁵⁵⁷ Main B and Johnston J, 'Remuneration committees and corporate governance' (1993) 23 A & BR 351-362.

⁵⁵⁸ Martin Conyon and Simon Peck, 'Board Control, Remuneration Committees, and Top Management Remuneration' (1998) 41(2) AMJ 146-157.

⁵⁵⁹ Dalton R Dan, Daily M Catherine, Johnson L Jonathan, and Ellstrand E Alan, 'Number of Directors and Financial Performance: A Meta-Analysis' (1999) 42(6) The AMJ 674-686.

⁵⁶⁰ High Pay Centre, *The New Closed Shop: Who's Deciding on Pay?* (High Pay Centre 2012).

⁵⁶¹ The independence of the remuneration committee as discussed earlier in p113.

⁵⁶² Ezzamel and Watson, 'Wearing Two Hats: The Conflicting Control and Management Roles of Non-executive Directors' (1997) CGEFI 61-92.

⁵⁶³ Martin Conyon and Simon Peck, 'Baord Control, Remuneration Committees, and Top Management Compensation' (1998) 41(2) AMJ 146,148.

⁵⁶⁴ O'Reilly A Charles, Main G Brian, and Crystal S Graef 'CEO Remuneration as tournament and social comparison: A Tale of two theories' (1998) 33 Admin Sci Quart 257-274.

⁵⁶⁵ Levels at which they are paid in the companies where they act as executives.

consequently pushing up pay levels that are not related to company performance. Johnston⁵⁶⁶ study which examined the association between market forces and internal control on the remuneration contracting process, found out that the appointment of executives to the REMCO is not associated with an opportunistic behaviour to set pay in their self-interest. The study also found out that the appointment of at least three NEDs to the committee was associated with lower levels of CEO remuneration. Their findings demonstrate that having executives on the REMCO could still restrain excessive executive remuneration. This study was further supported by another study by Gregory-Smith⁵⁶⁷ who examined REMCO and CEO influence on the remuneration setting process. He found out that the composition of the REMCO did not affect CEO remuneration levels. These finding suggested that using REMCOs in setting the remuneration of executives did not achieve significant link between executive pay and company performance.⁵⁶⁸

The REMCO is expected to design reward structures with a significant part of it based on challenging performance conditions so as to align executive pay with the company's performance (preferably the long term performance of the company).⁵⁶⁹ Main and Johnston⁵⁷⁰ analysing the composition of the REMCO and its role in the setting of executive pay, found out that the presence of the REMCO was associated with higher levels of executive remuneration with no corresponding link to company performance. Conyon and Peck's⁵⁷¹ study found out that the independence of the REMCO from the executives is associated with higher CEO remuneration levels and stronger pay for performance relationship. This study tends to suggest that the lack of the REMCO's independence from the executives may result in a weak link between

⁵⁶⁶ James Johnston, 'Independent Directors, Executive Remuneration and the Governance of the Corporation: Some Empirical Evidence from the United Kingdom' (2007) 3(1-2) RAE 105-122.

⁵⁶⁷ Ian Gregory-Smith, 'Chief Executive Pay and Non-executive Director Pay in the UK: Optimal Contracting vs Rent Extraction' (2009) NUBS Research Paper Series No 2009-02. Research Paper Nottingham University Business School Nottingham http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1345926 assessed 16 June 2014.

⁵⁶⁸ Catherine Daily, Jonathan Johnson, Alan Ellstrand and Dan Dalton, 'Remuneration Committee Composition as a Determinant of CEO Remuneration. (1998) 41(2) AMJ 209-220.

⁵⁶⁹ Martin Conyon and Simon Peck, 'Board Control, Remuneration Committees, and Top Management Remuneration' (1998) 41(2) AMJ 146-157.

⁵⁷⁰ Brian B.G. Main and James Johnston, 'Remuneration Committees and Corporate Governance' (1993) 23(91A) Accounting & Business Research 351-362.

⁵⁷¹ Martin Conyon and Simon Peck, 'Board Control, Remuneration Committees, and Top Management Compensation' (1998) 41(2) AMJ 146,148.

executive pay and company performance. Benito and Conyon⁵⁷² analysing the determinants of directors' remuneration found weak evidence that the presence of the REMCO led to stronger pay for performance relationship. Capezio et al.⁵⁷³ examining the role of the REMCO of 663 large companies from 1999-2006, found no evidence that independent REMCO were associated with better alignment of total CEO remuneration to company performance. The relationship between executive pay and company performance is one of the crucial outcomes that are expected of the REMCO when setting pay. These results demonstrate that the REMCO is ineffective in the determination of executive pay.

The inability of the REMCO to restrain executive pay was further demonstrated by Main et al.⁵⁷⁴ They found that first the REMCO felt constrained in their choice of pay design by institutional cultures and values particularly with regards to long-term incentive schemes. Secondly, the REMCO does not allocate sufficient time to calibrate or confirm remuneration plans. Finally, most of their actions are dominated by a perceived need to justify high pay outcomes. Ogden and Watson⁵⁷⁵ examined how the REMCO's decisions on executive pay are influenced by the RCONs. They found out that the REMCO are proactive in managing pay policy and ensuring that pay is regarded as appropriate and not over generous.⁵⁷⁶ They also found out that the REMCO's understanding of the wider pay environment makes them to increase pay so as to avoid losing its executives who may seek for higher pay in other companies.⁵⁷⁷ This findings provides more support to the earlier research on the fact that the REMCO and not able to restrain executive pay.

The REMCO as discussed earlier in the chapter is an important committee of the board in the determination of executive remuneration. However, it is not effective in its role of restraining executive remuneration because they are not completely

⁵⁷² Andrew Benito and Martin Conyon, 'The Governance of Director's Pay: Evidence from UK Companies' (1999) 3(2) *Journal of Management & Governance* 117-136.

⁵⁷³ Alessandra Capezio, John Shields and Michael O'Donnell, 'Too Good to be True: Board Structural Independence as a Moderator of CEO Pay-for-Firm Performance' (2011) 48(3) *JOMS* 487-513.

⁵⁷⁴ Brian GM Main, Calvin Jackson, John Pymm and Vicky Wright, 'Questioning the Remuneration Committee Process' (2007)

<http://homepages.ed.ac.uk/mainbg/Files/questioning%20the%20remuneration%20committee%20process%20-%202021%20feb%202007.pdf> assessed 16 July 2014.

⁵⁷⁵ Stuart Ogden and Robert Watson, 'Remuneration Committee, Pay Consultants and the Determination of Executive Director's Pay' (2012) 23(4) *Brit J Manage* 502-517.

⁵⁷⁶ *ibid*, at 502.

⁵⁷⁷ *ibid*, at 515.

independent from the board. This ineffectiveness is reflected in the fact that executive remuneration continue to increase with seemingly no link to company performance, and the gap between executive pay and average employee pay. The next section of this chapter will discuss the RCONs, their advice to the REMCO and its effect in the determination of executive remuneration.

Part Two: Executive remuneration consultants

The determination of the level and structure of an executive pay package is a process which is complicated and requires expert knowledge.⁵⁷⁸ A RCON is a person or organisation that supplies information and expertise to a separate client organisation on matters related to the pay and reward strategy of the top management team.⁵⁷⁹

The UKCGC recommends that REMCO s could appoint RCONs if needed to provide them with advise on remuneration matters.⁵⁸⁰ The REMCO can appoint as many RCONs as they deem necessary. With the advent of stronger governance rules as a result of exorbitant executive pay the REMCO has turn to rely more on the advice of independent consultants.⁵⁸¹ Past years have seen a widespread use of RCONs in the UK. This part on RCONs will be divided into the following sections. First the role of the RCON on executive pay setting process would be analysed. Secondly, the reasons for their appointment will be examined. Third, the independence of the RCONs will be examined. Fifth, the effect of the RCONs' advice on remuneration levels will be discussed. Lastly, the findings of the qualitative research on the methodology of executive remuneration benchmarking will be analysed and discussed.

The Role of Remuneration Consultants

The REMCOs' desires to set appropriate remuneration levels, and the need to be accountable for the outcome of their decisions, employ the services of RCONs to assist with the task of determining executive pay. Consultants use their experience in

⁵⁷⁸ G Voulgaris, K Stathopoulos and M Walker, 'Compensation Consultants and CEO Pay: UK Evidence' (2010) 18(6) CGIR 511, 513.

⁵⁷⁹ Kent Baker and Ronald Anderson, *Corporate Governance: A Synthesis of Theory, Research, and Practice* (John Wiley & Sons 2010) 287.

⁵⁸⁰ FRC, *The UK Corporate Governance Code* (FRC 2012) D.2.

⁵⁸¹ B Cadman, M Carter and S Hillegeist, 'The Role and Effect of Remuneration Consultants on CEO Pay' (2008) <http://www.kellogg.northwestern.edu/accounting/papers/carter.pdf> assessed 5 January 2011.

benchmarking data provide assistance to the company to choose economically appropriate remuneration level and structure that efficiently achieves labour market objectives and appropriate incentives to executives.⁵⁸² The use of surveys and comparing data serves solely as a means of providing more objective information regarding the pay levels based on the level of pay from other companies of same size and industry.⁵⁸³

Companies may get involved in remuneration benchmarking for the following reasons. Firstly, the company's performance is difficult to define and measure. Company performance can be measured in many different ways including accounting measures of performance, such as return on equity, return on assets, and this can be very difficult to collect an accurate picture of other company's accounts. The difficulty in ascertaining how much of the company's performance is attributable to the executive makes the issue of relative performance evaluation more ambiguous.

Secondly, companies engage in benchmarking as a result of pay equity theory.⁵⁸⁴ Pay equity theory suggests that executives who are underpaid relative to the market would demand a greater use of peer benchmarking. Members of the board of directors are fully aware of the rise in executive pay without a corresponding rise in the company's performance, so they tend to ignore the usefulness of the information about performance from other companies. With this in mind, most companies engage more in remuneration benchmarking.

Thirdly, where a company is facing uncertainty in relation to their pay structures and levels, they seek legitimacy in benchmarking. Uncertainty in pay packages results in a difficulty in evaluating a manager's individual performance and accuracy in performance measurement. The process of seeking legitimacy is inherently political. Companies rely on the logic of 'competitive' and 'market-level' pay to legitimize executive pay. Shareholders demand the internal alignment of pay and performance

⁵⁸² C Armstrong, C Ittner and D Larcker, 'Economic characteristics, Corporate Governance, and the Influence of Remuneration Consultants on Executive Pay Levels' (2008) Social Science Research Network <http://ssrn.com/abstract=1145548> assessed on the 23rd of November 2010.

⁵⁸³ P Foreman, D Fitzgibbons and J Howard, 'Foxes in the Henhouse? A Research Framework for Examining the Role of Remuneration Consultants in the Executive Pay Process' (2008) http://www.midwestacademy.org/Proceedings/2008/papers/Foreman%20etal_36.pdf assessed 23 January 2011.

⁵⁸⁴ William Pride, Robert Hughes and Jack Kapoor, *Business* (Cengage Learning 2011) 287.

while managers prefer market-level pay determined by external comparisons with peer companies. This difference in preferences underlies the political conflict surrounding the board. The REMCO is under pressure to justify their executive pay design and also to deal with the demands of executives who use power and position to influence the REMCO. With this political tension seeming too much for the REMCO, they adopt remuneration benchmarking as an easier solution than relative performance evaluation.

RCONs provide expert advice on trends in executive remuneration, and market data, assessment of executive remuneration relative to executive performance, an insight and advice on the level and mix of executive pay and benefits.⁵⁸⁵ Also the consultant is expected to provide impartial advice thus conferring legitimacy on the REMCO's decision.⁵⁸⁶ There exist no defined rules on how much to pay executive directors and thus pay is set in line with a self-defined 'market' with reference to a group of peer companies chosen with the aid of the RCON.⁵⁸⁷ The REMCO relies on their expertise in designing and implementing short-term and long-term incentive arrangements. The consultants provide advice on executive issues such as developing peer comparison and competitive benchmarking information on industry and market practices;⁵⁸⁸ designing equity remuneration plans, performance measures and targets; conducting surveys and analysing the accounting, legal and tax implications of service contracts.⁵⁸⁹ With this advice the REMCO makes decisions on the level and structure of executive package. The consultants are expected to respond to the conflicting incentives of the executives and act in the interest of the company and its members by advocating for efficient levels of remuneration packages that link pay to performance.⁵⁹⁰ However, their effect on the pay contract remains ambiguous and highly contested.⁵⁹¹

⁵⁸⁵ Ruth Bender, 'Paying for Advice: The role of the remuneration consultant in UK listed companies' (2011) 64(2) Vand. L. Rev. 361, 363.

⁵⁸⁶ *ibid.*

⁵⁸⁷ *ibid.*

⁵⁸⁸ K, Murphy and T, Sandino, 'Executive pay and "Independent" Remuneration Consultants' (2010) 49(3) Journal of Accounting and Economics 247, 247.

⁵⁸⁹ Ruth Bender, 'Paying For Advice: The Role of the Remuneration Consultant in UK Listed Companies' (2011) 64(2) Vand. L. Rev. s 361-398.

⁵⁹⁰ B Cadman, M Carter and S Hillegeist, 'The incentives of remuneration consultants and CEO pay' (2010) 49(3) Journal of Accounting and Economics 263, 264.

⁵⁹¹ L Goh and A Gupta, 'Executive Remuneration, Remuneration Consultants, and Shopping for opinion: Evidence from the UK' (2010) 25(4) JAAF 608, 608.

Remuneration consultants' independence

The RCON is naturally external to the company and exists as independent and autonomous personnel in his own right. The RCONs have the capacity to influence the choice and actions that the REMCO makes in respect of pay-setting strategy.⁵⁹² However, RCONs have been criticised⁵⁹³ as they seem to be assisting company executives in achieving excessive remuneration, justifying the pay through the use of remuneration surveys and remuneration peer groups. The consultant's firm may also provide other services for the client company which could lead to a conflict of interest⁵⁹⁴ e.g. in 2013, Marks & Spencer⁵⁹⁵ plc used Deloitte LLP to advise the company on remuneration matters, tax and consultancy on internal auditing. Potential loss of reputation in the market may deter consultants from colluding with management and recommending excessive pay package that are not linked to company performance.⁵⁹⁶ However, they may have an incentive to award generous pay packages in order to acquire repeat business. If they gain a reputation for recommending low pay packages executives may not engage them. This gives rise to altered incentives⁵⁹⁷ and a possibility of conflict of interest that may compromise their independence.⁵⁹⁸ For this reason consultants may not to be as objective as they should because they are often part of larger consulting companies and earn large sums of money for other consulting services.⁵⁹⁹

Past studies has considered the effect of the potential conflict of interest faced by the RCONs on executive remuneration,⁶⁰⁰ and have provided evidence that the use of

⁵⁹² M Conyon, S Peck and G Sadler, 'New Perspective on the Governance of Executive Remuneration: an Examination of the Role and Effect of Remuneration Consultant' (2009) 15(1) *Journal of Management and Governance* 29, 32.

⁵⁹³ Armstrong CC, Ittner CD and Larcker DF 'Corporate governance, compensation consultants, and CEO pay levels' (2012) 17(2) *RAS* 322-351.

⁵⁹⁴ M, Minhat, 'Three Essays on CEO Remuneration in the UK' (2009) 54 <https://dspace.stir.ac.uk/bitstream/1893/2300/1/Minhat-Three-Essays-on-CEO-Remuneration-in-the-UK.pdf> assessed 30 November 2010.

⁵⁹⁵ Marks & Spencer plc Annual Accounts and Reports 2013, p56.

⁵⁹⁶ L Goh and A Gupta, 'Executive Remuneration, Remuneration Consultants, and Shopping for opinion: Evidence from the UK' (2010) 25(4) *JAAF* 608, 617.

⁵⁹⁷ i.e. the incentive to award excessive pay and the incentive to impress the executives with other services they provide to the company.

⁵⁹⁸ L Bebchuk and J Fried, 'Executive Remuneration as an Agency Problem' (2003) 17(3) *Journal of Economic Perspectives* 71-92.

⁵⁹⁹ M Conyon, S Peck and G Sadler, 'Remuneration consultants and Executive Pay: Evidence from the United States and the United Kingdom' (2009) 23 *Academy of Management Perspectives* 43-55.

⁶⁰⁰ K Murphy and T Sandino, 'Executive Pay and 'Independent' Compensation Consultants' (2010) 49(3) *Journals of Accounting and Economics* 247-262.

RCONs correlates with high executive pay levels.⁶⁰¹ Consultants tend to focus more on the service which provides the best private return. If the other services that they provide to the company are paid well they will focus on them at the expense of designing a pay contract that is optimal for shareholders. For this reason, the consultants are tempted to recommend high executive pay so as to promote those other line of businesses that they offer to the company.⁶⁰² This conflict of interest could help the executives extract wealth from shareholders through higher remuneration and/or lower pay-performance sensitivity as the consultants may make more favourable recommendations to the executives.⁶⁰³ In most cases, the fees paid to consultants for other services are often more than the fees earned from providing executive pay services. This is still a very controversial point as some studies do find that consultants with other services recommend high executive remuneration⁶⁰⁴ while other studies find out that they do not.⁶⁰⁵,

Remuneration consultants and executive pay

The wide use of RCONs in advising on executive remuneration in the UK has been evidenced by past studies.⁶⁰⁶ Many studies on the determination of executive remuneration have analysed factors such as company size⁶⁰⁷, performance⁶⁰⁸, industry, human capital⁶⁰⁹ and board structure⁶¹⁰. Very few papers⁶¹¹ have examined the role of the RCON in the determination of executive remuneration in the UK. Past

⁶⁰¹ K Murphy and T Sandino, 'Executive Pay and 'Independent' Compensation Consultants' (2010) 49(3) *Journals of Accounting and Economics* 247-262.

⁶⁰² L Goh and A Gupta, 'Executive Compensation, Compensation Consultants, and Shopping for opinion: Evidence from the UK' (2011) 25(4) *JAAF* 608, 608.

⁶⁰³ R Bender, 'Paying for Advice: the role of remuneration consultant in the UK listed companies' (2008) http://www.baa.group.shef.ac.uk/events/conference/2008/papers/Bender-Corp_Gov.pdf assessed 23 November 2010

⁶⁰⁴ K Murphy and T Sandino, 'Executive pay and "independent" remuneration consultants' (2010) 49(3) *Journal of Accounting and Economics* 247, 260.

⁶⁰⁵ M Conyon, S Peck and G Sadler, 'New Perspective on the Governance of Executive Remuneration: an Examination of the Role and Effect of Remuneration Consultant' (2009) 15(1) *Journal of Management and Governance* 29-58

⁶⁰⁶ L Goh and A Gupta, 'Executive Compensation, Compensation Consultants, and Shopping for opinion: Evidence from the UK' (2011) 25(4) *JAAF* 608-644.

⁶⁰⁷ Peter Kostiuk, 'Firm Size and Executive Remuneration' (1990) 25(1) *JHR* 90-105.

⁶⁰⁸ Paul Gregg, Sarah Jewell and Ian Tonks, 'Executive Pay and Performance; Did Bankers' Bonuses Cause the Crisis?' (2011) 12(1) *IRF* 89-122.

⁶⁰⁹ David Laing and Charlie Weir, 'The Determination of Top Executive Pay: Importance of Human Capital Factors' (1998) 23(4) *Journal of General Management* 51-62.

⁶¹⁰ Vidhi Chhaochharia and Yaniv Grinstein, 'CEO Compensation and Board Structure' (2009) 64(1) *JF* 231-261.

⁶¹¹ For example, Ruth Bender, 'Paying for Advice: The role of the remuneration consultant in UK listed companies' (2011) 64(2) *Vand. L. Rev.* 361-398.

studies have capitalised on how executive pay levels and structures differ between companies using consultants and those that do not.⁶¹² Bender⁶¹³ conducted an in-depth qualitative study of RCONs analysing twelve UK companies selected from the FTSE 350. Thirty-five interviews were conducted with CEOs, REMCO chairs, and RCONs between 2001 and 2003. Her findings demonstrated consultants act as experts, by providing advice and recommendations in executive remuneration; model the implications of suggested plans; implement the chosen plans; provide an education in remuneration-related matters to committee members; and liaise on their behalf with institutional investors. Furthermore, they provide proprietary survey data on pay in comparator companies, on which the REMCO can base its decisions. Furthermore, the study also found out that consultants provide legitimacy to the decisions made by the REMCO.

The soaring level of executive remuneration has led to the questioning of the role of the RCONs and suggesting that they, along with the REMCO, contribute to spiralling executive pay.⁶¹⁴ Prior studies argue that RCONs have strong incentives such as the provision of other services to the company, to please the executives.⁶¹⁵ Companies' REMCO validates high levels of executive remuneration just by citing a RCON as an advisor in the pay-setting process.⁶¹⁶ Companies use survey data produced by RCONs to justify high executive pay when the REMCO refers to the use of consultants and surveys to explain executive salary allocations.⁶¹⁷ A company whose executives have large base salaries, bonuses justifies this outcome by reference to the role of consultants. Another study carried out by

⁶¹² L Goh and A Gupta, 'Executive Compensation, Compensation Consultants, and Shopping for opinion: Evidence from the UK' (2011) 25(4) JAAF 608-644.

⁶¹³ Ruth Bender, 'Paying for Advice: The role of the remuneration consultant in UK listed companies' (2011) 64(2) Vand. L. Rev. 361-398.

⁶¹⁴ L Bebchuk and J Fried, 'Executive Remuneration as an Agency Problem' (2003) 17(3) Journal of Economic Perspectives 71-92.

⁶¹⁵ M Minhat, 'Three Essays on CEO Remuneration in the UK' (2009) 54. <https://dspace.stir.ac.uk/bitstream/1893/2300/1/Minhat-Three-Essays-on-CEO-Remuneration-in-the-UK.pdf> assessed 30th November 2010.

⁶¹⁶ R Kabir and M Minhat, 'Multiple Remuneration Consultants and CEO Pay' (2011) SSRN:<http://ssrn.com/abstract=1646926> assessed 13 October 2011.

⁶¹⁷ J Wade, J Porac and T Pollock, 'Worth, Words, and the Justification of Executive Pay' (1997) 18(1) JOB 641, 642.

It has been noticed from past studies that companies tend to seek recommendations from more than one consultant.⁶¹⁸ Unlike most US companies that use only one consultant,⁶¹⁹ companies in the UK often use more than one consultant.⁶²⁰ The use of multiple consultants by the REMCO has been regarded as a means of justifying excessive pay.⁶²¹ Although having multiple RCONs can enable the REMCO to make a more informed judgment as different consultants specialize in different aspects of pay e.g. in 2011 Sainsbury plc used four different RCONs for advice on executive remuneration.⁶²²

This multiple use of consultants could result in a higher package as the REMCO can use the more favourable ones to justify a generous package. Some companies can use multiple consultants by splitting the consulting function among various consultants thus allowing the company to develop a remuneration package based on recommendations from individual consultants. The effect of this method is that the REMCO could end up with an overall high executive pay package.⁶²³ Considering the RCONs fight hard to keep their on-going and future relationship with the client company, multiple consultants could result in even higher pay because the prospect of lucrative business interest incentivized consultants to compete with each other.⁶²⁴ However, past studies by Kabir and Minhat⁶²⁵ and Goh and Gupta⁶²⁶ found no evidence that executives of companies that increase the number of consultants had higher changes in remuneration than non-increasing company therefore, indicating that multiple consultants may not necessarily be a way of rent extraction.

However, past studies have failed to investigate the actual process of benchmarking, factors considered when selecting comparator group and the effect on the

⁶¹⁸ R Kabir and M Minhat, 'Multiple Remuneration Consultants and CEO Pay' (2011) SSRN:<http://ssrn.com/abstract=1646926> accessed 13 October 2011.

⁶¹⁹ K Murphy and T Sandino, 'Executive Pay and 'Independent' Remuneration Consultants' (2010) 49 *Journal of Accounting and Economics* 247-262.

⁶²⁰ M Conyon, S Peck and G Sadler, 'Remuneration Consultant and Executive Pay: Evidence from the United States and the United Kingdom' (2009) 23 *Academy of Management Perspectives* 43-55.

⁶²¹ L Goh and A Gupta, 'Executive Remuneration, Remuneration Consultants, and Shopping for opinion: Evidence from the UK' (2010) 25(4) *Journal of Accounting, Auditing and Finance* 608, 617.

⁶²² J Sainsbury Plc Annual Report 2011, page 39.

⁶²³ L Goh and A Gupta, 'Executive Remuneration, Remuneration Consultants, and Shopping for opinion: Evidence from the UK' (2010) 25(4) *Journal of Accounting, Auditing and Finance* 608, 617.

⁶²⁴ R Kabir and M Minhat, 'Multiple Remuneration Consultants and CEO Pay' (2011) SSRN:<http://ssrn.com/abstract=1646926> accessed 13 October 2011 1, 7.

⁶²⁵ *ibid.*

⁶²⁶ L Goh and A Gupta, 'Executive Remuneration, Remuneration Consultants, and Shopping for opinion: Evidence from the UK' (2010) 25(4) *JAAF* 608, 629.

determination of executive remuneration. One study by Bender⁶²⁷ examined the determinants of executive RCONs' advice. The study found that RCONs take into account the size and ownership of the company, the company's business and strategy; the company's culture and organisation, the impact of individuals on the process and scheme; and the scope of the assignment to be able to advise the REMCO on executive pay structure and levels.

Further to the argument that RCONs are associated with high pay levels, no literature has examined the factors that the RCONs consider in choosing appropriate comparator companies for executive remuneration benchmarking and the effect it has on pay levels. The next section which is the result and discussion from interviews conducted with RCONs will examine the general methodology of benchmarking, paying particular attention to factors used in choosing peer groups and its effect on pay levels. This study provides detailed information on the factors considered in choosing appropriate comparator companies as oppose to the determinants of the advice as studied by Bender.

Executive remuneration benchmarking: Interview analysis

This section will analyse and discuss the interview findings on the methods of executive remuneration benchmarking. The RCONs Code of Conduct good practice guidelines⁶²⁸ recommend that the RCONs should provide objective advice to their clients but does not recommend how the RCONs should go about the benchmarking process. The results will be discussed in four parts. First, the definition of executive remuneration benchmarking will be examined. Second, factors considered when selecting appropriate comparator groups will be discussed. Third, the elements of the remuneration package considered when benchmarking examined. Fourth, the effect of benchmarking on executive remuneration level will be discussed. Last, the objectiveness of the RCON's advice to the REMCO will be assessed.

⁶²⁷ Ruth Bender, 'The Determinants of Executive Compensation Consultants' Advice' (2013) BAM 2013 Conference Paper.

⁶²⁸ RCG, *The Voluntary Code of Conduct in Relation to Executive Remuneration Consulting in the United Kingdom* (RCG 2014) para. 16.

Question 1: What is benchmarking?

Two respondents did not attempt a definition for benchmarking. The other four respondents talked about benchmarking as undertaking a comparison in the marketplace with other companies in relation to what they pay their executives. For example:

Executive pay benchmarking is the process of finding appropriate comparisons in the market place with organisations that are reasonably similar to the focus company that you are benchmarking with, and analysing what they pay their executives on a like-for-like basis relative to the pay of the focus company. (*Consultant 1*)

Benchmarking is taking a cut of the data in the market and comparing against executive roles... (*Consultant 2*)

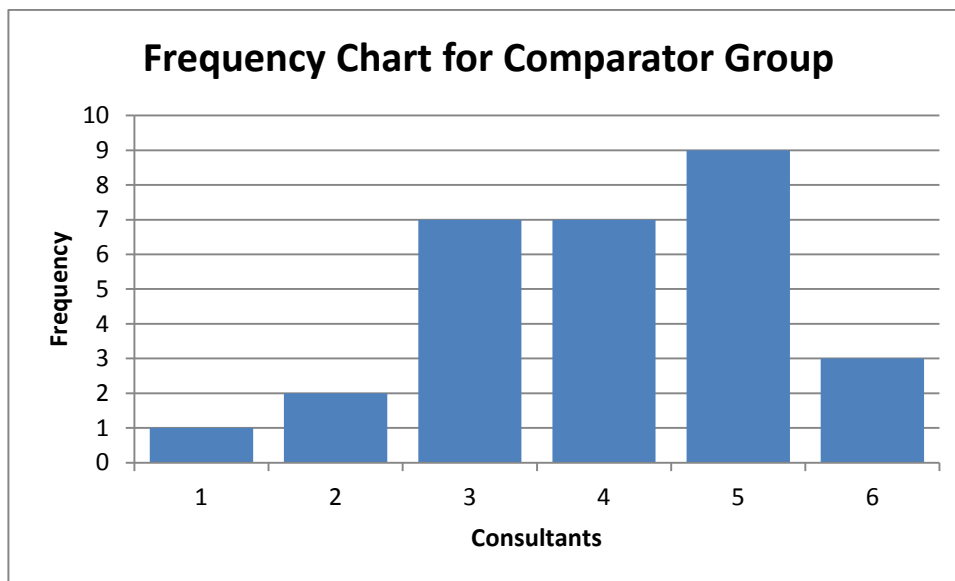
Putting together data from comparator [different] company for a particular position valuing the total package (salary, bonus, benefits and Long term incentive plans) and comparing the clients company against that data. (*Consultant 4*)

Our concept of benchmarking is to provide an indication at a medium lower quartile and high quartile level of the salary and total compensation of individuals working in certain financial service jobs. (*Consultant 6*)

Their definitions echoed strongly the use of a comparator group as an important factor of benchmarking. The identification of a comparator group is crucial in benchmarking because, it is only when the appropriate companies are selected that executive remuneration data of those companies can be collected and compared with the remuneration data of the company they need to advise. Depending on the type of companies selected it could significantly influence the executive pay levels of the company they need to advise. Furthermore, the factors that consultants consider when choosing comparator companies and why are crucial to the process of executive

remuneration benchmarking and the pay setting process. The histogram⁶²⁹ below demonstrates how frequently each of the consultants talked about the use of a comparator group. From the graph it can be seen that although all the respondents recognised comparator group as important, others emphasised its importance more than others. As explained in the methodology chapter, content analysis considers the importance of facts by relying on how frequent the respondents talks about it.

Figure 6: Frequency chart illustrating the use of comparator groups



However, Consultant 1 mentioned that the comparator group will be made up of companies that are reasonably similar to the focus company but did not say how they would be chosen. The other five respondents did not mention what their comparator would be and how they would determine the comparator group. This lack of clarity in the definition of benchmarking prompted the second question.

Question 2: What factors do you consider when benchmarking

A typical executive pay package is set through a survey of pay practices of other companies but the choice of ‘comparable’ company is a complex social and politically sensitive issue. From the data collected it emerged that the factors considered by the consultants when benchmarking (i.e. when selecting the comparator group) were

⁶²⁹ A histogram is a bar graph of raw data that creates a picture of the data distribution. The bars represent the frequency of occurrence by classes of data and shows basic information about the data set.

seven (although not all consultants considered all seven factors), namely (i) company size; (ii) company complexity; (iii) company sector; (iv) the geographical operation of the company; (v) the company’s remuneration policy; (vi) company’s performance, and; (vii) the role of the executive in the company. The company’s performance and the role and responsibility of the executives were identified as secondary factors. The table below shows how many times (frequency) each consultant talked about these factors.

Table 6: Factors considered in selecting comparator

Consultant	Size	Sector	Geography	Company performance	Role of the executive	Company policy	Complexity
1	5	8	3	7	3	5	4
2	4	8	4	0	0	8	3
3	7	7	6	0	0	0	0
4	1	4	2	0	0	5	0
5	5	6	4	0	0	7	1
6	4	1	1	0	0	1	0

From the table above, all the consultants identified three common factors which were company size, company sector, and the geographical operations of the company’s business. This could mean that these three factors are more important than the others. Consultant 1 mentioned in addition to other factors, company performance and the role of the executive as factors considered when selecting comparator group. For example, he stated:

The important factors to consider are the size, complexity, sector and the geography of the company... The performance factor is built-in the benchmarking...Once the benchmarking data is obtained, the important thing here is firstly what the company’s remuneration policy is, where the company positions itself in the market...Another important factor which we take into consideration but which is secondary is to match the role of the executives.
(Consultant 1)

These seven factors considered in benchmarking will now be looked at in details to find out how and why the various consultants use different factors.

Company Size

All the respondents recognised size as an important factor in the determination of executive benchmarking. Examples include:

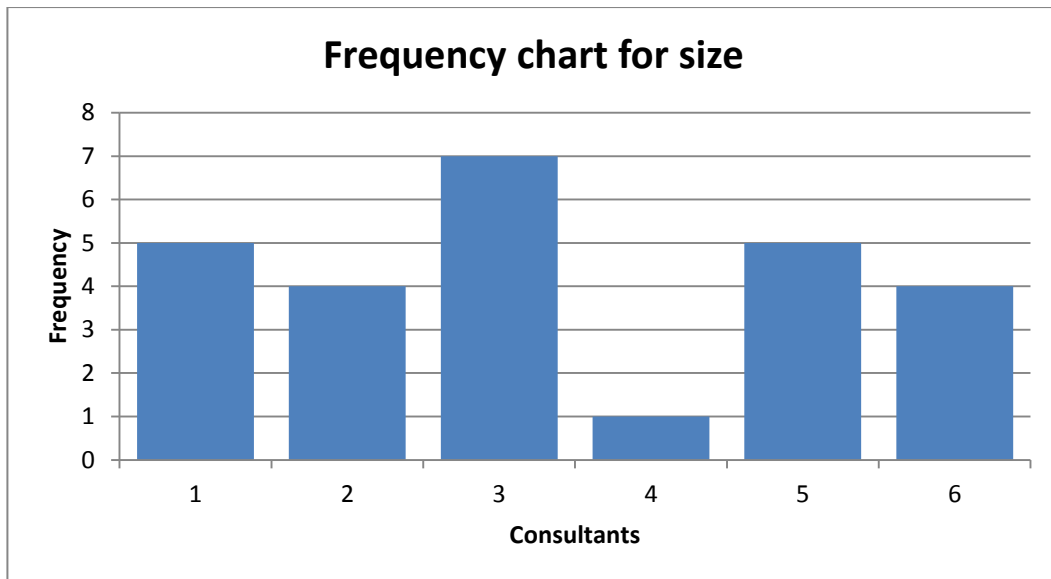
The important factors to consider are the size of the company...The reason being that, the size determines how big the job is and the worth of the job is determined by the complexity and not the financial performance of the company. (*Consultant 1*)

...the key factor being the size of the company...size of the company is very important as it help us determine the complexity of the job (*Consultant 2*)

...you will still be looking at the size of the company...The size of the company will tell you the data...and the market for which they compete. (*Consultant 5*)

This implies that larger companies pay more than smaller companies, indicating that selecting companies of the same size would prevent executive pay data of smaller companies being compared with those of larger companies. From the frequency chart below, it could be seen that consultant 3 emphasised more on size than the rest of the consultants, with consultant 4 mentioning size just once. This means that size could be the predominant factor considered in benchmarking by consultant 3, while size constitutes one of many factors for consultant 4. Out of the six consultants interviewed, five of them offered remuneration advice to companies from different sectors whilst one (consultant 6) offered remuneration advice only to companies from the financial sector. Considering that Consultant 6 emphasised the use of size as a factor in selecting comparator group suggest that the type of companies and sectors the RCONs advice does not influence the factors considered.

Figure 7: Frequency chart for size as a factor for choosing comparator group



The RCONs consider that the bigger the company, the more responsibility the executive will have to manage the company and consequently the higher their pay.

To determine the size of the company, different variables were used by different respondents to determine size. Although size was identified as an important factor in benchmarking, there no uniformity in the variables that were used to determine company size. The following variables were identified from the interview as the determinants of company size. They include company turnover (mentioned by consultants 3 and 4), market capitalisation (mentioned by consultants 2, 3, 4, and 5), total employee heads (mentioned by consultants 1 and 6) and company total revenue (mentioned by consultant 1). These factors will now be discussed.

The first factor used in determining company size was market capitalisation. The market capitalisation of a company is the number of shares publicly traded by that company multiplied by the share prices at a particular time – in short the value of the company.⁶³⁰ Four respondents talked about market capitalisation as a means of determining the size of the company, with examples including:

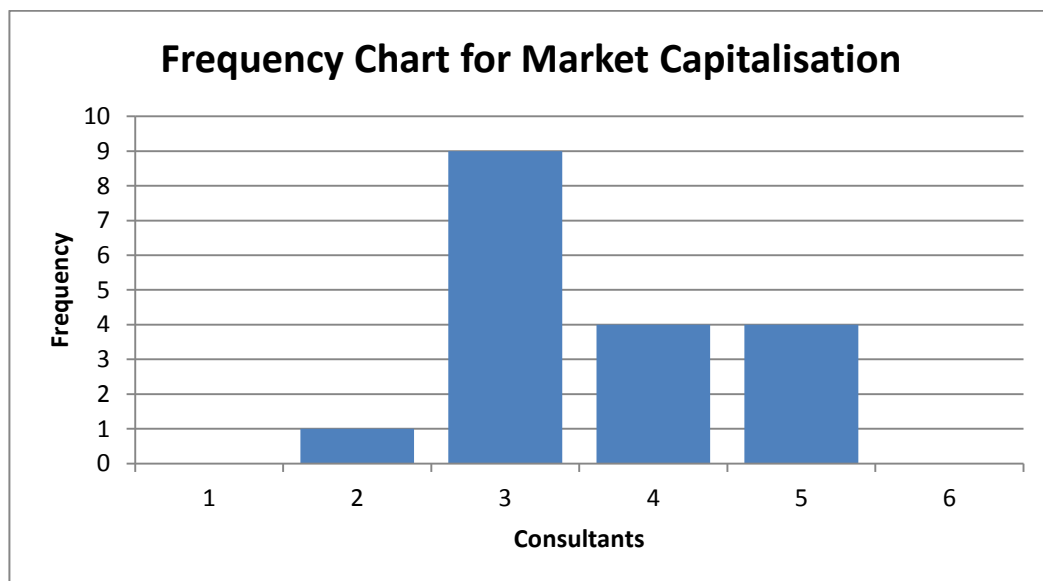
When constructing benchmarking, we will look at the size of the company in terms of market capitalization... (*Consultant 2*)

⁶³⁰ Ranganatham M., *Investment Analysis and Portfolio Management* (Pearson, 2004) 149

...but the single most important criteria tends to be the market capitalisation.
(Consultant 5)

This indicates that companies of the same size from different sectors and geographical locations can be selected as comparator companies. The advantage of this selection criterion is that companies will be able to retain their executives as they are paid at the market level, meaning they will not regard themselves as underpaid and leave or threaten to leave the company. However, the disadvantage of the criteria is that executives may be paid higher than they actually should earn because the company is trying to pay at the international level for companies that benchmark on a global basis. This may pose a potential problem as the pay package may not take into consideration the performance conditions of the particular company. The histogram below demonstrates how much each consultant emphasised on market capitalisation as an important variable for measuring company size.

Figure 8: Frequency chart for market capitalisation as a factor for company size



From the frequency graph above, consultants 1 and 6 did not consider market capitalisation as an important means of determining the company's size. Their reasons for not considering market capitalisation could be due to the lack of best practice on the subject the RCON did not consider it as a measure of company size. However, consultant 3 placed more emphasis on market capitalization than consultants 4 and 5. Using market capitalisation as a variable to determine the size of the company implies

that comparator companies could be chosen from any sector/industry so long as the company has the same market capitalisation. However, it is worth noting that all the consultants recognised company sector as an important factor to consider when choosing comparator groups. Different sectors have different pay structures and setting, and pay levels might be different in some sectors. For example, executive pay levels are higher in financial sectors than executive pay levels in non-financial sectors.⁶³¹ It therefore implies that using market capitalisation as a variable for company size could result in comparator group from various sectors including the financial sector (this point will be examined further under when the company sector as a factor is discussed). Consequently, benchmarking executive remuneration with companies with higher pay from other sectors would result in high levels of executive remuneration packages.

However, market capitalisation depends on share price at a given period. The volatility of share price will therefore influence the market capitalisation by either increasing or decreasing at any given period. This volatility in share price would mean that the company will constantly be changing comparator group depending on the share price as determines the size of the company at every given period in the year. This volatility in share price therefore cast doubts on the suitability of market capitalisation as a variable for company size. The consultant will have to consider other factors if the market capitalisation had been greatly influenced by the share price during the particular year.

If the company has been trading on fairly well, and its turnover or market capitalisation has not gone significantly up or down in the prior year, factors other than size that will be considered will be the international scope of the business and the business sector, apart from which no other circumstances will be taken into consideration. (*Consultant 3*)

The second factor used in determining company size is company turnover. A company's turnover is the total income derived by a business in an income year from

⁶³¹ Nathan Dong, 'Excessive Bank CEO Pay and Financial Crisis: Evidence from Structural Estimation' (2013) http://www.bath.ac.uk/management/news_events/events/corp-cgr-2013/pdf/DongNathan.pdf assessed 24 April 2014

sales excluding the value of closing stock⁶³²- or simply the total sales of a company over a stated period. Section 474(1) of the CA 2006 defines turnover as the amount derived from the provisions of goods and services falling within the company's ordinary activities after deducting trade discounts, value added tax and any other taxes based on the amounts derived. The CA 2006 uses turnover as a factor when determining whether a company is small, medium or large.⁶³³ In line with the Act, two respondents identified using company turnover to determine company size.

...The first is the market capitalisation and the second is turnover. (*Consultant 3*)

We would look at the size of the company by reference to their market capitalisation and turnover. (*Consultant 4*)

Company turnover depends on the amount of sales the company has made in a given year, this therefore means that where there has been less sales the company size will be less than when there is a boom in the market. Company turnover therefore, may not represent an appropriate variable for measuring company size. Apart from these two respondents, the rest did not say anything about company turnover. Consultant 3 talked about company turnover with more emphasis (frequency of 12) than consultant 4 who emphasised company turnover three times (frequency of 3). From these two consultants it appears that the type of industry from which the company is classified does not matter, so long as the turnover and the market capitalisation (as they both indicate they use market capitalisation too) is within the limit they are looking for. This therefore means that companies from the financial sector could be benchmarked with companies from the non-financial sector consequently driving executive pay levels as explained above.

The third factor considered as a measure of company size is total employee head. The Companies Act 2006 also uses employee numbers as one of the factors (in addition to turnover) to determine whether a company is small, medium or large.⁶³⁴ Two

⁶³² Andrew Ross, Peter Williams, *Financial Management in Construction Contracting* (John Wiley & Sons 2012) section 8.3.1

⁶³³ CA 2006, s465.

⁶³⁴ *ibid*, s465.

respondents identified total employee heads as a factor considered to determine the size of the company. Examples include:

When constructing benchmarking, we will look at the size of the company in terms of market capitalization, total revenues and total employee head counts.
(Consultant 1)

Considering the size, we look at the number of employees (*Consultant 6*)

However, Consultant 6 placed more emphasis on the use of total employee heads in determining the size of the company than consultant 1. These consultants believe that the number of employees in a company will determine the size of the company. However this might not be the case due to the increase in use of technology. Most companies are replacing human employees with machineries that can carry out the same responsibility. Furthermore, depending on the nature of business carried out by the company, some companies generally require more employees than others, e.g. a car manufacturing company may require more employee heads than a banking company.

The last factor identified in this study as a measure of company size is total revenue. Total revenue is the amount derived from provisions of goods or services falling within the company's ordinary activities before the deduction of any costs or expenses. The difference between company turnover and company revenue lies in the fact that turnover is the amount realised by the company after deducting all costs and expenses, while revenue is the amount realised by the company before any costs and expenses are deducted. Two respondents identified company total revenue as a means of determining the size of the company. Total revenue measures all sources of a company's income, including its sales for a given period of time. Examples include:

When constructing benchmarking, we will look at the size of the company in terms of market capitalization, total revenues and total employee head counts.
Consultant 1

This finding indicates that there is no uniformity on how to measure the size of the company. The factor that is considered to measure the size of the company would

depend on the consultant, and they influence the selection of comparator groups in different ways. As pointed above, depending on the factor used to measure company size, comparator companies may be selected from the same sector as the focus company or from other sectors.

Company Sector

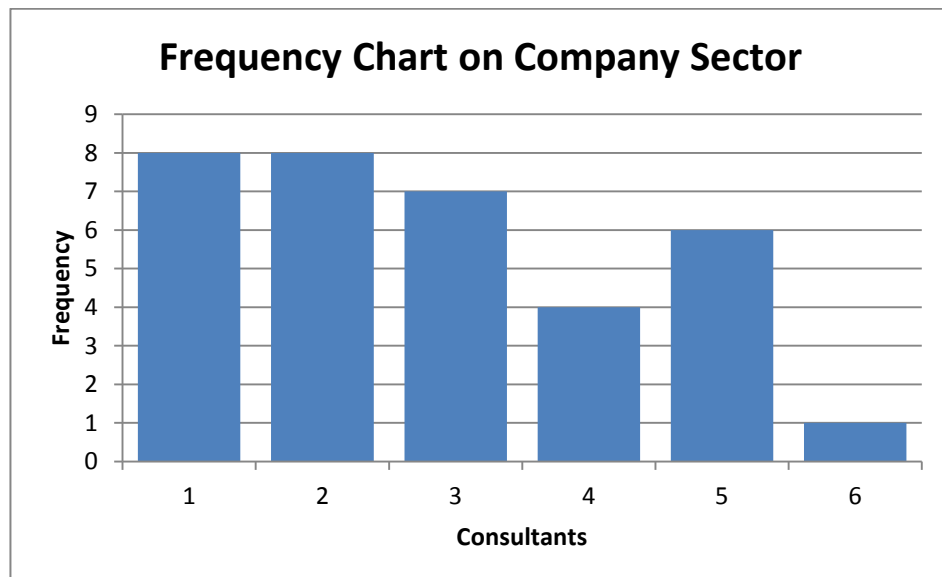
Company sector was identified by all the respondents as an important factor considered in benchmarking. Examples include:

The important factors to consider are the size, complexity, sector and the geography of the company (*Consultant 1*)

...hence the key factor being the size of the company, complexity, geography and sector. (*Consultant 2*)

...sector is a factor as well. (*Consultant 5*)

Figure 9: Frequency chart for company sector as a factor for choosing comparator group



Company sector was identified as an important factor because different sectors have different pay setting, structures and levels. The financial sector for example, its

executive pay levels are higher than those of non-financial sectors.⁶³⁵ Due to these sectorial differences, companies should be compared to companies within the same sector. From the data obtained two respondents emphasised the importance of company sector in benchmarking more than the others.

Furthermore, the consultants identified that comparator groups could be obtained from the same sector as the focus company (the company they will be advising) or from different sectors (across sectors). One respondent talked about selecting comparator companies from the same sector, two respondents talked about selecting comparator companies from different sector, two talked respondent said that they would select companies from both the same sector as the focus company and also from different sectors, and finally, one respondent did not specify whether companies would be selected from the same sector or different sectors as the focus company.

One consultant identified that only companies from the same sector will be considered when choosing comparator companies.

...we look at sectors, that is, companies from similar sectors. For example, a company in the retail sector will definitely look at other companies in the same sector (*Consultant 1*)

Ideally, by considering only companies from the same sector when selecting comparator companies, the differences in pay structure and levels between different sectors will be avoided. However, this may not be strictly possible in practice – for example, if a RCON decides to choose comparator companies from the same sector to benchmark executive pay for company A, one of the companies chosen might be benchmarking with other companies from other sectors and consequently, would influence the remuneration structures and levels of company A. Other consultants were of the opinion that some companies depending on their size and the talent of the executives might need comparator companies from different sectors. This may be because of the assumption that executive talent pool is limited causing the consultant to benchmark across sectors in an attempt to ensure that companies do not lose their executives to other companies. Examples include:

⁶³⁵ Nathan Dong, 'Excessive Financial Services CEO Pay and Financial Crisis: Evidence from Calibration Estimation' (2013) *Journal of Empirical Finance* 1-22.

...you can benchmark across sectors because if you are benchmarking total remuneration of FTSE 100 companies, there is an argument that they have got transferable skills. (*Consultant 2*)

Sometimes there will be companies who have peers that are not necessarily in the same sector, so we look at companies in different sectors that operate in the same broad base business (*Consultant 3*)

Consultant 3 went further to say that:

...we can get a good handle on how companies of similar size across all sectors would pay their senior executives.

The reasons given for cross-sector comparisons do not seem convincing because even though the executives might have transferable skills, different sectors have different cultures and values, as well as different pay practices (e.g. the financial sector remuneration structures are characterised by excessive risk-taking driven by the quest for performance related pay more than non-financial sectors).⁶³⁶ Selecting comparator companies from different sectors simply on the basis of transferable skills may lead to an unmerited ratcheting up of executive pay. It therefore means that although company sector is one of the factors considered in choosing comparator groups it is not as important as company size. Implying that by choosing comparator companies from different sectors benchmarking will cause the executive pay of the companies in less paying sector to level up with those of the high paying sector. This practice will consequently, cause benchmarking to have a ratcheting-up effect on executive pay as supported by prior research⁶³⁷. The question that remains unanswered in this study is how the consultant would adjust to the different pay practices and how they will situate the executive pay of the focus company.

Geographical operation of the company's business

The geographical operation of the company's business is important to determine whether the company is a domestic company (makes and sells its product in the same

⁶³⁶ Krishnan Sharma, 'Financial Sector Compensation and Excess Risk-taking: A Consideration of the Issues and Policy Lessons' (2012) DESA Working Paper No. 115, 1, 1.

⁶³⁷ Kevin Murphy and Tatiana Sandino, 'Executive Pay and 'Independent' Compensation Consultants' (2010) 49(3) Journal of Accounting and Economics 247-262.

nation) or global company (does business in/with other nations in making and selling its products). Companies with multinational operations may try to match-up pay levels with those of the executives in other nations in order to retain their executives. The growing internationalisation of the executive labour market with executives using their business skills in more than one country may also accounts for increases in executive pay packages.⁶³⁸ A possible implication of this design is that if the labour market is competitive, then the executives will move away from companies that pay less to companies that pay more.⁶³⁹ Therefore, considering the international operations of the company in selecting comparator companies is crucial in executive remuneration benchmarking. Using benchmarking to determine the remuneration of executives of a global company is bound to result to increase in executive pay levels. For example, if a US company pays its executives more than a UK company; the UK company's interaction with the US company may influence the executive remuneration practices of UK companies. Executives of UK companies with a US exchange listing may receive more remuneration than UK-listed companies because the company possesses US operations, facing US competitors, facing exposure to US legal environment may have an incentive to align their pay practices with those of US companies.⁶⁴⁰ Furthermore, executives of UK companies where either the company's directors or the executive have US board experience tend to receive more cash remuneration than companies without similar foreign board experience.⁶⁴¹

All the respondents recognised the importance of geographical nature of the company's business as a primary factor to consider when benchmarking, with examples including:

We look at global exposure as it also reflects on the complexity of the company and the job. We will then take into account the extent to which they have foreign operations and trying to benchmark companies with similar levels of foreign operations. (*Consultant 2*)

⁶³⁸ Brian Cheffins and Randall Thomas, 'The Globalisation (Americanization?) of Executive Pay' (2004) 1(2) Berkeley Bus. L.J. 223, 256.

⁶³⁹ Ian Gregory-Smith and Brian GM Main, 'Testing the Participation Constraint in the Executive Labour Market' (2013) http://homepages.ed.ac.uk/mainbg/Files/jobmoves2013_08_27.pdf assessed 11 March 2014.

⁶⁴⁰ J, Gerakos, J, Piotroski and S, Srinivasan, 'Globalisation and Executive Remuneration: An Analysis of pay Practices in UK Companies' (2009)

<http://www.nd.edu/~carecob/May2008Conference/Papers/Srinivasan.pdf> assessed 15 January 2011

⁶⁴¹ *ibid.*

if a company has a specific and easily identifiable international comparator companies, we would look at the remuneration data and how the international company would pay their senior executives. (*Consultant 3*)

We are a global organisation, so we report on every market in the world (*Consultant 6*)

Two reasons were identified from the responses as to why the international operations of the company would be considered. The first reason is as follows:

the global operations of the company is important because, the global the business is, the more complex the business is and that reflects in the salary, also the more domestic the business is the less complicated it is (*Consultant 5*)

the international exposure of the company is considered because generally international businesses are more sophisticated and difficult to manage...therefore perceived as being the reason for the higher remuneration paid to executive that manage international businesses... (*Consultant 3*)

The second reason identified for considering the international operations of the company was based on the fact that international trading companies would require an executive with some degree of experience in international trading. This will therefore help the company in the calibre of person to recruit:

Geography matters because it would influence who you recruit on a global basis (*Consultant 4*)

The consultants believe that by benchmarking executive remuneration based on the international activities of the company, it will stop the executives from leaving their companies in search of higher pay in other companies in other countries. However, a study by the High Pay Centre⁶⁴² found out that only 0.8% of chief executive officers were recruited from overseas and 80% were promoted from within the company. This finding is suggesting that the justification of high pay in the UK based on executive global talent pool is unfounded. By extension, it means that selecting comparator companies on a global basis for benchmarking executive remuneration is unjustified

⁶⁴² High Pay Centre, *The Myth of Global High Pay Talent Market* (High Pay Centre 2013) 5.

and would only lead to high pay. Companies in the United States have been noted in paying their executives more than the UK companies. Benchmarking UK companies' executive remuneration with a US company that trade in the same market would mean pushing up the UK company's executive pay to match the US company executive pay. As this practice will stop the UK company's executive from seeking a job with the US company for higher pay, this rises up executive pay and the effect will be felt by other companies that benchmark with it in the UK.

Company's performance

Only one respondent identified company performance as being an important factor considered when benchmarking. However, the consultant admitted that company performance was only a secondary factor as oppose to other factors such as company size.

The particular circumstances of the focus company like company's performance, and whether the company is making profit are all secondary considerations when considering factors for benchmarking... The performance factor is built-in the benchmarking but only to the actual package itself...
(Consultant 1)

From the quote above, it implies that company performance is not actually considered as a separate factor, but assumed to be built-in in the other factors such as company size etc. it is assumed that the size of the company is as a function of the company performance and consequently, considering the size of the company, would be indirectly considering the performance of the company. This assumption will be true if it can be proven that company size is strongly related to company performance. Executive remuneration has been proven by past studies to be strongly related to company size but a weak or no link has been found between executive remuneration and company performance. The UKCGC⁶⁴³ recommends that executive remuneration should be determined so as to link executive pay to the company's performance. This recommendation makes company performance an important factor that should be considered when benchmarking executive remuneration. Despite this recommendation, only one out of the six respondents identified company performance

⁶⁴³ FRC, *The UK Corporate Governance Code* (FRC 2012) D.1.

as a factor used when benchmarking executive remuneration. REMCO's devise pay packages based on consultants' advice, but the finding of this study suggests that RCONs do not generally take into account the performance of the company when benchmarking executive remuneration. This indicates the flaws in the pay determination process of executive pay that leads to excessive pay packages that are not related to company performance. Furthermore, this may be used to justify the lack of link between executive remuneration and company performance found by past studies on the investigation of the link between pay and performance (discussed in detail in chapter 5). The debate on executive remuneration is still on-going today largely because of the lack of link between pay and performance. It would have been expected for the RCONs to place company performance as a paramount factor in selecting comparator group of which the results of this study demonstrates the contrary.

The important factors to consider are the size of the company...The reason being that, the size determines how big the job is and the worth of the job is determined by the complexity and not the financial performance of the company. *Consultant 1*

But what was then considered important was the fact that the executives should be seen as paid the same with other companies. This could be noted as a weakness in the benchmarking process of executive remuneration considering the fact that executive remuneration should be strongly linked to the performance of the company. The fact that five consultants did not regard company performance as an important factor in selecting comparator companies for executive remuneration benchmarking indicates that executive remuneration is not determined in accordance with the recommendations of the UKCGC. The UKCGC recommends that all listed companies must comply with its recommendations or explain in situation where they failed to.⁶⁴⁴ However, none of the twenty-five companies considered in this study disclosed or explained the fact that company performance was not considered in the benchmarking of executive remuneration likely because they are not aware of the factors that the RCONs adopted in selecting the comparator companies. This apparent lack of considering company performance in executive remuneration benchmarking could be

⁶⁴⁴ FRC, *The UK Corporate Governance Code* (FRC 2012) para. 5-6

one of the reasons why past studies have failed to find a strong correlation between executive remuneration and company performance.

Role of the executive

The executives of a large company have different roles to play in the success of the company. These include: CEO who puts together resources to support the company and take the company's product to market for consumers; the general manager who makes sure that the company's operations flow smoothly and economically; the marketing manager who markets the products of the company, chief financial controller who deals with banking issues of the company; just to name a few. This means that different executives would be paid differently from others depending on their job role. In general the CEOs of companies are paid more than the rest of the executives of that company. The role and responsibility of the executive in the company was identified by one respondent as another secondary factor considered when selecting comparator companies for executive remuneration benchmarking.

Another important factor which we take into consideration but which is secondary is to match the role of the executives (*Consultant 1*)

This respondent added that where the role of the executives in the focus company and the comparator company are not the same, the size of the company will be considered. Also, that matching the role could be achieved by considering the job description of the executives.

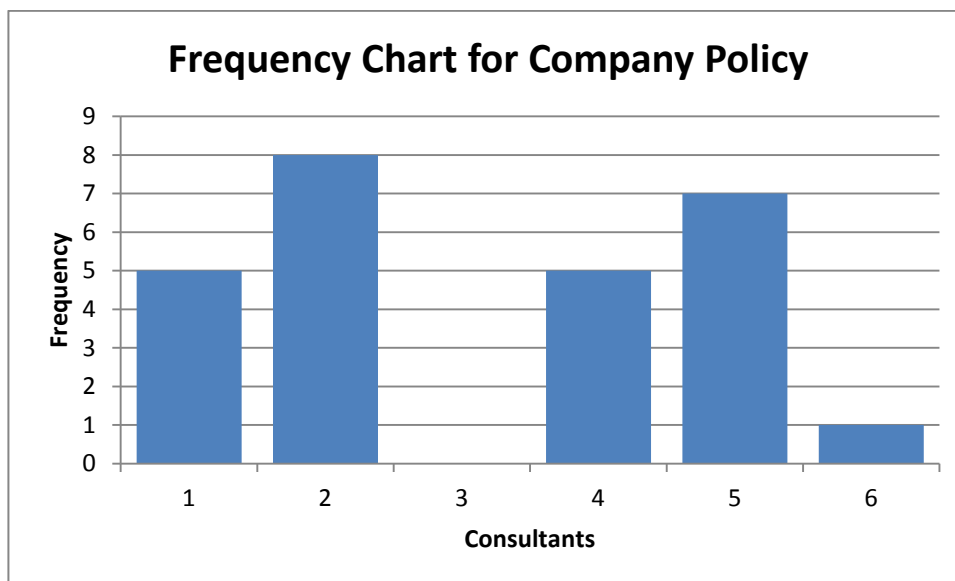
Matching the role on a like-for-like basis is important in benchmarking. This can be done sometimes with the brief role description...[where the roles are not similar] we look at the size of the division as an indicator of the size of the job. (*Consultant 1*)

This therefore indicates that the respondents who do not consider the role of the executive as important would benchmark executive pay with others irrespective of the job role. This could potentially drive-up executive pay where for instance a production manager's pay is compared with a CEO's pay.

Company policy

Company remuneration policy was another secondary factor identified by five respondents as important in selecting comparator companies. One respondent emphasized more on the importance of company policy as a factor than the rest of the respondents as demonstrated in the frequency chart below.

Figure 10: Frequency chart for company policy as a factor for choosing comparator group



Examples include:

...the important thing here is firstly what the company's remuneration policy is, where the company positions itself in the market (*Consultant 1*)

...we would do a desktop review in which we look at the remuneration policy, its strategies and, what it says about its development. (*Consultant 2*)

The important point that can be drawn from the responses is that the company remuneration policy is very important as it will say where the company is positioned in the market, which could either be at the top quartile, median or lower quartile. Therefore the RCONs need to know this information to be able to present the REMCO with appropriate data and information.

We would also interview members of the remuneration committee like the chairman to get their opinion...on the policy and the position in the market
(*Consultant 2*)

It follows that selecting a comparator company on the basis of the company's remuneration policy would be the most appropriate factor to consider when benchmarking executive remuneration. This is because the company's remuneration policy is considered and voted upon by the shareholders in the annual general meeting. This would mean that any benchmarking based on this remuneration policy would be within the comfortable zone of the shareholders.

Company complexity

From the sample size, three respondents identified complexity as a means of determining the company's size.

The important factors to consider are the size, complexity, sector and the geography of the company. (*Consultant 1*)

...the key factor being the size of the company, complexity, geography and sector. (*Consultant 2*)

However, one of the respondents said:

In considering complexity, we look at sectors, that is, companies from similar sectors (*Consultant 1*)

This could mean that for this consultant company complexity is a more important factor considered in benchmarking than company sector. However, degree of importance of this factor cannot be verified in this study due to the limited number of participants, but a good point for further investigation. This is because company sector is used in this case as a means of determining the complexity of the company even though, not all businesses in the same sector will have the same degree of complexity. Furthermore, another respondent said:

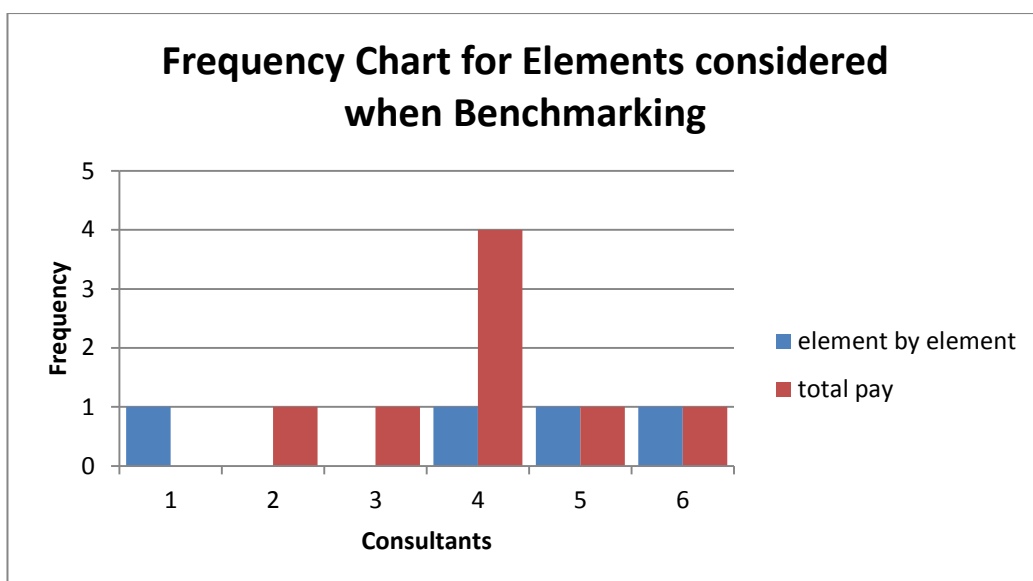
...we will also look at international exposure which gives us an idea of the complexity (*Consultant 2*)

This indicates that there is a clear link between complexity and the geographical operations of the business. International exposure of the company is used to determine the complexity of the company. Therefore, going by these two respondents, company complexity is major key factor over international exposure and company sector. It will then depend on the individual consultant which secondary factor they would want to use to determine complexity, be it sector or international exposure. After discussing the various factors that consultants considered important in selecting comparator group, it was then necessary to understand what components of the remuneration package the consultants use for benchmarking.

Question 3: Which elements of the pay package do you consider for benchmarking?

The element of remuneration package considered in benchmarking executive pay is important because of its potential effect on remuneration levels. The executive pay package is made up of various components as discussed in chapter 2. The variable pay of the remuneration package depends on the performance of the company and will vary between executives and companies. Consequently, total remuneration or variable pay components could be misleading as the performance of the executives and their company might not be the same. However, benchmarking executive remuneration considering only the fixed elements of the pay package (base salary and benefit) could potentially provide appropriate comparisons of executive pay without necessarily driving up executive pay levels. This is because these elements of the remuneration package are set on the basis of the executive's experience and skills in the job, his responsibilities in the company and the size of the company.

Figure 11: Frequency chart for remuneration elements considered in benchmarking



Two respondents (consultants 2 and 3) said they would benchmark considering only the total remuneration package. Quoted companies are required to disclose the remuneration of each named executive in a single figure table.⁶⁴⁵ It therefore means that this single figure which represents the executive’s remuneration would be considered for benchmarking irrespective of how the figure was realised which could be misleading and potentially driving executive pay levels up.

...you can benchmark across sectors because if you are benchmarking total remuneration of FTSE 100 companies, there is an argument that they have got transferable skills. (*Consultant 2*)

When we are undertaking benchmarking, there are two things that we do, rather than looking at base pay in isolation (elements of pay), we prefer to look at total remuneration. (*Consultant 5*)

One respondent said they would benchmark only on an element-by-element basis. This respondent acknowledged that the variable components of the remuneration package are not guaranteed and depends on the performance of the executives and the company. This implies that the respondent understood the effect of the variable elements of the pay package on remuneration levels, consequently limiting its effect

⁶⁴⁵ The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Part 3, reg. 4.

by benchmarking on an element-by-element basis, but applying caution on variable pay.

An important point worth noting here is that fact that elements of executive remuneration package are made up of fixed components which is the base salary, pension and benefits and variable components...The company is not guaranteeing those variable components. Thus their future compensation would depend on their performance and the performance of the company.

(Consultant 1)

Half of the sample size (i.e. three respondents) said they would consider both element-by-element and total remuneration package as well. For example:

When we are undertaking benchmarking, there are two things that we do, rather than looking at base pay in isolation (elements of pay), we prefer to look at total remuneration. Generally, we provide advice to our clients saying what the various elements look like and then adding that up. Looking at the element in isolation can be misleading as some companies tend to pay high salaries because they do not pay pensions and this hints the greatest danger of looking at only one element of pay. *(Consultant 5)*

We tend to look at it as a total then we look at it as a spilt. We look at it really in three ways which includes as salary, cash bonus, and long term incentives. Total compensation is the primary comparator and then would say within that you may be under market for salary, and under market for long term incentives. But total compensation comes first. *(Consultant 6)*

The finding demonstrates inconsistencies in the elements of the remuneration package considered in benchmarking. Furthermore, the different elements of the remuneration package would have a different influence on the pay levels. For example, the variable elements of the remuneration package are based on performance conditions. If this element is considered when the executives of the comparator company had made huge gains, it may cause the executive pay levels of the focus company to increase. The danger in this increase is that it may not be linked to company performance. After understanding the factors that are considered in selected comparator group and the

elements considered in benchmarking, it was important to understand the effect of benchmarking on executive remuneration.

Question 4: What is the effect of benchmarking on executive remuneration?

At first sight, it seems that executive remuneration benchmarking is a sensible way of setting a total value for a remuneration package. Unfortunately over-reliance on competitive pay data has resulted in upward spiral in executive remuneration. Five respondents said that the act of benchmarking can affect executive remuneration by increasing it. Examples include:

Benchmarking will generally increase executive remuneration because when the executives sign their contract, the contract does not normally allow the company to reduce the pay and that does create some inherece or resistance to downward pay flexibility (*Consultant 1*)

The disadvantage of this is that the position of more information is making CEOs compare with their peers and for those who are paid less wanting a pay increase (*Consultant 4*)

The CA 2006 requires quoted companies to disclose in a remuneration report the remuneration policy of the company which includes the amount paid to each named executive during each financial year. As identified by these two consultants, the availability of this pay data therefore potentially has the effect of increasing executive pay levels. Executive pay benchmarking could therefore be considered as one of the main upward drivers of executive pay.

On the other hand one respondent said that the act of benchmarking has the effect of reducing executive pay. For example:

...we belief in the fact that benchmarking can actually help in driving down compensation... (*Consultant 6*)

This respondent was of the opinion that if the executive remuneration of the focus company is more than the comparator companies, then benchmarking can help reduce it. This is because when selecting comparator companies, they would avoid

remuneration data of a newly hired executive who are generally paid higher to attract them to the post. Consequently, avoiding this data will reduce the level of executive remuneration from what it would have been if the data of newly hired executives were included. Only this respondent raised this point, meaning that ignoring the influence of newly hired executive pay data would consequently drive up pay levels considerably. This is because as already pointed out by other respondents, benchmarking helps to match up executive pay levels as a means of retaining the executives in the company. Furthermore, avoiding the data of newly hired executives by this consultant would result in the executives of that company having less remuneration package than other executives from other companies. This could consequently encourage the executive to seek for jobs in other companies that will pay better.

Two respondents, who said that the act of benchmarking can increase pay, also said that the act of benchmarking also brings about transparency in the executive remuneration setting process. For example:

What benchmarking does is make the process of executive pay setting more systematic, transparent and more scientific relying on proper data which are facts... (*Consultant 1*)

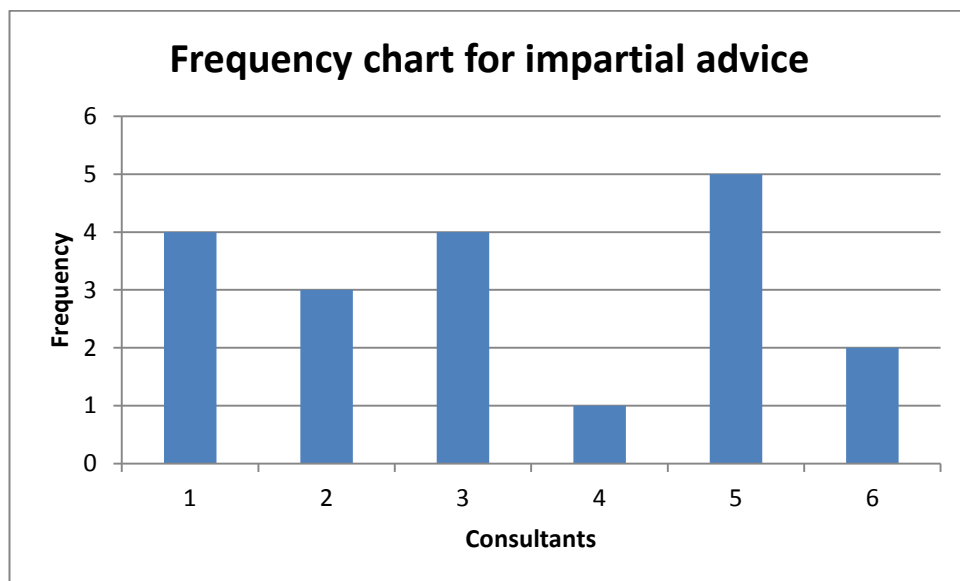
Benchmarking puts transparency into a more rigorous form...it is the company's policy and transparency that drives increase in executive pay. (*Consultant 2*)

These two respondents points out the fact that benchmarking brings transparency into the executive remuneration process. It seems rather untrue as the finding from this study is pointing to the fact that benchmarking practice lacks uniformity. Benchmarking seems to be helping executive justify their pay even when not linked to the performance of the company. Benchmarking process will bring transparency to the pay setting exercise if there are a set of rule or guideline for every RCON to follow. The effect of executive benchmarking on executive pay is influenced by the nature of advice that the consultants offer to the REMCO. This prompted the next question.

Question 5: What is the nature of the advice consultants give to remuneration committees after benchmarking?

The nature of advice (objective or subjective) that the consultants give to the REMCO is important as it can have a great impact on the executive remuneration determination process. The RCONs are considered to be independent from the company they are advising and consequently are expected to provide the REMCO with objective advice on executive remuneration benchmarking. Murphy and Sandino⁶⁴⁶ argues that RCON's potential conflict of interest could result in the RCONs providing subjective advice to the REMCO as they seek to retain the other services that they provide to the company. All the respondents talked about the type of advice they offer to the REMCO in line with their independence from the company that they advise. The frequency table and graph below shows how often each of the respondents talked about how they advise the REMCO.

Figure 12: Frequency chart for impartial advice by the RCON



From the frequency chart above, one respondent emphasised more their independence and the impartiality of their advice to the REMCO. Examples of nature of advice include:

⁶⁴⁶ Kevin Murphy and Tatiana Sandino, 'Executive Pay and 'Independent' Compensation Consultants' (2010) 49(3) Journal of Accounting and Economics 247-262.

...we are very careful to ensure that the advice we give is impartial and independent (*Consultant 1*)

We provide a fair third party advice... (*Consultant 6*)

In my experience, remuneration consultants do provide independent robust advice... (*Consultant 3*)

However some responses start by making reference to the RCON Code. For example:

The Remuneration Consultant Code say people must give best advice as they see it and behave with integrity at all times... well, totally unbiased... (*Consultant 5*)

We have a code of conduct (The Remuneration Consultants Code of Conduct) that we are signatories to and it requires us to give impartial advice... I am not saying that some consultants' advice is not subjective and have not followed the impartiality requirement strictly enough (*Consultant 1*)

The RCON's independence from the company they are advising can impact on the nature of advice that they offer to the REMCO as discussed above. This could also mean that if the RCON is not independent from the company they are advising, that might cause them not to offer objective advice. For example:

I believe consultants are generally independent... if a consultant has only one client then he will not be independent because his entire income would depend on that company... having a balance of portfolios of companies is so important when it comes to the independence of the consultant (*Consultant 2*)

As mentioned earlier in the chapter, companies sought out various services from these consultancy firms which include benchmarking services. These consultancy firms are paid depending on the services that they are offering to the company. Like any other business relationship, if the company is not satisfy with any service that the consultancy firm is offering, they will end the contract and get a different consultancy firm to offer the required services. RCONs as pointed out by consultant 1 and 2,

might offer subjective advice to the REMCO in order to keep their contract of other services that they offer to the company.

One other interesting factor that cropped up in one of the transcripts was on the character of the RCON. One of the consultants responding to the question on nature of advice said:

Trying to impress the executives to get work is not my experience. I think there is slightly more subtle question to ask if a remuneration consultant have sufficient strength of character and is he prepared to stand up to confrontation because executives are by and large, have strong characters and whether the consultant is ready to advise on small pay knowing that they are making the executives feel bad (*Consultant 5*)

This could therefore mean that, some RCONs would provide advice that would increase executive pay simply because they are afraid of a possible outrage from the executives. This outrage could be manifested in the form of terminating the consultant's business dealings with the company. Therefore, the consultant's effort to minimise a possible outrage from the executive could encourage them to provide advice to the REMCO that is subjective in nature. Executive pay has been a hot issue in the UK since the early 1990s and the government are still in the process of finding appropriate regulatory methods. Benchmarking being one of the key drivers of executive pay, the process of benchmarking is required to be systematic and transparent and not dependent on emotions.

Conclusion

The REMCO is a subcommittee of the board in charge of determining remuneration packages of executives of the company as recommended by the UKCGC. It has great potentials to restrain excessive remuneration packages, but due to its lack of independence from the board, most past studies suggest that they are ineffective in restraining excessive executive pay. They rely on information from various sources to enable them make informed judgement in the determination of executive remuneration. They rely on RCONs to advise them on executive remuneration benchmarking. Executive benchmarking is an important exercise in the process of

determining executive remuneration. It has also been identified as one of the key drivers of executive remuneration. However, with seemingly no best practice on the subject it is difficult to say how the process is carried out, what factors are used and why those factors are used. The interview findings have revealed that various consultants consider different elements for different reasons when benchmarking executive remuneration. Although, it has been identified from the data that the factors considered may include company size, company sector, company complexity, company's geographical operations, the role of the executive and the company's policy, it all depends on the individual consultant. The interview population was not large enough to enable the researcher draw any conclusions as most commonly used factors and why which is the biggest limitation to this work. This work is recommended to be used as a basis for further research in this area to determine the factors considered in benchmarking.

Chapter 5: Pay for Performance

Introduction

The UKCGC 2012, principle D.1 recommends that a significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. Performance-based pay is regarded as the process of providing a financial reward to an individual which is linked directly to individual, group or organisational performance.⁶⁴⁷ It is a reward given to specific employees for their discretionary and special contribution towards the achievement of assigned individual and company goals. Over the last two decades, the use of performance-related components has increased dramatically. Consequently, executive remuneration packages have seen a decrease in the fixed cash pay components (base salary and benefits) and an increase in the performance related part of the package. Beginning from the mid-90s executive pay has witnessed a decline in the use of share options as the main performance related scheme and an increase in use of long term incentive plan schemes. This has made performance a principal determinant of executive remuneration. Companies use performance related pay to motivate their executives and to align the interest of the executives with those of the shareholders.⁶⁴⁸ Executive performance influences company performance and shareholder value. Therefore, the desired result of the performance related pay is to achieve the company's set goals.

This chapter aims to investigate the compliance of companies with this recommendation by investigating the link between executive and CEO remuneration with company performance; the link between executive and CEO remuneration with company size; and finally the link between company size and company performance. The following sections will look at the existing literature on the topic, the rationale for pay for performance, the methods used in this study, and the results and conclusion.

The rationale for pay-for-performance

⁶⁴⁷ Ophelia D. Dogbe, 'Performance-Based Pay As A Motivational Tool for Achieving Organisational Performance: An Explanatory Case Study' (2011) 6 International Journal of Business and Management 270, 271.

⁶⁴⁸ Steve Lim, 'The Advantages of Motivation and Inspiration?' (2011) <http://stevelim.hubpages.com/hub/What-are-the-Advantages-of-Motivation-and-Inspiration> assessed 4 December 2013.

Principle D.1 of the UKCGC states that ‘[a] significant proportion of executive directors pay should be structured so as to link rewards to corporate and individual performance.’⁶⁴⁹ This means that some of the pay executives will receive should be dependent on their performance both at individual and corporate level. As discussed in chapter 1, an executive’s pay package is made up of different components which include base salary, benefits, annual bonuses (that could be tied to some financial performance of the company) and variable pay (e.g. share options, long term incentive plans). One of the reasons for linking executive pay to performance is rooted in agency theory. Agency theory identifies the relationship where one party (the principal) delegates responsibilities to another party (the agent) to perform some services on their behalf. Some of these responsibilities involve delegating decision making authority to the agent.⁶⁵⁰ This definition suggests that executives are agents and shareholders are the principals. This is because the shareholders have entrusted the running and management of their investments in the hands of the executives and their pay is structured as to link pay to individual and corporate performance as recommended by the UKCGC. However, under the CA 2006, the company is a separate legal entity and thus it is the principal (not the shareholders), with the executives being agents of the company. The agent’s principal duty is to act in the interest of his principal, with the divergence of interest between principal and agent known as the agency cost. This divergence in interest can be limited by establishing appropriate incentives for agents and by monitoring the executives.⁶⁵¹ Linking pay to performance is a means of aligning the interest of the executives to that of the company⁶⁵² and thereby should reduce agency costs.⁶⁵³ The executives are expected to perform in the best of their ability in order to earn their reward whilst maximising profits for the company. The separation of ownership and control which involves placing the management of the company under the responsibility of the executives has the potential to increase agency cost.⁶⁵⁴ Consequently, performance related pay is being used as a motivational factor for the executives to act in a way that will promote

⁶⁴⁹ FRC, *The UK Corporate Governance Code* (FRC 2012).

⁶⁵⁰ M Jensen and W Meckling, ‘Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure’ (1976) 3 JFE 305, 310.

⁶⁵¹ *ibid.*

⁶⁵² Ruth Bender, ‘Why Do Companies Use Performance-Related Pay for Their Directors?’ (2004) 12 CGIR 521,522.

⁶⁵³ Luis Gomez-Mejia, Pascal Berrone and Monica Franco-Santo: *Compensation and Organisational Performance: Theory, Research and Practice* (ME Sharpe 2010) 253.

⁶⁵⁴ Jill Solomon, *Corporate Governance and Accountability* (3edn. John Wiley & Sons Ltd. 2012) 9.

the success of the company for the benefit of its members. An example of this scheme is when an executive is promised a number of shares in the company if the company share price increases. The executive in his effort to acquire shares in the company will work hard towards making decisions that will result in an increase in the company's share price. Therefore in this case, the promised shares act as a motivating factor for the executive to promote the success of the company by making decisions that will go to increase the share price of the company.

Executives are believed to perform to the best of their ability and have a greater chance at succeeding if they have some motivation in place⁶⁵⁵ (e.g. the company can motivate the executives to perform better by promising them shares in the company or a percentage rise in their salary if the company makes more profit). Motivation is defined as the psychological forces that determine the direction of a person's behaviour in an organisation, a person's level of effort and a person's level of persistence.⁶⁵⁶ Motivation can be intrinsic or extrinsic. Intrinsic motivation refers to motivation that comes from inside an individual, for example the pleasure one gets from the task itself or from the sense of satisfaction in completing or even working on a task.⁶⁵⁷ Extrinsic motivation refers to motivation that comes from outside an individual.

In relation to performance-related pay, the motivating factors are external, in this study the external factor being the reward either in cash or in shares that the executives receive. Performance related pay serves as an extrinsic motivation for executives to act in a way that will promote the success of the company and benefit its members. Extrinsic motivation has been proven by various theories of motivation⁶⁵⁸ to be driving employees to the attainment of higher performance levels and corporate goals.

⁶⁵⁵ Steve Lim, 'The Advantages of Motivation and Inspiration?' (2011) <http://stevelim.hubpages.com/hub/What-are-the-Advantages-of-Motivation-and-Inspiration> assessed 4 December 2013.

⁶⁵⁶ Ophelia D. Dogbe, 'Performance-Based Pay As A Motivational Tool for Achieving Organisational Performance: An Explanatory Case Study' (2011) 6 *International Journal of Business and Management* 270, 271.

⁶⁵⁷ Richard Ryan and Edward Deci, 'Intrinsic and Extrinsic Motivation: Classic Definitions and New Directions' (2000) 25 *Contemporary Educational Psychology* 54, 56.

⁶⁵⁸ Roland Benabou and Jean Tirole, 'Intrinsic and Extrinsic Motivation' 2003 (70) *Review of Economic Studies* 3, 489-520; Richard Ryan and Edward Deci, 'Intrinsic and Extrinsic Motivation: Classic Definitions and New Directions' (2000) 25 *Contemporary Educational Psychology* 54-67.

implementing extrinsic motivation by using performance related pay as the motivating factor executives may be encouraged to work hard towards achieving the company's goals and consequently maximising shareholder value, and in return to get their reward. This is based on the fact that motivation influences performance.

Furthermore, companies use performance related pay because it is a current market practice in which other companies are actively involved. By so doing they remain competitive and are seen as legitimate in the eyes of their stakeholders, and consequently gaining support from the stakeholders.⁶⁵⁹ Also, performance related pay makes it possible to recognise and reward performance. This is when executives take difficult and risky decisions in a situation they would rather have abandoned it and succeeds.⁶⁶⁰ Recognition is a vital aspect of motivation and linking pay to performance is an important motivational tool for executives.⁶⁶¹

Performance related pay helps in the recruitment of executives, as top performing executives would consider performance-related pay as valuable, attractive and as a chance to prove their capability. Performance related pay helps the company to identify the executives who could consistently deliver satisfactory performance in the most cost-effective manner.⁶⁶² It is a major tool to differentiate between the performers and the non-performers. Otherwise, the performers will lose their commitment, effort and dedication towards the company's goals if their performance is not recognised.

However, some past studies have shown that extrinsic rewards can damage the intrinsic job interest of the executives.⁶⁶³ That is, executives lose focus on the needs of the job at hand as there are being distracted by the promised rewards.⁶⁶⁴ For example, the executive has the responsibility of promoting the success of the company most

⁶⁵⁹ M Suchman, 'Managing Legitimacy: Strategic and Institutional Approach' (1995) 20 AMR 571, 574.

⁶⁶⁰ Ruth Bender, 'Why Do Companies Use Performance-Related Pay for Their Directors?' (2004) 12 CGIR 521, 522.

⁶⁶¹ Patrick Gerard, *Performance and Reward: Managing Executive Pay to Deliver Shareholder Value* (Troubador 2006) 15.

⁶⁶² Mridul Maheshwari and Manjari Singh, 'Organizational Readiness for Performance-Related Pay: Focus on Government of India Employees' (2010) 35 VIKALPA 63, 65.

⁶⁶³ Ruth Bender, 'Why Do Companies Use Performance-Related Pay for Their Directors?' (2004) 12 CGIR 521, 522.

⁶⁶⁴ Peter Reilly, 'The Link Between Pay and Performance' (2003) The Institute of Employment Studies 5 <http://www.employment-studies.co.uk/pdflibrary/mp18.pdf> accessed 7 October 2013.

preferably with long-term consequences, the executive might decide to make decision that yield desired results and earn him the promised reward. Furthermore, it has been argued that performance related pay works more in creating a temporary compliance than a sustained improvement for the company.⁶⁶⁵ Individual executives could struggle to meet a target alone for the reward promised when the target is meant for a team work.⁶⁶⁶ The risk associated with performance related pay is that it might lead to short-termism when what is desired by most companies is a longer-term perspective.⁶⁶⁷ Short-termism is a situation in which company display a preference for business strategies that generates an early pay-off relative to strategies that would have added much more value, but at a significantly later time.⁶⁶⁸ Performance-related pay encourages short-termism when payments on performance-related incentives such as long-term incentive plans and share options are linked to short term performance (e.g. three to twelve months). Another driver of short-termism in companies is the investors' attitude. For example, institutional investors and managers of investments funds are preoccupied with short term earnings of the companies in their portfolios rather than the long-term indicators which are desirable for the companies. These investors put significant pressure on corporate bodies and executives to deliver short-term gains in stock price consequently, making short-term behaviour inevitable.⁶⁶⁹

Executive performance cannot be fully measured because the actions and strategies implemented by the executives are not directly observable. The results of their actions and decisions are sometimes influenced by events that are beyond the executive's control, for example, economic recession.⁶⁷⁰ At such a time the company profitability might drop or remain the same which does not necessarily mean that the executives are not performing well. Linking pay to performance can give rise to dysfunctional behavioural responses where directors pay attention only to those aspects of

⁶⁶⁵ Canice Prendergast, 'The Provision of Incentives in Firms' (1999) 37 *Journal of Economic Literature* 7, 8.

⁶⁶⁶ Peter Reilly, 'The Link Between Pay and Performance' (2003) *The Institute for Employment Studies* <http://www.employment-studies.co.uk/pdflibrary/mp18.pdf> assessed 1 October 2013.

⁶⁶⁷ *ibid.*

⁶⁶⁸ IOD, 'Getting to Grips with Short-Termism' summer 2012 www.iod.com assessed 17 October 2013.

⁶⁶⁹ Malcolm S. Salter, 'How Short-Termism Invites Corruption ...And What to Do About It' (2012) Working Paper http://www.hbs.edu/faculty/Publication%20Files/12-094_8260785f-0417-45d1-8abc-0afe86f87eaa.pdf assessed 2 February 2014.

⁶⁷⁰ Pim Van Gijssel 'The Importance of Non-Financial Performance Measures During the Economic Crisis' (2012) Master Thesis <http://arno.uvt.nl/show.cgi?fid=127357> assessed 7 October 2013.

performance that are rewarded.⁶⁷¹ The structure of the incentive scheme is very important because incentives that are intended to achieve a particular outcome could have potentially harmful unintended consequences if inadequately designed. Different forms of incentive-based pay come with different levels of risk and uncertainty for which the remuneration committee have to consider when setting the targets.

One of the challenges faced by linking pay to performance is the difficulty in selecting appropriate performance measures.⁶⁷² Performance can be measured in many different ways, yielding different results and conclusions.⁶⁷³ The challenge is more difficult if performance measures chosen are subject to volatility of share price/market or if there is limited correlation between different performance measures.⁶⁷⁴ Performance can only be adequately rewarded if measured in a consistent manner with clear objective and verifiable measures. Performance measures cannot be effectively set because performance cannot be known perfectly until after the task is completed. This is because some of the performances are not observable or measurable either quantitatively or qualitatively.⁶⁷⁵ Thus performance measures will always be imperfect representations of actual performance. It is also not all aspects of managerial performance that can be measured. The next section below will discuss performance target and performance measure.

Literature review

This section will provide a brief account of the existing literature on pay for performance in the UK. Past studies on this area in the UK have yielded inconsistent results due to different and ambiguous remuneration measures adopted by the researchers. This section intends to point out what studies that have been done on the topic, their findings, their limitations and the reason why this study is important. Over the past two decades linking executive pay to performance has become a growing

⁶⁷¹ Canice Prendergast, 'The Provision of Incentives in Firms' (1999) 37 *Journal of Economic Literature* 7, 8.

⁶⁷² Ruth Bender, 'Why Do Companies Use Performance-Related Pay for Their Directors?' (2004) 12 *CGIR* 521, 530.

⁶⁷³ J Kozan and C Boulanger, 'Managing the Complex Relationship Between Executive Pay and Performance' (2004) <http://iveybusinessjournal.com/topics/governance/managing-the-complex-relationship-between-executive-pay-and-performance#.U10DXaKsiSo> assessed 15 October 2013.

⁶⁷⁴ *Ibid.*

⁶⁷⁵ Luis Gomez-Mejia, Pascal Berrone and Monica Franco-Santo: *Compensation and Organisational Performance: Theory, Research and Practice* (ME Sharpe 2010) 255.

practice amongst companies due to the perceived lack of link between executive pay and company performance. This area of study has witnessed large amount of literature in the United States, but with limited literature in the United Kingdom. Studies on pay-for-performance beginning with the work done by Jensen and Murphy⁶⁷⁶ found that there was a very weak relationship between CEO pay (using the cash component of the remuneration package) and company performance (using shareholder wealth also known as shareholder return as the performance measure). Gregg et al⁶⁷⁷ studied 300 large UK companies over the 1980s and early 1990s and found out that growth of directors' remuneration was very high over this time period but very weakly linked to corporate performance.⁶⁷⁸ Furthermore, they also found out that pay-performance relationship had weakened between the periods 1983-1991.⁶⁷⁹

Early studies on pay for performance in the UK mainly focussed on the cash elements of compensation (i.e. salary and bonus), largely because at the time only the cash elements were disclosed in the annual report and accounts. This made it difficult for early researchers to obtain remuneration figures for share options and long-term incentive schemes; they relied on cash measurement of remuneration which took no account of long term incentive plans and share options. Excluding an estimation of these additional components underestimated the actual level of pay and could lead to an inaccurate result in the estimation of the levels of executive pay and company performance.⁶⁸⁰ It was not until 1997 when disclosure rules prompted by the Greenbury Report 1995 came into effect recommending the detailed disclosure of each director's remuneration which included base salary, benefits, annual bonuses, share options and long-term incentive schemes pay.⁶⁸¹ Main et al⁶⁸² was one of the first studies to be completed in the UK that incorporated the values of executive option grants. They found out that there was a significant variation in total pay but that this was weakly related to changes in shareholder return. Total shareholder return

⁶⁷⁶ M Jensen and K Murphy, 'Performance Pay and Top-management Incentives' (1990) 98(2) J.Pol.Econ. 225-264.

⁶⁷⁷ P Gregg, S Machin and S Szymanski, 'The Disappearing Relationship Between Directors' Pay and Corporate Performance' (1993) 31(1) BJIR 1-9.

⁶⁷⁸ *ibid*, at 6.

⁶⁷⁹ *ibid*.

⁶⁸⁰ DTI and Kings College London, *Report on Key Drivers of 'Good' Corporate Governance on the Appropriateness of UK Policy Responses* (DTI 2007) 53.

⁶⁸¹ Gee, *Greenbury Report on Directors' Remuneration* (Gee Publishing 1995) para. 5.8-5.12.

⁶⁸² B Main, A Bruce and T Buck, 'Total Board Remuneration and Company Performance' (1996) 106(439) Economic Journal 1627-1644.

(TSR) is the total return on investment achieved for shareholders during the review period.⁶⁸³ They also found out that the inclusion of share option value increased the pay-performance elasticity (this refers to the degree to which executive remuneration changes in levels in response to change in company performance) for total board remuneration but reduced for the highest paid director. This indicated that the pay of other executives of the company was more tied to company performance than the pay of the highest paid director. Conyon and Murphy⁶⁸⁴ on the other hand, shifted from looking at stock options and used performance based incentives such as long-term incentive plans to analyse the difference in CEO pay and incentives in the US and the UK for the year 1997 and using shareholder wealth as the measure for company performance. Their study found out that pay-performance elasticity of the largest 510 companies of FTSE All Share index was just 0.12 meaning that the relationship between pay and performance was weak because for every ten percent increase in executive pay there is only a corresponding 0.12 percent increase in company performance. Their findings also showed that after controlling for the determinants of CEO pay, CEO pay in the US was 200% higher than the CEO pay in the UK on their sample for the fiscal year 1997. Although, their findings highlighted the fact that executives in the US are paid more than the executives in the UK, the important fact still remains that on either sides of the country the link between executive pay and company performance was weak. However, the study was limited to the fact that only one year's data was analysed. Buck et al⁶⁸⁵ argued that the inclusion of long-term incentive plans is essential when determining the link between pay and performance, but recognised that by including long-term incentive plans and share options, the pay-performance relationship will be strengthened. This is because long term incentive plans and share options are performance related and would give a better link between pay and performance than cash pay. Cash pay includes base salary and benefits which are not performance contingent. Gregg⁶⁸⁶ et al in 2005 using cash compensation (this includes base salary plus annual bonus) as the main performance measure examined the relationship between executive pay and company's performance for a sample of

⁶⁸³ Jane King and Mary Carey, *Personal Finance: A Practical Approach* (Oxford University Press 2013) 131.

⁶⁸⁴ M Conyon, and K Murphy, 'The Prince and the Pauper? CEO Pay in The United States and United Kingdom' (2000) 110 *Economic Journal* 640-671.

⁶⁸⁵ T Buck, A Bruce, BGM Main and H Udueni, 'Long Term Incentive Plans, Executive Pay and UK Company Performance' (2003) 40(7) *JOMS* 1709-1727.

⁶⁸⁶ *ibid.*

large UK companies over the period 1994-2002. They showed a weak link between CEO pay and firm performance using total shareholder return as the main performance measure. Other performance measures that the study used included earnings per share, return on assets and growth in sales, but their results do not specifically point out to what was the result for each of these performance measures. The study also found out that the link between pay and performance was high when stock returns were relative high, but that pay was less sensitive to performance when the stock returns were low. This suggests that the executive pay increase was linked only to stock price cycles and not to the performance of the company. This suggested that over the period 1994-2002 and across companies, executive pay continued to increase irrespective of whether the company was profitable or not, implying that during that period executive pay had little or no relationship with company performance. Their study indicated that the relationship between pay and performance appeared to have become stronger after the stock market crash of March 2000. The study showed that executive pay rose greatly between the period of 1994-2002 but with little relationship between pay and performance. It was also found out that the link between pay and performance for cash remuneration varies across companies, industries, company size and board size. This finding indicates that individual and corporate performance are not the only elements that effect levels of executive pay as other factors such as company size, board size, industry also have an effect on the levels of executive pay.

Gregg et al⁶⁸⁷ examined individual pay-performance sensitivity in and across companies as opposed to an average across all companies and found out that pay varied across directors and companies due to different company strategies and policies. Their findings suggested that there was a weak relationship between CEO total pay and company performance using total shareholder return, earnings per share and sales revenue as the performance measures. Furthermore, they noticed companies with stronger corporate governance structures (such as more NEDs on their board) had high pay-performance sensitivity (i.e. pay being more closely related to performance) with board pay and not with the highest paid director. A study by

⁶⁸⁷ P, Gregg, S, Jewell and I, Tonk, 'Executive Pay and Performance in the UK 1994-2002' (2005) CMPO Working Paper Series No. 05, Discussion paper No 657, http://www2.lse.ac.uk/fmg/workingPapers/discussionPapers/DP657_2010_ExecutivePayandPerformancetheUK.pdf assessed 24 August 2011.

Girma et al⁶⁸⁸ studying 992 companies over the periods 1981-1996 using cash components and ignoring equity-based components, found out that the relationship between pay and performance (using profit and sales as their performance measure) remained weak. One possible weakness of this study as with many others⁶⁸⁹ is the use of cash compensation as the main measure of executive compensation ignoring equity-based components of compensation package.⁶⁹⁰ Eichholtz et al's study⁶⁹¹ suggested weak evidence of pay-for-performance (using total shareholder return, earnings per share and market value as their performance measure) sensitivity using both cash and long-term components of remuneration package. Ozkan⁶⁹² examining the influence of corporate governance mechanisms on the level of CEO pay on a sample of 414 UK companies for the year 2003, found that there was no significant relationship between company performance (using stock return and return on asset as their performance measure) and CEO pay for period 2003/2004. Although, this study included the cash components and equity-based components of compensation, its major limitation was that the data was just for a year and limited to CEO pay and cannot be used conclusively to judge what happens over the years. Ozkan⁶⁹³ based on hand collected data set from 390 non-financial sector UK companies over the period 1999-2005 found that there was a positive significant relationship between company performance (using stock return and return on asset as their performance measure) and CEO cash pay but with a positive weak relationship with CEO total pay. The findings also indicated that the average pay-performance elasticity was 0.075 for CEO cash compensation, meaning that for every ten percent increase in CEO cash remuneration there was only a corresponding 0.075 percent in total shareholder return indicating a weak relationship between pay and performance.⁶⁹⁴

⁶⁸⁸ S Girma, S Thompson and W Wright, 'Corporate Governance Reforms and Executive Compensation Determination: Evidence from the UK' (2007) 75(1) *The Manchester School* 65-81.

⁶⁸⁹ Examples include; M Jensen and K Murphy, 'Performance Pay and Top-management Incentives' (1990) 98 (2) *J.Pol.Econ.* 225-264; P Gregg, S Machin and S Szymanski, 'The Disappearing Relationship Between Directors' Pay and Corporate Performance' (1993) 31(1) *BJIR* 1-9.

⁶⁹⁰ P Gregg, S Machin and S Szymanski, 'The Disappearing Relationship Between Directors' Pay and Corporate Performance' (1993) 31(1) *BJIR* 1-9.

⁶⁹¹ P Eichholtz, N Kok and R Otten, 'Executive Compensation in UK Property Companies' (2008) 36(4) *Journal of Real Estate Finance And Economic* 405-426.

⁶⁹² N Ozkan, 'Do Corporate Governance Mechanisms Influence CEO Compensation? An Empirical Investigation of UK Companies' (2007) 17 *Journal of Multinational Financial Management* 349-364.

⁶⁹³ N Ozkan, 'CEO Compensation and Firm Performance: An Empirical Investigation of UK Panel Data' (2009) 12 *European Financial Management* 1-26.

⁶⁹⁴ H Joubert and H Fakhfakh, 'Does CEO Performance-Based Compensation Wait on Shareholders? A Cross National Analysis' (2011) 2 *IJBAM* 68, 69.

Dever et al.⁶⁹⁵ and Farmer⁶⁹⁶ examining the existing literature on pay for performance in the UK are of the opinion that there is no consistency in the results so far due to the different measures and ambiguous remuneration measures adopted by the researcher. In all fairness to the researchers, companies use these ambiguous performance measures to determine pay, which makes it difficult for the researchers. They recommended a more theoretical guidance in future research on the subject in particular with the choice of performance measures, timeframes, samples, methods and variables.

Consequently the aim of this study is to shed new light on the link between executive/CEO remuneration and company performance for UK companies. In this study, both cash and equity-based components of executive/ CEO remuneration packages for a number of large UK companies for the period 1996-2011⁶⁹⁷ will be analysed. The relationship of cash pay (which will include base salary and benefits), and performance related pay (which will include annual bonuses, LTIPs and share options) of both executive and CEO remuneration and company performance will be established. Other factors considered by past studies include the effect of firm size on executive pay.⁶⁹⁸ Firm size has been proven by past research (and as also discussed in chapter 4) as an important determinant of the level of executive remuneration as executive pay tends to increase with firm size.⁶⁹⁹ The size of the firm affects all the components of executive pay. Eichholtz et al's⁷⁰⁰ findings showed that executive shareholdings provide a stronger link between pay and performance. Their findings also indicated that company size was the most important variable for the determination of pay levels in large UK companies. The literature discussed above overwhelmingly indicates that the link between pay and performance is weak even though very few found a significant link. The hypothesis is formulated what is expected of a 'desirable' executive remuneration package as:

⁶⁹⁵ CE Devers, AA Cannella, GP Reilly and ME Yoder, 'Executive Compensation: A Multidisciplinary Review of Recent Developments' (2007) 33(6) *Journal of Management* 1016-1077.

⁶⁹⁶ Mark Farmer, 'Chief Executive Compensation and Company Performance: A Weak Relationship or Measurement Weaknesses?' (2008) 17th EDAMBA Summer Academy <http://www.edamba.eu/userfiles/Mark%20Farmer.pdf> accessed 23 October 2012.

⁶⁹⁷ The reason for the time frame is explained in the methods section in ch 2.

⁶⁹⁸ For example, P Gregg, S Machin and S Szymanski, 'The Disappearing Relationship Between Directors' Pay and Corporate Performance' (1993) 31(1) *BJIR* 1-9.

⁶⁹⁹ Peter Kostiuk, 'Firm Size and Executive Compensation' (1990) 25 *JHR* 90, 104.

⁷⁰⁰ P Eichholtz, N Kok and R Otten, 'Executive Compensation in UK Property Companies' (2008) 36(4) *Journal of Real Estate Finance And Economic* 405-426.

H1: It is hypothesised that there is a significant positive relationship between executive/CEO remuneration and company performance.

H2: It is hypothesised that there is a significant positive relationship between executive/CEO remuneration and company size.

H3: It is hypothesised that there is a significant positive relationship between company size and company performance.

Before testing the validity of these hypotheses, performance targets and performance measures will be explained.

Performance targets and performance measures

It is important to discuss performance targets and performance measure because of its wide use in determination and measurement of performance-related pay. Performance targets are defined as ‘the objects or aims of managerial action or as borderlines that differentiate success from failure’.⁷⁰¹ For example, the performance targets for Severn Trent plc for 2011 were as follows:

Table 7: Performance target for Severn Trent plc 2011

The targets for awards granted in 2011 will be as follows:

Severn Trent average annual RoRCV outperformance against the Ofwat Final Determination expectation	Vesting level for performance shares
Less than or equal to Final Determination ($\leq 100\%$)	0%
102%	50%
107% or higher	100%

Source: Severn Trent plc Annual Reports and Accounts 2011, pg 48

For performance targets to be effective, they must be perceived as being reliable, fair, achievable, agreed, and understood by the executives.⁷⁰² Performance targets need to be reviewed periodically to take into account the environmental and competitive

⁷⁰¹ Monica Franco-Santos and Mike Bourne, ‘The Impact of Performance Targets on Behaviour: A Close Look at Sales Force Contexts’ (2008) 5 Research Executives Summaries Series 1, 2

⁷⁰² Ruth Bender, ‘Why Do Companies Use Performance-Related Pay for Their Directors?’ (2004) 12 CGIR 521, 530.

nature of the market. The effectiveness of performance targets can be compromised if mainly based on past performance as it could sometimes result in making the targets even harder each time. If targets are perceived to be too high, it de-motivates the executives leading to non-achievement and, if perceived to be too low it can result in payment for poor performance.

Performance measures are used to assess the success of companies. Selecting the appropriate measures that will take into account the environmental and competitive nature of the market is an important decision the remuneration committee must make. It must be informative to help the company determine whether the targets were met or not. It is based on this information that any rewards can be made to the executives. Performance measures need to be perceived as objective and relatively small (e.g. one or two measures) as to keep the executives focused. This is because some companies use too many performance measures (to guide against external factors like economy that may affect some of the performance measures) making it difficult to understand what the priorities are and where attention should be focused. For example, in 2011 J Sainsbury plc had seven performance measures (earnings per share, profit, sales, return on capital employed, cash flow, total shareholder return and market share).⁷⁰³ However, the report did not specify which of them was of prime importance leaving the executives with the struggle of which to focus on more. The report stated that ‘share-based awards will be made to participants subject to performance against a basket of key strategic measures...’ the word ‘basket’ in the sentence means many performance measures and it would be difficult for the executives to remain focused with many performance measures. The logical reasoning for having a basket of indicators is to prevent the indicators from being effected by external forces (e.g. the economy) or easily manipulated by the executives. Performance measures can be financial or non-financial. Financial performance measures include profitability (e.g. return on equity, return on assets, return on capital employed etc.), liquidity, gearing ratios, other investor ratios (for example earnings per share) and shareholder values (for example total shareholder return). Non-financial measures include the number of employees and the number of products.

⁷⁰³ These terms will be explained later in the chapter.

Furthermore, financial performance measures can also be classified as accounting related performance measures. It aims at maximising shareholder wealth which is the main objective of the company. Shareholders are generally concerned about their present and future earnings, dividends and the risk of their investment in the company – all of which are driven by financial measures. It also causes management to focus on short term results rather than long term growth in order to increase their remuneration in the short term.⁷⁰⁴ Focusing on short term investment may inhibit investment in research and development, which is important for the future growth of the company in certain sectors (e.g. the pharmaceutical sector).⁷⁰⁵ Most companies are linked to short-term financial measures of corporate performance such as earnings per share and share price movement. This encourages executives to focus on short termism and the need for quick returns, and thus companies failing to link performance to the long term success of the company.⁷⁰⁶ Also, investors, business and related press tend to focus on share price as an indicator of the success or failure of the company thus building pressure on the executives which then encourages executives to focus on short-term success of the company. According to the Companies Act 2006⁷⁰⁷ requires the long-term success of the company is a factor that must be taken into account when promoting the success of the company for the benefit of its members, which implies that in all decision making, the directors should consider its long-term consequence a priority. Non-financial measures are considered to be more long term focus and reflect on different dimension of managerial performance.⁷⁰⁸ The UKCGC recommends that executive remuneration should be related to individual and company performance. However, the Code does not recommend which performance measure(s) companies should use. The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008⁷⁰⁹ requires quoted companies to explain the performance conditions, how they are being assessed and why those performance conditions and measures were chosen in relation

⁷⁰⁴ SLC Tan and CM Lau, 'The Impact of Performance Measures on Employee Fairness Perceptions, Job Satisfaction and Organisational Commitment' (2012) 10 JAMAR 57, 57.

⁷⁰⁵ Pim Van Gijssel 'The Importance of Non-Financial Performance Measures During the Economic Crisis' (2012) Master Thesis <http://arno.uvt.nl/show.cgi?fid=127357> assessed 7 October 2013.

⁷⁰⁶ 'British Business at risk unless executive rewards linked to long term performance' (2013) High Pay Centre January 14th.

⁷⁰⁷ Companies Act 2006, s 172.

⁷⁰⁸ SLC Tan and CM Lau, 'The Impact of Performance Measures on Employee Fairness Perceptions, Job Satisfaction and Organisational Commitment' (2012) 10 JAMAR 57, 57.

⁷⁰⁹ The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Sch. 8, part 2, reg. 3(2).

to executive's share options or long term scheme entitlement. The REMCO are required to include in their remuneration report a graph of total shareholder return (TSR) of the company with those of its peers.⁷¹⁰ It could be deduced from this provision of the law that total shareholder return is therefore an important performance measure that companies should adopt in assessing performance conditions. The CA 2006⁷¹¹ states that the business review must use financial KPIs and, where appropriate, other measures such as environmental or employee matters. The Act provided the meaning of key performance indicator as factors by reference to which the company's performance can be measured effectively. The law does not go further to state which performance measures companies should adopt. For the purposes of this chapter, all of the financial performance measures used by the nineteen companies under study will be discussed, beginning with return on assets

Return on Assets (ROA)

ROA is a financial performance measure which takes into account assets used to support the business activities of the company. It shows the percentage of profit that a company earns in relation to its overall resources (total assets).⁷¹² This value can be calculated by dividing a company's net income or annual income by its total assets, and is displayed as a percentage. For example, Morrisons plc for the year 2011 had an annual net income of £658 million, and total assets of £5,420 million. Therefore its ROA will be:

$$\text{ROA} = \text{annual net income} / \text{total assets}$$

$$\text{ROA for Morrison 2011} = \frac{\text{annual net income}}{\text{non current assets} + \text{current assets}} \times 100$$

$$658\text{m}/5420\text{m} \times 100\% = \frac{658}{8011+1138} \times 100$$

$$\text{ROA} = 7.19\%$$

⁷¹⁰ The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Sch. 8, part 2, reg. 3(4).

⁷¹¹ Companies Act 2006, s 414C(4) & (5).

⁷¹² Belverd Needles, Marian Powers and Susan Grosson, *Principles of Accounting* (Cengage Learning 2010) 204.

Annual net income is the profit that the company makes once interest, taxes and other expenses are deducted. Total assets are anything tangible or intangible owned by the company that has economic value. All these figures can be obtained from the company's income statement and balance sheet of the annual report and financial statement of the company.

Unlike other profitability ratios, such as return on equity (discussed next), ROA measurements include all of a business's assets. This includes assets which arise out of liabilities to creditors as well capital paid in by investors. ROA is usually of less interest to shareholders than some other financial ratios such as shareholder return because shareholders are more interested in the return they receive on their investment. This makes ROA more important to the management than the shareholders. ROA is used internally by companies to track asset-use over time, to monitor the company's performance in light of industry performance, and to look at different operations or divisions by comparing them one to the other. ROA can signal both effective uses of assets as well as under-capitalization.⁷¹³

Return on Equity (ROE)

Return on equity (ROE) is another profitability performance measure which assesses the rate of return on the ownership interest or shareholders' equity of the common stock. It is a measure that shows how much profit a company has made from the money shareholders invested in the company.⁷¹⁴ ROE focuses on return to the shareholders and the company. It is commonly used as a target for executive compensation because it gives management an incentive to perform better. For example, the net income of Tesco plc for the year 2011 was £1,870 million, non-current assets of £35,337 million and current assets of £11,438 million. ROE can be calculated using the formula below:

$$\text{ROE} = \text{net income} / \text{book value of shareholders' equity} \times 100\%$$

$$\text{ROE} = \frac{1870}{35337+11438} \times 100$$

⁷¹³ Herbert Mayo, *Investment: In Introduction* (Cengage Learning 2013) 292.

⁷¹⁴ William Hettinger and John Dolan-Leitlinger, *Finance without Fear: A Guide to Creating and Managing a Profitable Business* (Inst for Finance & Entrepren 2011) 156.

$$\text{ROE} = 3.99\%$$

Net income as discussed above can be obtained from the company's income statement contained in the annual report and financial statement of the company. The book value of shareholders' equity represents the actual worth of the company which will be the total assets of the company minus any debt owed by the company. However, ROE is sensitive to leverage.⁷¹⁵ Leverage⁷¹⁶ is the ratio of the company's debt to the value of its ordinary shares. The greater the ratio of the company's debt to the value of its ordinary shares, the smaller the value of ROE, consequently creating more risk for the company in hard economic times. This simply means that the more a company is in debt, the less profit it makes. ROE and total shareholder return (discussed next) align shareholder interest with company performance better than most other indicators. ROE depends on net income that does vary and could be affected by accounting practices. As a result ROE alone cannot be used to judge the performance of a company, but it can be used in conjunction with other measures to do so.

Total Shareholder Return (TSR)

TSR is the total return on investment achieved for shareholders during the review period.⁷¹⁷ This is the net stock price change plus the dividends paid during a particular period. It measures share price growth and dividends. Stock price represents the cost of one share of the company. For example if Sainsbury plc wants to calculate TSR for the year 2011, the stock price at start of period would be the price that one share in the company costs at the beginning of January 2011. The stock price at the end of period would be the price that one share in the company cost at the end of December 2011. The dividends paid would be the dividend that the company has paid to one shareholder during that year. TSR can be calculated using the formula below:

$$\text{Total shareholder return} = (\text{stock price at end of period} - \text{Stock price at start of period} + \text{dividends paid}) \div \text{stock price at start of period}$$

⁷¹⁵ William Hettinger and John Dolan-Leitlinger, *Finance without Fear: A Guide to Creating and Managing a Profitable Business* (Inst for Finance & Entrepres 2011) 156.

⁷¹⁶ Simply put, leverage shows how much debt a company has got in relation to what the company owns.

⁷¹⁷ Jane King and Mary Carey, *Personal Finance: A Practical Approach* (Oxford University Press 2013) 131.

$$\text{TSR for Sainsbury 2011} = (3.51 - 3.32 + 0.15) \div 3.32$$

$$\text{TSR} = 0.10$$

TSR aligns the interest of executives and shareholders by linking reward to returns shareholders make on their investment in the company.⁷¹⁸ TSR represents a readily understood figure of the overall financial benefits generated for shareholders. Most investors in a company prefer TSR because it indicates the profits that shareholders have made on their investment in a company at a particular period. The figure can be interpreted as a measure of how the market evaluates the overall performance of a company over a specified period. Given that TSR is expressed in percentage terms, the figures are readily comparable between companies in the same sector. Quoted companies are required to include in remuneration report a graph of TSR of the company with those of its peers. Most companies are therefore using TSR for comparing company performance and ranking.⁷¹⁹ For this reason shareholders and investors want executives to only be fully rewarded for their performance if they achieve at least 75-100% of their target (upper quartile) or partially rewarded if they achieved at least 50% of their target (median quartile).

However, TSR targets need to be supported by secondary targets (e.g. ROA targets) which will be company specific because TSR is market driven. TSR reflects the past overall return to shareholders, with no consideration of future returns. TSR is externally focused in that it reflects the market's perception of performance. It could, therefore, be adversely impacted should a share price of a fundamentally strong company suffer excessively in the short term. For example, if company A's share price at the start of the period is £3.50, its share price at the end of the period is £2, and there is a dividend of £0.15 per share. This shows that the share price has dropped by £1.50, consequently its TSR will be -0.1. Therefore, it can be hard getting an appropriate comparator group for a company using TSR as it will depend on the share price at the particular time.⁷²⁰

⁷¹⁸ Martin Webster, *The Director's Handbook: Your Duties, Responsibilities and Liabilities* (3edn. Institute of Directors 2010) 165.

⁷¹⁹ The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Sch. 8, part 2.

⁷²⁰ Martin Webster, *The Director's Handbook: Your Duties, Responsibilities and Liabilities* (3edn. Institute of Directors 2010) 165.

Earnings Per Share (EPS)

EPS is earnings available to the shareholder (excluding preference shareholders as they often receive fixed dividend amounts) divided by the number of ordinary shares outstanding (this represents the shares of the company that has been issued and are in the hands of the public).⁷²¹ The values for EPS are usually disclosed in the profit and loss accounts of the company. EPS can be basic or diluted. Basic EPS is the total earnings per share based on the number of shares outstanding at the time,⁷²² whereas diluted EPS represents the earnings per share a business would have generated considering all dilutive securities (e.g. share options and convertible debt). For example, company A has 200 outstanding common shares for 9 months and 240 outstanding common shares for 3 months. The weights of 9 months and 3 months would be 0.75 and 0.25 respectively. These figures (0.75 and 0.25) represent 3/4 of a year and 1/4 of a year. Therefore to obtain the diluted EPS for this company, it would be $0.75(200) + 0.25(240)$, which would equal a weighted average of 210 common shares for the entire year. It is the universally accepted and most crucial measurement and indicator of financial performance of a company as EPS normally drives the share price (the higher the EPS of a company the higher its share price).⁷²³ Growth in EPS is an important measure of management performance as it shows how much money the company is making for its shareholders although it is usually an annual measurement, thus encouraging short-termism.⁷²⁴ It is a measure that executives can easily relate to and directly influenced by the performance of the management.

EPS says very little about long term issues of the company meanwhile long term sustainability of earnings is a key issue for shareholders.⁷²⁵ Setting company specific performance targets based purely on EPS can be difficult considering that executives are rewarded according to their company and not their peers. Investors fear that EPS is open to manipulation by the executives as they can be distorted by mergers and

⁷²¹ Pamela Peterson Drake, Frank J Fabozzi, CFA, *Analysis of Financial Statements* (John Wiley & Sons 2012) 156.

⁷²² Carl Warren, James Reeve and Jonathan Duchac, *Corporate Financial Accounting* (12edn. Cengage Learning 2013) 516.

⁷²³ Ambrish Gupta, *Financial Accounting for Management: An Analytical Perspective* (Pearson Education 2008) 583.

⁷²⁴ Jane King and Mary Carey, *Personal Finance: A Practical Approach* (Oxford University Press 2013) 132.

⁷²⁵ Patrick Gerard, *Performance and Reward: Managing Executive Pay to Deliver Shareholder Value* (Troubador 2006) 106.

acquisitions and, can also be affected by changes in company's accounting policy. For example, The US company Diamond Food's then-chief financial officer fraudulently underreported money paid to walnut growers by delaying the recording of payments into later fiscal periods. By manipulating walnut costs, Diamond correspondingly reported higher net income and inflated earnings to exceed analysts' estimates for fiscal quarters in 2010 and 2011. After Diamond restated its financial results in November 2012 to reflect the true costs of acquiring walnuts, the company's stock price slid to just \$17 per share from a high of \$90 per share in 2011. Former CEO Michael Mendes should have known that Diamond's reported walnut costs were incorrect at the time he certified the company's financial statements. Diamond Foods misled investors to believe that the company was consistently beating earnings estimates on Wall Street.⁷²⁶ This example shows how the executives can manipulate EPS, therefore indicating that EPS might not be a good variable for measuring company performance.

Return on Capital Employed (ROCE)

ROCE indicates what profits the company has made on the resources available to it. It is the ratio of net operating profit of a company to its capital employed and it measures the profitability of a company.⁷²⁷ For example, WM Morrisons plc for the year 2011, current assets was £1,138 million, non-current assets was £8,011 million, and operating profit was £904 million. ROCE is calculated using this formula:

$$\text{ROCE (\%)} = \text{operating profit/capital employed} \times 100$$

$$\text{ROCE for Morrisons} = \frac{904}{8011+1138} \times 100$$

$$\text{ROCE} = 9.88\%$$

Operating profit is the gross profit the company has made before deduction of taxes and expenses. Capital employed is the capital investment necessary for a business to

⁷²⁶ US Security and Exchange Commission, 'SEC Charges Diamond Foods and Two Former Executives in Accounting Scheme to Boost Earnings Growth' (2014) Press Release http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540598296#.Uu5a_KK-2So assessed 2 February 2014.

⁷²⁷ Rao Peddina Mohana and Reddina Mohana Rao, *Financial Statement Analysis and Reporting* (PHI Learning Pvt. Ltd. 2011) 140.

function. This would include share capital (assets) and non-current liabilities (long term debt e.g. loans) these figures can be obtained from the balance sheet of the company's annual report and financial statement. ROCE enables comparisons to be made between companies of different sizes.⁷²⁸ ROCE is a good measure of company profitability however, it may not provide an accurate reflection of performance for large cash reserves companies. ROCE does not always state the accurate amount of capital employed because intangible assets (assets that cannot be physically touched) such as brands and trademarks are not counted as capital employed.

Return on invested capital (ROIC)

The ROIC indicates how well a company is using its money to generate returns. It is the net profit after taxes plus interest paid on long-term debt.⁷²⁹ It tells the investors how good a company is at turning its capital into profits. Unlike ROA and ROE, ROIC does not consider the debt of the company which can make highly indebted companies look profitable.⁷³⁰ For example, the ROIC of Scottish and Southern Energy (SSE) plc for the year 2011 was based on net operating profit £2,367.8 million, income tax of £607.2 million, long-term debt £4,133.4 million, and shareholder equity of £2951.3 million. ROIC is calculated therefore as follows:

$$\text{ROIC} = \frac{\text{net operating profit} - \text{income tax}}{\text{long term debt} + \text{shareholder equity}}$$

$$\text{ROIC for SSE} = \frac{2367.8 - 607.2}{4133.4 + 2951.3}$$

$$\text{ROIC for SSE} = 0.25 \text{ or } 25\%$$

Market share

This is the percentage of the market that a company controls in relation to a particular product or service. It is a measure used by the company to determine consumer preferences for a product in relation to other products of similar kinds. A high market

⁷²⁸ Rao Peddina Mohana and Reddina Mohana Rao, *Financial Statement Analysis and Reporting* (PHI Learning Pvt. Ltd. 2011) 140.

⁷²⁹ Robert Follett, *How to Keep Score in Business: Accounting and Financial Analysis for the Non-Accountant* (FT Press 2011) 102.

⁷³⁰ Pat Dorsey, *The Five Rules of Successful Stock Investing: Morningstar's Guide to Building Wealth and Winning in the Market* (John Wiley & Sons 2011) 94.

share will indicate greater sales meaning that the company is likely profitable. Investors look at market share as it indicates how well the company is performing in the market as well as how competitive the company is in relation to other companies. Companies with high market share are generally more successful than those with low market shares. For a company that is a conglomerate or is trading in different national markets, a high market share brings greater recognition for the company, makes potential customers aware of the company and its products.

Earnings before interest and tax (EBIT)

EBIT represent all the profits that the company has made before interest and tax are deducted.⁷³¹ EBIT is also known as the operating income of a company. Pre-tax operating income measures both the profits the company has made and the expenses. For example, the EBIT for Marks & Spencer plc in 2011 was £782.7 million. This figure can be obtained from the company's annual report and accounts (particularly in the income statement). These are all financial performance measures that indicate how well a company can use its resources to generate income over a period of time. Investors use these measures to be able to determine whether the company is doing well or not financially.

Share price

Share price is the price of a particular company's shares at a particular time.⁷³² Investors use share price as a performance measure to assess a company's performance over a period of time by examining the share price performance in the share market which will indicate how well the company is doing. However, it is worth noting here that increase in share price does not always reflect on the performance of the company because some shares prices are affected by the ups and downs of the of the economy (known as cyclical stock). The improvement in the company's performance is reflected by an increase in the share price in the stock market. The more the company performance increases the more the share price increases and the more the stock market will be expecting from the company and consequently, the more the company is urged on to keep up the performance which could encourage

⁷³¹ Prasanna Chandra, *Financial Management* (Tata McGraw-Hill Education 2011) 51.

⁷³² Andy Neely, *Business Performance Measurement: Theory and Practice* (Cambridge University Press 2002) 10.

executives to focus on short-termism.⁷³³ This indicates that the limitation for using share price as a performance measure for performance-related pay is the fact that it will encourage short-termism.

Revenue

Revenue is the money that a company receives before any deductions (tax, interest, and expenses) are made over a period of time from its activities.⁷³⁴ Revenue is used as a performance measure because a growth in revenue usually indicates improvements in company performance. However, revenues might increase but performance might worsen. Example, oil company A earns £300 m in 2011 and £400 million in 2012. This would seem to be an improvement in performance. However, if the price of oil was double in 2012, it would mean that the number of barrels sold was considerably less. It is a poor measure of performance if the costs of production are not taken into account.

Cash flow

Cash flow simply refers to the money that goes in and out of a company.⁷³⁵ For example, the cash flow for Scottish and Southern Energy plc for the year 2014 was £212.7 million indicating money going into the company after discounting for money that the company paid out.⁷³⁶ Investors use cash flow to determine the performance of a company because a constant increase in cash flow indicates that the company is performing well.⁷³⁷ Free cash flow represents that money left to the company after deducting money needed for expanding the business and buying of assets. Free cash flow is important to investors as it indicates that the company has got money to take up opportunities that can enhance shareholder value.

⁷³³ Richard Dobbs and Timothy Koller, 'Measuring stock market performance' (2005) The McKinsey Quarterly: The Online Journal of McKinsey & Co. <http://www.softomic.com/blog/McKinseyTSRetAl.pdf> assessed 10 December 2013.

⁷³⁴ Richard Kotas and Michael Conlan, *Hospitality Accounting* (Cengage Learning EMEA 1997) 142.

⁷³⁵ Rachchh Minaxi, *Introduction To Management Accounting* (Pearson Education India 2011) 265.

⁷³⁶ Scottish & Southern Energy plc, Annual Reports and Accounts 2014, p103.

⁷³⁷ Marc Lichtenfeld, 'The Best Way to Measure Company Performance' (2011) <http://www.investmentu.com/2011/October/measure-company-performance-with-cash-flow.html> assessed 10 December 2013.

Return on Regulatory Capital Value (RoRCV)

RoRCV is the return on the net worth of a company defined according to the rules of a regulatory body (such as OFWAT which is a regulatory body for the water industry in the UK). It is a regulatory constraint for companies to have adequate capital for their business and to remain capially adequate. Companies focus on economic capital as they believe it provides an accurate assessment of performance, but economic capital will only work as a good performance measure if the company has more than enough regulatory capital.⁷³⁸

Following the discussion on performance measures above, the table below represent the performance measures used by the nineteen companies under study. As seen from the table, different companies use different performance measures for pay purposes. The table represents only the financial performance measures and does not include non-financial performance measures used by the companies. For companies that have more than one financial performance measure, it is not stated in their remuneration reports whether or not all the performance measures be satisfied. Furthermore, some of the companies attribute different percentages of rewards to be awarded to the executives on different performance measures. For example, Marks and Spencer plc reward scheme for executive and company performance is 20% for ROCE, 50% for EPS and 30% for revenue.

Table 8: Companies and performance measures used

Company	Performance measure
Barclays Bank plc	ROE
Legal and General plc	TSR, EPS
Cairn plc	TSR
HSBC Bank plc	ROE
ICAP plc	EPS
Sainsbury plc	ROCE, TSR, EPS, market Share, profit, cash flow, sales
Johnson Matthey plc	EPS

⁷³⁸ David Murphy, *Understanding Risk: The Theory and Practice of Financial Risk Management* (CRC Press 2008) 268.

Kingfisher plc	EPS, TSR
Lonmin plc	Relative TSR, EBIT, share price
Marks and Spencer plc	EPS, ROCE, revenue
National Gird plc	Adjusted EPS, TSR
Prudential plc	TSR, company cash flow, IFRS operating income, pre-tax operating income
Southern and Scottish Energy plc	EPS, TSR
Severn Trent plc	RoRCV, Relative TSR
Shire plc	ROIC, share price
Smith and Nephew plc	Relative TSR, free cash flow
Tesco plc	ROCE, EPS, TSR
United Utility plc	TSR, operational performance measures
Morrisons plc	EPS, market price

Results and discussion of the quantitative study

This section will describe the results for each research objective. It will also provide the interpretation of major findings and demonstrate how the findings correspond or differs with published studies. The results will be discussed in the following sections first, the link between executive/CEO remuneration and company performance. In this section the relationship between executive/CEO total remuneration, performance-related pay and total cash pay with TSR, ROA and EPS will be discussed. The separation of this analysis will help to build up the understanding on the pay for performance relationship. Second, the link between executive total remuneration and company size will be discussed. Last, the relationship between company size and company performance will be discussed.

The link between executive/CEO remuneration and company performance

A positive strong relationship is expected according to hypothesis one because executive/CEO increase in remuneration levels will depend on the performance of the company. The following results will demonstrate the results obtained from the correlations between executive/CEO remuneration and company performance to either reject or confirm the hypothesis.

The links between total remuneration and company performance using TSR

Total shareholder return is the performance measure that is most preferred by investors as it indicates what the investors gain from investing in the company. It is considered to be the ultimate measure of company performance because it indicates the profits that the shareholders get from company after all expenses have been made, which directly links executive incentives with those of the shareholders. The correlation calculations were carried out separately for executives and the CEOs because CEOs are in most cases the highest earning individuals in the company and possibly with more incentives than the rest of the executives.

Executive total remuneration and company performance Pearson's correlation coefficient (explained in chapter 2) yielded the following results. Five out of nineteen companies demonstrated a positive relationship between executive total remuneration and total shareholder return indicating that executive pay increases as company performance increases. However, the relationship was not significant because one out of the five companies, Marks and Spencer showed a moderately positive relationship with a correlation coefficient of $r=0.34$; and four out of the five companies demonstrated a positive weak relationship, for example, Kingfisher with a correlation coefficient of $r=0.23$. This result mean that executive total remuneration is moderately linked to company performance in the case of Marks & Spencer plc , and weakly linked to company performance in the rest four companies that demonstrated a positive relationship. Even though, there is a moderate and weak relationship between executive total remuneration and company performance, a strong relationship is what is expected to justify the high level of pay executives receive. This result therefore rejects hypothesis 1. This finding is similar to the findings of Eichholtz et al⁷³⁹ and Main et al⁷⁴⁰ which suggested that there was a weak relationship between executive total remuneration and company performance using TSR as the performance measure.

Fourteen out of nineteen companies showed a negative relationship between executive total remuneration and total shareholder return. This suggests that executives are being paid for no/poor performance contrary to the recommendations of the UKCGC.

⁷³⁹ P Eichholtz, N Kok and R Otten, 'Executive Compensation in UK Property Companies' (2008) 36(4) *Journal of Real Estate Finance And Economic* 405-426.

⁷⁴⁰ B Main, A Bruce and T Buck, 'Total Board Remuneration and Company Performance' (1996) 106(439) *Economic Journal* 1627-1644.

Thirteen out of the fourteen companies demonstrated a weak negative relationship, for example, Shire with a correlation coefficient of $r=-0.06$, indicating a negative weak relationship between executive total remuneration and company performance. HSBC Bank showed a moderately negative relationship with correlation coefficient of $r=-0.33$. Lonmin showed a significant strong negative relationship with a correlation coefficient of $r=-0.62$ indicating that executive remuneration increases even more when the company's performance decreases. The differences in the correlations could be related to the size of the companies. Company size and sector are some of the factors (as identified by past studies and the interviews in chapter 4) that are considered when determining executive pay. The variation could be due to the size of the company as the larger the company the higher the executive pay.⁷⁴¹ However, the results have demonstrated trend that could reflect different sector practices. This finding suggests that the setting of executive total remuneration does not depend on the performance of the company because the results indicate that most of the companies executive remuneration' pay still continues to increase even when the company is under-performance.

CEO total remuneration and company performance Pearson's correlation coefficient yielded the following results. Six out of the 19 companies demonstrated positive coefficient between CEO total remuneration and company performance, indicating that CEO total remuneration increased as the company performance increases. However, the positive relationship was not significant. Three out of the six companies demonstrated a weak positive coefficient, for example, Lonmin with correlation coefficient of $r=0.09$; and the rest three companies demonstrated a moderately positive coefficient, for example, Kingfisher with a correlation coefficient of $r=0.39$. The finding shows that more (six) companies demonstrated a positive relationship between CEO total remuneration and company performance than executive total remuneration (five companies) and company performance. However, the difference is not significant and indicating that CEOs pay is not significantly more than the pay of other executive in the company. Although, the difference is not much, it suggests that CEO total remuneration is more closely related to company performance than executive total remuneration. Furthermore, this result also rejects hypothesis 1,

⁷⁴¹ Correlations for company size and executive pay discussed later in the chapter.

suggesting that CEO total remuneration is not strongly related to company performance.

Thirteen out of 19 companies demonstrated a negative coefficient with CEO total remuneration indicating that as CEO total remuneration is increasing, whilst company performance using TSR as the performance measure is decreasing. Nine out of the thirteen companies showed a negative weak coefficient, for example, HSBC had a correlation coefficient of $r=-0.14$ indicating a negative weak relationship between CEO total remuneration and company performance. Of the thirteen companies that displayed a negative coefficient, the remaining four showed a negative moderate coefficient, (e.g. Barclays Bank with a correlation coefficient of $r=-0.35$). This suggests that CEOs total remuneration is not determined depending on the company's performance.

The results for both executives and CEO, indicates that using TSR as the performance measure to determine the relationship between total remuneration and company performance, different companies yield different results. Out of the 19 companies analysed in this study, 11 companies use TSR as the only financial performance measure or in conjunction with other financial performance measures and non-financial measures. With five out of the nineteen companies (for executives) and six out of nineteen companies (for CEO) demonstrating a positive relationship with total remuneration and TSR indicates that executive/CEO remuneration is not related to company performance. However, the lack of a positive relationship between executive/CEO total remuneration and TSR for the rest of the companies could also be due to the limitations of using TSR as a performance measure. These include the fact that TSR is determined independently by the market and hugely relies on share price. Share prices may vary for reasons that are unconnected to the company or the executive/CEO's performance. The results obtained for both executive and CEO total remuneration generally suggest that there is no strong relationship between pay and performance therefore rejecting hypothesis 1 which suggest that there is a strong relationship between pay and performance.

The links between total remuneration and company performance using ROA

Return on asset is a performance measure that is the least used measure in determining the relationship between pay and performance. Rather than the management focusing on the shareholder return, return on assets forces the management to focus on the assets that the company needs to run the business.

Pearson's correlation coefficient for the link between executive total remuneration and ROA yielded the following results. Six out of nineteen companies demonstrated a positive relationship between executive total remuneration and ROA indicating that executive remuneration increases with increase in company performance. Two out of the six companies, for example, Marks and Spencer showed a moderately positive relationship with a correlation coefficient of $r=0.35$. The rest four companies demonstrated a weak positive relationship, for example, Smith and Nephew with correlation coefficient of $r=0.12$ indicating that although executive pay increases with increase in company performance, the strength of the relationship is weak. This finding follows the same trend as findings for executive total remuneration and TSR which rejects hypothesis 1.

Thirteen out of nineteen companies demonstrated a negative relationship between executive total remuneration and ROA indicating that executive remuneration increases whilst company performance using ROA as the performance measure decreases. Five out of the thirteen companies showed a weak negative association, for example, Cairn Energy with a correlation coefficient of $r=-0.14$ indicating that executive remuneration slightly increases with decrease in company performance. Six out of the thirteen companies demonstrated a moderately negative association, for example, Severn Trent with a correlation coefficient of $r=-0.38$. Two out of the thirteen companies demonstrated a significantly strong negative relationship, for example, ICAP with a correlation coefficient of $r=-0.51$ indicating that executive remuneration increase even more with the decrease in company performance.

Pearson's correlation coefficient for the link between CEO total remuneration and ROA yielded the following results. Five out of the nineteen companies demonstrated a positive coefficient between CEO total remuneration and ROA indicating that executive remuneration increases with increase in company performance using ROA

as the performance measure. None of the five companies demonstrated a strong positive relationship between CEO total remuneration and ROA indicating therefore rejecting hypothesis 1. Three out of the five companies showed a weak positive relationship, for example, Sainsbury with correlation coefficient of $r=0.05$ meaning that executive remuneration only increases slightly with increase in company performance. Two out of the five demonstrated a moderately positive association between CEO total remuneration and ROA, for example, Legal & General with correlation coefficient of $r=0.45$.

Fourteen out of nineteen companies demonstrated a negative Pearson's coefficient between CEO total remuneration and ROA indicating that executive remuneration increasing whilst company performance using ROA as the performance measure decreases. Eight out of the fourteen companies demonstrated a negative weak coefficient between CEO total remuneration and ROA, for example, Cairn Energy with correlation coefficient of $r=-0.17$ indicating that executive remuneration increases slightly when company performance decreases. Three out of the fourteen companies demonstrated a moderately negative association between CEO total remuneration and ROA, for example, Johnson Matthey with correlation coefficient of $r=-0.48$. Furthermore, 3 out of the 14 companies demonstrated a strong negative relationship between CEO total remuneration and ROA, for example, Barclays Bank with correlation coefficient of $r=-0.59$ indicating that executive remuneration increases so much with the decrease of company performance.

These results indicate that for most of the companies there is a negative relationship between executive/CEO total remuneration and company performance using ROA as the performance measure indicating executives and CEOs remuneration are not related to the company's performance. As mentioned earlier, ROA is the least used performance measure and none of the 19 companies under study used it as a performance measure. Considering that ROA does not suffer the setbacks that TSR suffers and yielding results that are almost similar to that of TSR, executive/CEO total remuneration is therefore not related to company performance for a majority of the companies and weakly related to very few of them. On the contrary a few of the companies have demonstrated a significant negative relationship between executive remuneration and company performance, supporting the fact that executive

remuneration is not related to company performance. Consequently, the findings rejects hypothesis 1 which suggest that there is a strong relationship between pay and performance.

The links between total remuneration and company performance using EPS

EPS is another performance measure that is widely used to measure pay and performance in the UK. EPS is a performance measure that can be directly influenced by the performance of the executives.

Pearson's correlation coefficient for the link between executive total remuneration and EPS yielded the following results. Fourteen out of nineteen companies demonstrated a positive relationship between executive total remuneration and EPS indicating that executive remuneration increases as company performance increases using EPS as the performance measure. The results suggest that executives can get more pay when they appease the short-term interest of their shareholders. This may encourage executives to rely on short-term performance of the company rather than the long-term performance of the company resulting in 'short-termism'. Six out of the fourteen companies showed a significantly strong positive relationship, for example, Johnson Matthey with a correlation coefficient of $p=0.86$ indicating that executive remuneration significantly increases with significant increase in company performance. These six companies confirmed hypothesis 1 to the effect that there is a significant relationship between executive remuneration and company performance. The other eight companies demonstrated a moderate and weak relationship between executive remuneration and company performance thereby rejecting hypothesis 1. Three out of the fourteen companies showed a moderate positive association, for example, HSBC with a correlation coefficient of $r=0.35$. Five out of the fourteen companies demonstrated a weak positive relationship, for example, Kingfisher with a correlation coefficient of $r=0.002$ indicating that executive remuneration increases slightly with increase in company performance. This finding indicates that on a general note there is a relationship between executive remuneration and company performance. Furthermore, most of the company demonstrate a weak relationship between executive remuneration and company performance.

Four out of the nineteen companies demonstrated a negative relationship between executive total remuneration and EPS indicating that executive remuneration increases whilst company performance decreases. Three out of the four companies showed a weak negative relationship, for example, Cairn Energy with correlation coefficient of $r=-0.10$ meaning that executive remuneration increases slightly with decrease in company performance. Shire showed a moderately negative relationship with a correlation coefficient of $r=-0.30$. The study found out that one company, Severn Trent, demonstrated no relationship between executive total remuneration and EPS, as the correlation between the two variables was $r=0.00$ indicating that executive remuneration increases and decreases independently of the company's performance. For this company, there appears to be no link at all between pay and performance.

Pearson's correlation coefficient for the link between CEO total remuneration and EPS yielded the following results. Fifteen out of nineteen companies showed a positive Pearson's correlation coefficient between CEO total remuneration and EPS. This indicates that CEO total remuneration is positively related to company performance using EPS as the performance measure. Contrary to the findings of Eichholtz et al⁷⁴² which suggested a weak relationship between executive total remuneration and company performance using TSR, EPS and market value as the performance measures, 5 out of the 15 companies demonstrated a significant association with CEO total remuneration and company performance using EPS as the performance measure (e.g. ICAP with a correlation coefficient of $r=0.88$). These five companies confirms hypothesis 1 to the effect that executive remuneration is significantly related to company performance. The remaining ten companies demonstrated a moderate or weak relationship between executive remuneration and company performance thereby rejecting hypothesis 1. Four out of the fifteen companies demonstrated a moderately positive relationship, for example, HSBC Bank with correlation coefficient of $r=0.41$. Six out of the fifteen companies demonstrated a weak positive relationship, for example, Barclays Bank with a correlation coefficient of $r=0.03$. However, four out of nineteen companies demonstrated a negative weak association between CEO total remuneration and EPS, for example, Cairn Energy

⁷⁴² P Eichholtz, N Kok and R Otten, 'Executive Compensation in UK Property Companies' (2008) 36(4) *Journal of Real Estate Finance And Economic* 405-426.

with correlation coefficient of $r=-0.16$ indicating that CEO remuneration only slightly increased with the decrease of company performance.

EPS is a more short term based performance measure than TSR and ROA. This findings support the argument that executive remuneration encourages short termism in companies, where executives tend to focus on short term achievement rather on the long term success of the business. The shareholders of the company and investors are interested in the returns they can obtain from their investment consequently mounting pressure on the executives to management the investment and make profits. In order to appease the shareholders, the executives are seen to rely on short-term performance measures like EPS. This is because more than half of the companies in the study sample have demonstrated a strong significant relationship with EPS which is a short term performance measure as oppose to ROA and TSR which are a more long term performance measure. Executive pay packages across the FTSE 100 are found to be linked to short-term financial measures of corporate performance such as earnings and share price movement.⁷⁴³ Out of the nineteen companies studied, nine of the companies in the sample under study used EPS either as the only financial performance measure or in conjunction with other performance measure.

Considering the different performance measures used, this study suggests that different companies yield different results with different performance measures. This means that different companies would yield results depending on the performance measure used to determine the link between executive remuneration and company performance. For example, most companies demonstrated a positive relationship between executive remuneration and company performance using EPS and a negative relationship using ROA and TSR. However, Legal & General plc that only uses TSR as their financial performance measure demonstrated a positive relationship between executive remuneration and company performance using all three performance measure.

Considering that there is no best practice as to which financial performance measure(s) companies should adopt the results suggest in general that there exist a

⁷⁴³ The High Pay Center, 'British Business at risk unless executive rewards linked to long term performance' 14th January 2013 <http://highpaycentre.org/pubs/british-business-at-risk-unless-executive-rewards-linked-to-long-term-perfo> assessed 1 November 2013.

weak relationship between executive remuneration and company performance rejecting hypothesis 1. From a general point of view, for CEO total remuneration, eighteen companies have demonstrated a positive relationship with at least one of the performance measures used in this study (TRS, EPS or ROA). For executive total remuneration seventeen companies demonstrated a positive relationship between executive remuneration and company performance. There is a relationship (weak) between executive pay and company performance but hypothesis 1 is rejected because a strong significant relationship between executive pay and company performance is required to justify the level of pay executives receive.

The table below represents Pearson correlation coefficients for CEO/executive total remuneration with company performance for the sample under study.

Table 9: Correlation coefficient for CEO/executive total remuneration and company performance

	company	Correlation coefficients for CEO			Correlation coefficients for executives		
		TSR	ROA	EPS	TSR	ROA	EPS
1	Barclays Bank plc	-0.35	-0.59	0.02	-0.18	-0.69	0.44
2	Legal and General plc	0.32	0.45	0.20	0.13	0.39	0.11
3	Cairn plc	0.10	-0.17	-0.16	-0.03	-0.14	-0.09
4	HSBC Bank plc	-0.14	-0.03	0.41	-0.33	-0.43	0.35
5	ICAP plc	-0.18	-0.51	0.86	-0.15	-0.51	0.75
6	Sainsbury plc	0.02	0.05	0.34	0.06	0.003	0.25
7	Johnson Matthey plc	-0.10	-0.48	0.63	-0.09	-0.38	0.86
8	Kingfisher plc	0.39	-0.06	-0.49	0.23	0.12	0.002
9	Lonmin plc	0.09	-0.01	0.04	-0.62	-0.44	-0.29

10	Marks and Spencer plc	0.38	0.33	0.43		0.35	0.35	0.49
11	National Grid plc	-0.14	-0.31	0.23		-0.16	-0.29	0.23
12	Prudential plc	-0.36	-0.30	0.01		-0.10	-0.29	0.22
13	Southern and Scottish Energy plc	-0.17	-0.25	0.54		-0.05	-0.18	0.64
14	Severn Trent plc	-0.14	-0.35	-0.24		-0.16	-0.38	0.000
15	Shire plc	-0.32	0.19	-0.21		-0.06	0.08	-0.30
16	Smith and Nephew plc	-0.25	0.11	0.35		-0.29	0.12	0.77
17	Tesco plc	-0.32	-0.65	0.93		-0.22	-0.47	0.93
18	United Utility plc	-0.06	-0.20	0.18		0.05	-0.29	-0.14
19	Morrisons plc	-0.15	-0.10	0.62		-0.08	-0.37	0.64

The link between performance related pay and company performance using TSR

Principle D.1 of the UKCGC 2012 recommends the REMCO to sets executive remuneration in such a way that a significant proportion of the pay package be linked to corporate and individual performance. This means that the performance-related components should not account for only a small percentage of the total remuneration. In theory a significant positive correlation is expected between performance related pay and company performance. The main purpose of performance related pay is to align the interest of the executives with that of the company and a positive relationship will mean that the objective is achieved.

Pearson's correlation coefficient for the link between executive performance-related pay and TSR yielded the following results. Six out of nineteen companies demonstrated a positive relationship between executive performance-related pay and

total shareholder return indicating that executive remuneration increases with increase in company performance. However, only one company Marks and Spencer plc, demonstrated a strong significant relationship with a correlation coefficient of $r=0.48$ indicating that executive remuneration significantly increased with increase in company performance. This one company confirmed hypothesis 1 to the effect that there is a significant relationship between executive remuneration and company performance. The other five companies demonstrate a weak relationship thereby rejecting hypothesis 1 (e.g. United Utilities with a correlation coefficient of $r=0.23$ indicating that executive remuneration slightly increased with increase in company performance).

Thirteen out of nineteen companies demonstrated a negative relationship between executive performance-related pay and TSR indicating that executive remuneration increases whilst company performance decreased using TSR as a performance measure. Eleven out of the thirteen companies demonstrated a weak negative relationship, for example, Southern and Scottish Energy with a correlation coefficient of $r=-0.04$ indicating that executive remuneration slightly increased with decrease in company performance. Two out of the thirteen companies showed a moderately negative relationship, for example, Lonmin with a correlation coefficient of $r=-0.44$. These thirteen companies reject hypothesis 1, and suggest company performance is not considered when determining executive variable pay.

Pearson's correlation coefficient for the link between CEO performance-related pay and TSR yielded the following results. Seven out of 19 companies showed a positive relationship between CEO performance-related pay and total shareholder return indicating that CEO remuneration increases with increases in company performance. In line with the findings of Main et al,⁷⁴⁴ 3 out of the 7 companies demonstrated a strong significant positive relationship between CEO performance related pay and TSR and confirming hypothesis 1, e.g. Marks and Spencer with a correlation coefficient of $r=0.73$. The reasons why these companies demonstrated a strong positive relationship between CEO performance related pay and company performance could be that, they use mainly long term performance measure for their

⁷⁴⁴ B Main, A Bruce and T Buck, 'Total Board Remuneration and Company Performance' (1996) 106(439) *Economic Journal* 1627-1644.

performance related pay such as TSR and ROCE. Their main objectives for performance related pay are to incentivise executives to achieve superior returns to shareholders; to align interest of executive and shareholders through building a shareholding; and to retain key executives over the performance period. Their targets and performance measures are reviewed annually. These characteristics are all possessed by the rest of the companies in the sample. Therefore the reason for their strong significant relationship with TSR has not been identified by this study. One reason may be the slightly stable nature of their dividend pay-out, and share price over the period under study which in turn affects TSR ratio. However, these three companies are a minority of the data sample as the majority of the companies demonstrate a weak negative or weak positive relationship. The other four companies demonstrated weak positive relationship thereby rejecting hypothesis 1, e.g. Sainsbury with a correlation coefficient of $r=0.02$ indicating that CEO performance related pay slightly increases with increase in company performance..

Twelve out of nineteen companies demonstrated a negative association between CEO performance-related pay and total shareholder return indicating CEO performance related pay increases whilst company performance decreases. Eight out of the twelve companies showed a weak negative association, for example, ICAP with a correlation coefficient of $r=-0.10$ indicating that CEO performance related pay slightly increases with decrease in company performance. Four out of the twelve companies demonstrated a moderately negative relationship, for example, Prudential with a correlation coefficient of $r=-0.36$.

The results obtained for correlating executive/CEO total remuneration and executive/CEO performance related pay with TSR are almost similar but some of the companies demonstrated a significantly strong relationship with TSR. Although the findings points out to the fact that executive/CEO performance related pay are weakly related to company performance, the limitations of TSR discussed above cannot be ignored. The results obtained for both executive and CEO total remuneration generally suggest that there is no strong relationship between pay and performance therefore rejecting hypothesis 1.

The link between performance related pay and company performance using ROA

Return on asset as mentioned above, encourages the management to focus on the asset that the company needs to run the business.

Pearson's correlation coefficient for the link between executive performance-related pay and ROA yielded the following results. Six out of nineteen companies demonstrated a positive relationship between executive performance-related pay and ROA indicating that executive performance related pay increases with increase in company performance using ROA as the performance measure. One out of the six companies, demonstrated a strong positive relationship thereby confirming hypothesis 1, e.g. Legal and General with a correlation coefficient of $r=0.52$ indicating that executive performance related pay significantly increases with increase in company performance. The rest five companies showed a weak positive relationship thereby rejecting hypothesis 1, e.g. Kingfisher with a correlation coefficient of $r=0.15$ indicating that executive performance related pay slightly increases with increase in company performance.

Thirteen out of nineteen companies showed a negative association between executive performance-related pay and ROA indicating that executive performance related pay increases whilst company performance decreases. Seven out of the thirteen companies showed a weak negative relationship, for example, Cairn Energy with a correlation coefficient of $r=-0.25$ indicating that executive performance related pay slightly increases with decrease in company performance. Five out of the thirteen companies showed a moderately negative relationship, for example, National Grid with a correlation coefficient of $r=-0.32$. One out of the thirteen companies, Barclays Bank demonstrated a significantly strong negative relationship with a correlation coefficient of $r=-0.72$ indicating that executive performance related pay significantly increases with decrease in company performance. This means that executive performance related pay are not be tied to challenging performance as recommended by the UKCGC, consequently rewarding executives for failure.

Pearson's correlation coefficient for the link between CEO performance-related pay and ROA yielded the following results. Seven out of nineteen companies demonstrated a positive relationship between CEO performance-related pay and

ROA. One out of the seven companies being Legal & General showed a strong positive significant relationship between CEO performance related pay and ROA, with a correlation coefficient of $r=0.62$. ROA is used by companies to monitor the company's performance with that of the industry performance. Six out of the seven companies showed a positive weak relationship, for example, Sainsbury with a correlation coefficient of $r=0.12$ indicating that CEO performance-related pay was weakly related to company performance using ROA as the performance measure.

Twelve out of nineteen companies demonstrated a negative relationship between CEO performance-related pay and ROA indicating that CEO performance related pay increases whilst company performance decreases. Seven out of the twelve companies showed a negative weak relationship, for example, Cairn Energy with a correlation coefficient of $r=-0.25$ indicating that CEO performance-related pay slightly increased with decrease in company performance. Three out of the twelve company showed a moderately negative relationship, for example, ICAP with correlation coefficient of $r=-0.43$. Two out of the twelve companies demonstrated a significantly strong negative relationship, for example, Barclays bank with a correlation coefficient of $r=-0.53$ indicating that CEO performance-related pay significantly increases with decrease in company performance. The results obtained for both executive and CEO total remuneration generally suggest that there is no strong relationship between pay and performance therefore rejecting hypothesis 1 which suggest that there is a strong relationship between pay and performance.

The link between performance-related pay and company performance using EPS

Pearson's correlation coefficient for the link between executive performance-related pay and EPS yielded the following results. Fourteen out of nineteen companies demonstrated a positive relationship between executive performance-related pay and EPS indicating that executive performance related pay increases with increase in company performance. Six out of the fourteen companies showed a significantly strong positive relationship thereby confirming hypothesis 1, e.g. Tesco with correlation coefficient of $r=0.85$ indicating that executive performance related pay increases significantly with increase in company performance. Three out of the fourteen demonstrated a moderately positive relationship, for example, HSBC Bank with a correlation coefficient of $r=0.42$. the rest five companies showed a weak

positive relationship, for example, Severn Trent with a correlation coefficient of $r=0.02$ indicating that executive performance related pay weakly increases with increase in company performance.

Five out of the nineteen companies demonstrated a negative relationship between executive performance-related pay and company performance. Four out of the five companies demonstrated a weak negative relationship, for example, Cairn Energy with a correlation coefficient of $r=-0.25$ indicating that executive performance related pay weakly increases with decrease in company performance. One out of the five companies, Lonmin demonstrated a moderately negative relationship with a correlation coefficient of $r=-0.30$. This suggest that for these few companies executive performance related pay is not linked to company performance as pay and performance seem to go in opposite direction of each other.

Pearson's correlation coefficient for the link between CEO performance-related pay and EPS yielded the following results. Fifteen out of nineteen companies showed a positive association between CEO performance-related pay and EPS indicating that CEO performance related pay increases with increase in company performance. Three out of the fifteen companies demonstrated a significantly strong positive relationship between CEO performance-related pay and EPS. For example, Tesco with a correlation coefficient of $r=0.92$ indicating that CEO performance related pay significantly increases with increase in company performance. These three companies use predominantly EPS as their financial performance measure. Therefore, even though these companies did not demonstrate a positive significant relationship with neither TSR nor ROA, the CEO of the company met his performance target. Consequently, the pay of the CEO performance related pay correlates with company performance based on EPS. Four out of the fifteen companies showed a moderately positive relationship, for example, Sainsbury with correlation coefficient of $r=0.38$. Eight out of thirteen companies showed a weak positive relationship, for example, National Grid with a correlation coefficient of $r=0.26$ indicating that CEO performance related pay only weakly increased with increase in company performance. Furthermore, four out of nineteen companies showed a negative weak relationship between CEO performance related pay and EPS, for example, Severn

Trent with correlation coefficient of $r=-0.11$ indicating that CEO performance related pay increased weakly with the decrease in company performance.

This findings support the fact that linking pay to performance depends on the performance target and measure used. Since there is no recommendation or regulation stating what performance targets and performance measures for companies to use, different companies use different performance targets and performance measures. All performance measures have got its limitations but some measures are more long-term based than others. The discretion for companies to choose performance measures may be demanded by the fact that no measure is infallible. However, for the long-term success of the company more long-term performance measures should be used by companies as opposed to the short-term performance measures. In the meantime, to accurately determine whether there is a link between pay and company performance, each company would have to be treated individually considering the performance targets and performance measures used by the particular company to be able to make informed judgments on its pay for performance link. The results of these findings show that, considering the nineteen companies in the sample in general using TSR, ROA and EPS; it cannot be generalised that there is a positive strong significant relationship between executive/CEO pay and performance based on these performance measures. However, considering the companies individually and what performance measures that were used by the companies, there seems to be the strong positive significant link between pay and company performance. The results obtained for both executive and CEO total remuneration generally suggest that there is weak relationship between pay and performance therefore rejecting hypothesis 1. Furthermore, eighteen companies demonstrated a positive relationship between CEO/executive performance-related pay and company performance using one or more of the performance measures used (TRS, EPS or ROA)

The table below represents the Pearson's correlation coefficient for the link between CEO/executive performance-related pay and company performance for the sample under study.

Table 10: Correlation coefficient for CEO/executive performance-related pay and company performance

	company	Correlation coefficients for CEO			Correlation coefficient for executives		
		TSR	ROA	EPS	TSR	ROA	EPS
1	Barclays Bank plc	-0.39	-0.59	-0.07	-0.39	-0.72	0.32
2	Legal and General plc	0.25	0.44	0.28	0.26	0.52	-0.03
3	Cairn plc	0.09	-0.24	-0.24	0.05	-0.25	-0.25
4	HSBC Bank plc	0.02	-0.13	0.18	-0.17	-0.25	0.42
5	ICAP plc	-0.10	-0.43	0.79	-0.003	-0.43	0.67
6	Sainsbury plc	-0.01	0.22	0.47	0.04	0.07	0.29
7	Johnson Matthey plc	-0.41	-0.25	0.25	-0.08	-0.36	0.77
8	Kingfisher plc	0.49	0.03	0.04	0.21	0.15	0.02
9	Lonmin plc	0.15	0.07	0.13	-0.44	-0.28	-0.30
10	Marks and Spencer plc	0.15	0.27	0.09	0.48	0.29	0.39
11	National Grid plc	0.24	-0.24	0.04	-0.13	-0.32	0.22
12	Prudential plc	-0.38	-0.20	0.08	-0.12	-0.28	0.23
13	Southern and Scottish Energy plc	-0.10	-0.20	0.77	-0.04	-0.11	0.53
14	Severn Trent plc	0.15	-0.01	-0.04	-0.02	-0.35	0.02
15	Shire plc	-0.34	0.12	-0.13	-0.06	0.10	-0.29

16	Smith and Nephew plc	0.01	-0.08	-0.16		-0.28	0.09	0.72
17	Tesco plc	-0.31	-0.62	0.87		-0.06	-0.31	0.85
18	United Utility plc	0.09	-0.24	0.05		0.23	-0.19	-0.14
19	Morrisons plc	0.30	0.26	-0.02		-0.12	-0.14	0.79

The link between total cash pays and company performance using TSR

Total cash pay are not related either to individual or corporate performance. However, these elements are revised annual to take into account various factors that affects the business, one of which is the performance of the company. Considering that cash pay is not related to performance, a correlation is not expected between the two and if there is a correlation it will be due to other reasons. Executive base salary is agreed upon when the executive is appointed, which may also include a yearly increment depending on the terms of the contract of service. This increment may depend on the general performance of the company or not. For example, Johnson Matthey plc base their cash pay (base salary) increments on the financial, environmental, social and governance performance of the individual CEO.⁷⁴⁵ This therefore means that if the company has been performing well and making profits, the base salary would be increased. In which a little fraction of their cash pay is tied to company performance and a link may exist. It is worth noting that in this case the base salary could remain the same if the company is not performing well but not decreased as would be expected in a performance-related pay. Consequently, some positive relationship could be expected between total cash pay and company performance as performance impacts on base salary. Executive base salary has been constantly on the rise since the early 1990s and given the time period over which this study covers, it would be relevant to consider whether cash pay has any relationship with company performance.

⁷⁴⁵ For example Johnson Matthey Plc.

Pearson's correlation coefficient for the link between executive total cash pay and TSR yielded the following results. In line with previous studies⁷⁴⁶ using only cash pay in determining the pay for performance relationship however; six out of nineteen companies demonstrated a positive relationship between executive total cash pay and total shareholder return. One out of the six companies, Barclays Bank, showed a moderately positive relationship with a correlation coefficient of $r=0.40$. Five out of the six companies demonstrated a weak positive relationship, for example, Shire with a correlation coefficient of $r=0.12$. However, the difference between past studies in this area of studies with this study is the fact that annual bonus was considered as cash payment, meanwhile this study has considered annual bonus as a performance related pay because it is only awarded after the performance targets have been met. The findings obtained therefore, confirm the fact that executive cash pay is not determined based neither on the executives' individual performance nor the company's performance. This is further confirmed with thirteen out of nineteen companies demonstrated a negative relationship between executive total cash pay and total shareholder return. Nine out of the thirteen companies showed a weak negative relationship, for example, United Utilities with a correlation coefficient of $r=-0.14$. two out of the thirteen companies demonstrated a moderately negative association, for example, Cairn Energy with a correlation coefficient of $r=-0.40$. two out of thirteen companies showed a strong negative relationship, for example, HSBC Bank with a correlation coefficient of $r=-0.66$.

Pearson's correlation coefficient for the link between CEO total cash pay and TSR yielded the following results. Three out of nineteen companies demonstrated a positive weak relationship between CEO total cash pay and total shareholder return, for example, Marks and Spencer with a correlation coefficient of $r=0.02$. This is further confirmed with sixteen out of nineteen companies demonstrated a negative relationship between CEO total cash pay and total shareholder return. Eleven out of the sixteen companies demonstrated a weak negative relationship, for example, Prudential with a correlation coefficient of $r=-0.28$. four out of the sixteen companies showed a moderately negative relationship, for example, Barclays Bank with a correlation coefficient of $r=-0.34$. One out of the sixteen companies being HSBC

⁷⁴⁶ For example M Jensen and K Murphy, 'Performance Pay and Top-management Incentives' (1990) 98(2) *Journal of Political Economics* 225-264.

Bank demonstrated a strong negative relationship with a correlation coefficient of $r=-0.55$. Based on this finding, CEO cash pay is not related to company performance as expected.

The link between total cash pays and company performance using ROA

Pearson's correlation coefficient for the link between executive total cash pay and ROA yielded the following results. Three out of nineteen companies demonstrated a positive relationship between executive total cash pay and ROA. One out of the three companies, Cairn Energy, demonstrated a strong positive relationship with a correlation coefficient of $r=0.59$. Two out of the three companies showed a weak positive association, for example, Marks and Spencer with correlation coefficient of $r=0.28$. Sixteen out of nineteen companies demonstrated a negative association between executive total cash pay and ROA. Six out of the sixteen companies showed a weak negative association, for example, Barclays Bank with a correlation coefficient of $r=-0.17$. eight out of the sixteen companies showed moderately negative relationship, for example, Lonmin with correlation coefficient of $r=-0.44$. Two out of the sixteen companies showed a strong negative relationship, for example, Morrison with a correlation coefficient of $r=-0.63$.

Pearson's correlation coefficient for the link between CEO total cash pay and ROA yielded the following results. Similar to the findings obtained with TSR, four out of nineteen companies demonstrated a positive relationship between CEO total cash pay and ROA indicating that there is a relationship between CEO total cash pay and company performance. Three out of the four companies showed a positive moderate association between CEO total cash pay and ROA, for example, Smith and Nephew with a correlation coefficient of $r=0.41$. One out of the four companies being Marks and Spencer showed a weak positive relationship, for example, with a correlation coefficient of $r=0.27$ indicating that CEO total cash pay is weakly related to company performance. Fifteen out of nineteen companies demonstrated a negative association between CEO total cash pay and ROA indicating that CEO total cash pay tends to increase with the decrease in company performance. Five out of the fifteen companies showed a negative weak relationship, for example, United Utilities with a correlation coefficient of $r=-0.26$ indicating that CEO total cash remuneration will slightly increase with decrease in company performance. Six out of the fifteen companies

showed negative moderate relationship, for example, National Grid with correlation coefficient of $r=-0.23$. Four out of the fifteen companies showed a significantly strong negative relationship between CEO total cash pay and ROA, for example, Johnson Matthey with a correlation coefficient of $r=-0.51$ indicating that CEO total cash pay tends to increase significantly with the decrease in company performance.

Based on the finding from TSR and ROA, it can be confirmed that cash pay is not related to company performance, therefore the positive obtained from some companies relationship could be due to the company making more profits. Also it has been shown that executive pay has been on the constant rise, meaning if these companies have been making constant profit as well, it will account for the relationship.

The link between total cash pays and company performance using EPS

Pearson's correlation coefficient for the link between executive total cash pay and EPS yielded the following results. Fourteen out of nineteen companies demonstrated a positive relationship between executive total cash pay and EPS indicating that executive total cash pay is linked to company performance using EPS as the performance measure. Five out of the fourteen companies showed a strong positive relationship, for example, Tesco with a correlation coefficient of $r=0.97$ indicating that executive total cash pay increases significantly with increase in company performance. Three out of the fourteen companies, for example, Marks and Spencer showed a moderately positive relationship with a correlation coefficient of $r=0.42$. Six out of the fourteen companies demonstrated a weak positive relationship, for example, Severn Trent with a correlation coefficient of $r=0.13$ indicating that executive total cash pay increases slightly with increase in company performance. Five out of nineteen companies demonstrated a weak negative relationship between executive total cash pay and EPS, for example, Shire with a correlation coefficient of $r=-0.24$ indicating that executive total cash pay increases slightly with decrease in company performance using EPS as the performance measure.

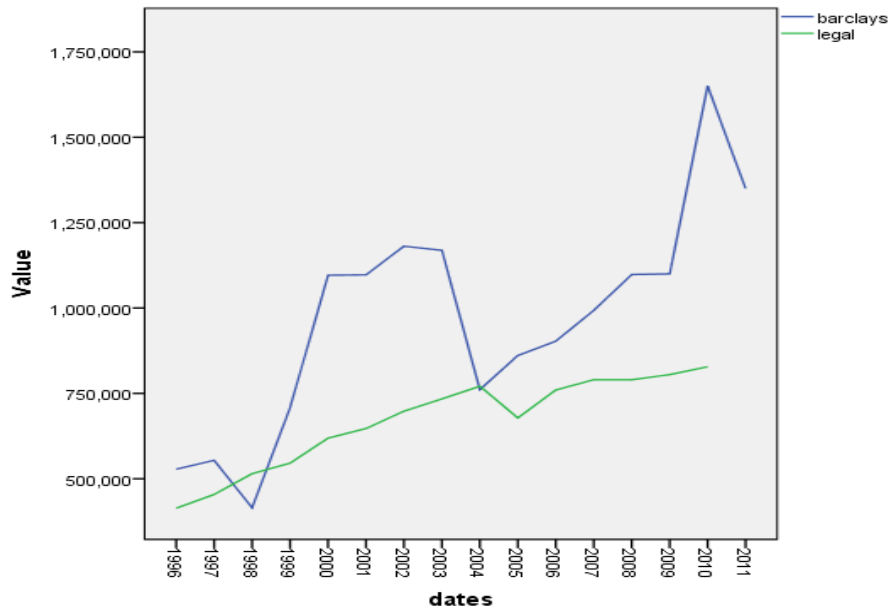
Pearson's correlation coefficient for the link between CEO total cash pay and EPS yielded the following results. Fourteen out of nineteen companies demonstrated a positive relationship between CEO total cash pay and EPS indicating that CEO total

cash pay is positively linked to company performance using EPS as the performance measure. Six out of the fourteen showed a significantly strong positive relationship, for example, Smith and Nephew with a correlation coefficient of $r=0.67$ indicating that CEO total cash pay significantly increases with increase in company performance. Two out of the fourteen companies, for example, Marks and Spencer demonstrated a moderately positive relationship with a correlation coefficient of $r=0.45$. Six out of fourteen companies demonstrated a weak positive relationship, for example, United Utilities with a correlation coefficient of $r=0.11$ indicating that CEO total cash pay increases slightly with increase in company performance.

Five out of nineteen companies demonstrated a weak negative relationship between CEO total cash pay and EPS indicating that CEO total cash pay increased when company performance decreases. Four out of the five companies demonstrated a weak negative relationship, for example, Sainsbury with a correlation coefficient of $r=-0.04$ indicating that CEO total cash pay increased slightly with decrease in company performance. One out of the companies, being Kingfisher, demonstrated a moderately negative relationship with a correlation coefficient of $r-0.43$.

As explained above, the positive relationships could be due to the fact that the companies witnessed some increase in their profitability. The results above demonstrate that there is not relationship between CEO cash pay and company performance which is what is expected as cash pay is not tied to performance. The limited positive relationship demonstrated by the results could be due to constant increase in cash pay over the years and not as a result of the company's performance. This is therefore confirming the fact that executive/CEO cash pay is not performance-based related. Companies like Legal and General plc, Kingfisher plc and Marks and Spencer plc that have shown to perform better, did not experience more increase in cash pay than the rest of the companies. For example, below is a comparison graph between Legal and General plc and Barclays Bank plc CEO Base salaries from 1996-2011.

Figure 13: A comparison graph between Legal & General plc and Barclays Bank plc CEO Base salaries from 1996-2011



Barclays bank demonstrated a weak relationship between CEO related pay and company performance using TSR and ROA as a performance measure. However, Barclays has over the years experienced more rise in base salary than Legal and General plc that demonstrated a strong significant relationship between CEO performance-related pay and company performance using TSR and ROA as performance measures. This supports the fact that, even though some companies for example Barclays show a strong relationship between CEO cash pay and company performance, it is not because cash pay is related to company performance but due to the fact that cash pay has been on the increase across the board for all FTSE 100 companies.

The links between total remuneration and company size using market capitalisation, total revenue and total assets as measures for company size

Market capitalisation is the market value of all of a company’s outstanding shares. It is used as a determinant of the company’s size. Company size has been proven by past studies to be one of the variables that are highly correlated with executive pay.

Hallock⁷⁴⁷ commented that it does not matter whether company size is measured as total asset, sales, market value or number of employees, there will be a strong correlation between size and executive pay.

Pearson's correlation coefficient for the link between executive total remuneration and company size using market capitalisation, total revenue and total assets yielded the following results.

Seventeen out of nineteen companies showed positive relationship between executive total remuneration and market capitalisation. Eight out of the seventeen companies showed a significantly strong positive relationship confirming hypothesis 2 which is to the effect that there exist a strong relationship between executive remuneration and company size, e.g. Cairn Energy with a correlation coefficient of $r=0.86$. The findings of these eight companies support past studies⁷⁴⁸ to the effect that executive remuneration is significantly related to company size. However, the other nine companies demonstrated a moderate positive/negative or weak positive/negative relationships between executive remuneration and company size thereby not confirming or rejecting hypothesis 2. Five out of seventeen companies demonstrated a moderately positive relationship, for example, Barclays Bank with correlation coefficient of $r=0.39$. Marks and Spencer showed a moderately positive relationship with correlation coefficient of $r=0.44$. Four out of seventeen companies showed a weak positive relationship, for example, Kingfisher with a correlation coefficient of $r=0.24$. Two out of nineteen companies demonstrated a negative relationship between executive total remuneration and market capitalisation. Sainsbury and Marks and Spencer demonstrated a weak $r=-0.11$ and moderately $r=-0.40$ negative relationship respectively. In general, eleven companies did not demonstrate a strong relationship between executive pay and company size rejecting hypothesis 2. Nine companies have demonstrated a relationship suggesting that executive remuneration cannot be justified on company size alone, but indicating that it is a factor that influences pay (as discussed in chapter 4).

⁷⁴⁷ Kevin F Hallock, 'The Relationship between Company Size and CEO Pay' (2011) 02 Workspan <http://www.ilr.cornell.edu/ICS/InsightsAndConvenings/upload/02-11-Research-for-the-real-world.pdf> assessed 24 June 2013.

⁷⁴⁸ Peter Kostiuk, 'Firm Size and Executive Compensation' (1990) 25(1) JHR 90-105; Brain Main, Charles O'Reilly III and James Wade, 'Top Executive Pay: Tournament or Teamwork?' (1993) 11(4) Journal of Labor Economics 606-628.

All the nineteen companies demonstrated a positive relationship between executive total remuneration and total revenue indicating that executive remuneration is linked to company performance as executive remuneration increases with increase in company size using revenue as the measure for company size. With fourteen out of nineteen companies showed a significantly strong positive relationship thereby confirming hypothesis 2, e.g. Johnson Matthey with a correlation coefficient of $r=0.84$. Four out of nineteen companies demonstrated a weak positive association, for example, Shire with correlation coefficient of $r=0.09$. Therefore, using total revenue as the variable for company size, it can be generalised that executive remuneration is significantly related to company size and therefore confirming hypothesis two.

Fifteen out of nineteen companies demonstrated a positive relationship between executive total remuneration and total asset indicating that executive remuneration is linked to company size using total assets as the measure for company size. Ten out of fifteen companies showed a significantly strong association and thereby confirming hypothesis 2, e.g. Severn Trent with correlation coefficient of $r=0.87$. The rest of the nine companies did not demonstrate a significant relationship between executive remuneration and company size thereby rejecting hypothesis 2. Five out of fifteen companies demonstrated weak positive relationship, for example, Barclays Bank with a correlation coefficient of $r=0.01$. Four out of nineteen companies demonstrated a negative relationship between executive total remuneration and total asset. Three out of four companies showed a weak negative relationship, for example, Legal and General with correlation coefficient of $r=-0.04$. Marks and Spencer showed a significantly strong negative relationship with a correlation coefficient of $r=-0.52$. However, more than half of the companies demonstrated a significant relationship between executive remuneration and company size generally confirming hypothesis 2 and also supporting the findings of past research.

Considering company size using the variables total revenue and total assets, the results indicates that executive total remuneration is significantly related to company size confirming hypothesis 2 and supporting past studies. However, using market capitalisation as the variable for company size, the findings rejects hypothesis 2 to the effect that executive remuneration is not significantly related to company size. The

table below sets out the correlation coefficient of the relationship between executive total remuneration and company size.

Table 11: correlation coefficient of executive total remuneration and company size

	Company	Market capitalisation	Total revenue	Total assets
1	Barclays bank plc	0.07	0.61	0.45
2	Legal & General plc	0.18	0.13	0.32
3	Cairn plc	0.86	0.59	-0.05
4	HSBC Bank plc	0.62	0.44	0.28
5	ICAP plc	0.70	0.68	0.58
6	Sainsbury plc	-0.07	0.71	0.21
7	Johnson Matthey plc	0.63	0.74	0.77
8	Kingfisher plc	0.08	0.61	0.49
9	Lonmin plc	0.83	0.35	0.20
10	Marks and Spencer plc	-0.12	0.36	-0.40
11	National Grid plc	0.75	0.95	0.96
12	Prudential plc	0.02	0.23	0.74
13	Southern and Scottish Energy plc	0.44	0.57	0.63
14	Severn Trent plc	0.01	0.43	0.28
15	Shire plc	0.21	0.42	0.22
16	Smith and Nephew plc	0.62	0.11	0.31
17	Tesco plc	0.81	0.93	0.92

18	United Utility plc	0.30	-0.07	0.63
19	Morrisons plc	0.67	0.66	0.62

The link between company size and company performance

As explained above and in chapter 2 company size and company performance play a significant role in the determination of executive remuneration. If the growth in company size and growth in company performance justifies increase in executive remuneration levels, then a significant relationship would be expected between company size and company performance. Determining the relationship between company size and company performance yielded different results. Fourteen out of the nineteen companies demonstrated a strong positive relationship between company size (using market capitalisation, total revenue or total assets) and company performance (using, TSR, ROA or EPS) confirming hypothesis 3 which suggest that company size is strongly related with company performance. This finding indicates that increase in executive remuneration could be justified based on the increase in company size and company performance. But most importantly, it confirms the fact that company performance and company size and factors considered when determining pay. Ten companies demonstrated a significant relationship using EPS, three companies using ROA, and one company using TSR. The table below sets out the companies and only the strong positive or negative relationships indicated.

Table 12: relationship between company size and company performance

company	Strong positive relationship
HSBC Bank plc	Total assets with ROA
Sainsbury plc	Market capitalisation with TSR
Lonmin plc	No strong relationship
Tesco plc	<ul style="list-style-type: none"> – Market capitalisation with EPS – Total revenue with EPS – Total assets with EPS
Smith and Nephew plc	<ul style="list-style-type: none"> – Market capitalisation with EPS – Total revenue with EPS – Total assets with EPS
Kingfisher plc	No strong relationship
Barclays Bank plc	– Market capitalisation with EPS

	– Total revenue with EPS
ICAP plc	– Market capitalisation with EPS – Total revenue with EPS – Total assets with EPS
National Grid plc	No strong relationship
Marks and Spencer plc	Total revenue with EPS
Cairn plc	– Total assets with EPS – Total assets with ROA
United Utility plc	No strong relationship
Prudential plc	No strong relationship
Legal and General plc	Market capitalisation with EPS
Johnson Matthey plc	– Market capitalisation with EPS – Total revenue with EPS – Total assets with EPS
Scottish and Southern Energy plc	– Market capitalisation with EPS – Total revenue with EPS – Total assets with EPS
Shire plc	Market capitalisation with ROA Total revenue with ROA
Morrisons plc	Market capitalisation with EPS
Severn Trent plc	No strong relationship

Out of the three variables that determine company size, market capitalisation is the variable that gave ten positive relationships with EPS. This could be due to the fact that market capitalisation is influenced by the number of shares in the company and the share price which are the same factors that influence EPS. Because these two variables (market capitalisation and EPS) are influenced by the same factor (share price) they demonstrate a strong significant relationship with each other. Furthermore, total revenue and total assets also demonstrated a strong relationship with EPS. According to this finding executive remuneration increases could be justified on the basis of increases in company size corresponding to good company performance.

The significant relationship found between executive remuneration and company size; company size and company performance; and the weak relationship between executive remuneration and company performance suggest that there are more factors that influence the executive remuneration package that maybe more important than company performance. This could be justified by the elements that drive executive

remuneration level high which are not necessarily linked to company performance, e.g. executive remuneration benchmarking, globalisation etc. discussed in chapter 1.

Conclusion

This chapter was set out to examine the pay for performance paradigm. Past studies in the area have identified no significant relationship between executive pay and company performance. Most of the studies were based on cash pay and considering annual cash bonus as cash payment. Very few studies considered variable pay with limitations of study period. In this chapter cash pay, variable pay and total pay were used to determine the relationship between pay and performance. Two long term performance measures TSR and ROA were used and one short term performance measure EPS used. On a general note, the result obtained suggest that there exist a weak relationship between executive/CEO pay and company performance using TSR, EPS and ROA as performance measure. On the other hand, the findings suggest that there exist more positive relationship between executive/CEO pay and company performance using EPS as the performance measure. These results suggest that companies are more involved in the short term achievement of the company (EPS results) than the long term success of the company (TSR and ROA results). The diversity of performance measures used by individual companies makes it difficult to determine the link between pay and performance a group of companies. Also, different companies use different time periods over which performance is measured and delivered and studying many companies together could face the problem of balancing time perspectives. Therefore looking at the findings on an individual company basis there exist a significant relationship between pay and performance for most of the companies depending on the performance measure used. The findings also suggest that company size is a strong determinant of executive remuneration which is consistent with all past researches on the subject.

Chapter 6: The Role of the Law

Introduction

The law does not make provisions on how executive remuneration should determine. The UKCGC has made a set of recommendations on how executive remuneration should be determined (discussed in chapter 4). Despite this, the law does have strong role to play by acting as a corrective instrument in instances where remuneration levels or structure are deemed inappropriate or excessive. Company law and corporate governance highlight the shareholders as the key players in controlling executive pay levels.⁷⁴⁹

The UK legislature's interest in executive remuneration began in the early 1990s when the level of executive pay was rapidly increasing with tenuous links between pay and performance. In late 1994, the 70% pay rise given to the then CEO (Mr Cedric Brown) of British Gas plc generated public outcry and made headlines in the press such as 'Fat Cat in the Dock'⁷⁵⁰ and 'Derailing the Gravy Train'.⁷⁵¹ Mr Brown's large pay rise was criticized as at the time the company was implementing voluntary redundancies in relation to its employees. Parliament having previously argued that executive remuneration was a matter for the market and the shareholders⁷⁵² required Mr Brown to defend his pay increase to the House of Commons Employment Committee.

The role of the law on the determination of executive remuneration can be seen to operate in three stages: firstly to provide the shareholders with detailed information on executive remuneration (through its disclosure requirements) to enable the shareholder make informed judgment in the annual general meeting; secondly, the law vests the shareholders with voting powers to enable them influence the pay setting process (through voting rights) and; thirdly by granting the shareholders a remedy (through common law and statutory remedies). The objective of the role of the law is not to regulate the amount of remuneration given to the executives, but rather to make sufficient information available to shareholders to assess the appropriateness of the

⁷⁴⁹ Charlotte Villiers, 'Controlling Executive Pay; Institutional Investors or Distributive Justice?' (2010) JCLS 309, 311.

⁷⁵⁰ 'Fat Cats in the Dock' (1995) Economist March 4th.

⁷⁵¹ 'Derailing the Gravy Train' (1995) Sunday Times January 22nd.

⁷⁵² Case Study: The Case of British Gas (1996) 4(1) Corp. Gov. Inter. Rev. 21, 22.

company's remuneration policy.⁷⁵³ In addition to the disclosure requirements, the law mandates binding and advisory votes on the remuneration report by the shareholders of quoted companies.

To better analyse the role of the law in the determination of executive remuneration, this chapter will be split into four parts. First, director's entitlement to executive remuneration will be considered. Second, the disclosure requirements and their effect on executive remuneration as well as their weaknesses will be discussed. The third part will consider the mandatory shareholder binding and non-binding voting power on the remuneration report, its effect and possible problems. Fourth, and finally, the chapter will discuss shareholder remedies in cases of excessive executive remuneration.

Director's entitlement to remuneration

By default, directors' have no lawful entitlement to remuneration as was decided in the case of *Hutton v West Cork Railway Co*⁷⁵⁴, unless otherwise than stated in the company's articles of association or in a separate contract.⁷⁵⁵ The articles of association or the service contract (usually the latter) will make clear provisions and detail the appropriate decision making process for the determination of director's remuneration. Once there is a provision for remuneration, it is payable whether the company makes profit or not⁷⁵⁶ and the director will be ranked as an ordinary creditor in the case of the company winding up.⁷⁵⁷

The directors' of a company have no authority to pay themselves or anyone else the company's money unless authorised by the company's constitution or an approval of its members.⁷⁵⁸ In the case of *Guinness plc v Saunders*⁷⁵⁹ the House of Lords decided that payments made to a director were void if not decided upon by the whole board according to the company's articles of association. If the director of a company pays

⁷⁵³ F Ferri and D Maber, 'Say on Pay Vote and CEO Compensation: Evidence from the UK' (2010) page 7 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420394 accessed 23 June 2011.

⁷⁵⁴ (1883) 23 Ch D 654.

⁷⁵⁵ Charlotte Villiers, Maria Isabel and Huerta Viesca, 'Controlling Directors' Pay in English Law and Spanish Law' (1995) 2(4) Maastricht J. Eur. & Comp. L. 377, 381.

⁷⁵⁶ *Re Lundy Granite Co* (1872) 26 LT 673.

⁷⁵⁷ The Insolvency Act 1986, Part 4, Chapter V, s 107.

⁷⁵⁸ *Re George Newman and Co* [1895] 1 Ch 674.

⁷⁵⁹ [1990] 2 AC 663.

himself remuneration out of the company's fund, he could be compelled to restore it, even though he believed it was permissible.⁷⁶⁰ However, the courts can make its own determination of director's remuneration if the company's articles of association fail to provide how remuneration was determined.⁷⁶¹ The law has been reluctant to impose restrictions on executive remuneration thereby giving powers to the board through the company's articles of association to decide on executive remuneration. This is because the law considers that the managements of companies have the expertise in the job and are in the best position to make informed decisions on the determination of executive remuneration.

As indicated above the law does not make provisions on how executive remuneration should be set, however, it adopts rather a corrective measure on the setting of executive pay where executive pay is regarded as excessive. The corrective measures includes, the requirement for all quoted companies to disclose information relating to executive remuneration setting process, empowering the shareholders with voting rights on remuneration policy as a means of influencing the remuneration setting process. The next section of this chapter will discuss executive remuneration disclosure requirements, its aims and effectiveness as a means of informing shareholders (and others) on pay issues and to make the payment of directors more transparent.

Remuneration Disclosure Requirements

The purpose of disclosing information on executive remuneration is to bring transparency and accountability to the pay setting process. Generally, disclosure also aims to prevent fraud and protect investors and potential investors by enabling them to make accurate decisions.⁷⁶² Based on remuneration issues, it aims to enrich the shareholder with relevant information on executive remuneration policy that will enable them to influence the determination process of executive remuneration. CA 2006 also aims to enhance shareholder engagement in making decisions that will

⁷⁶⁰ *Brown and Green Ltd v Hays* (1920) 36 TLR 330.

⁷⁶¹ *Re Richmond Gate Property Co Ltd* [1965] 1 WLR 335.

⁷⁶² Charlotte Villiers, 'Disclosure Obligations in Company Law: Bringing Communication Theory Into The Fold' (2001) JCLS 181, 182.

promote the long-term success of the company.⁷⁶³ The directors of the company are responsible for the disclosure of this information.⁷⁶⁴ Before the CA 2006, disclosure requirements under CA 1985 were limited. Section 232 merely required the directors to disclose the emoluments of the highest paid directors and chairman, the aggregate emoluments of all directors, and loss of office payments. The information did not have to specify who the highest paid director was, or the remuneration of individual directors. The Act did not provide a method of disclosure and also the remuneration for the highest paid director was not broken down to the various components of the remuneration package. Consequently, monitoring executive remuneration was a difficult task as the information available to the shareholders was limited.⁷⁶⁵ Due to the limitations in the CA 1985, the Directors' Remuneration Report Regulations 2002 (DRRR 2002) inserted several new provisions into the CA 1985, which were later largely transplanted into the CA 2006 (CA 2006). Further disclosure requirements have been introduced into the CA 2006 by the Enterprise and Regulatory Reform Act 2013. These greater disclosure requirements have been placed on the directors in relation to their remuneration as a means to create an open and effective framework to increase transparency and accountability in the pay setting process and the quality of information disclosed.⁷⁶⁶ The shareholders having access to information on executive remuneration will enable them to make informed judgements when voting on the remuneration report at a general meeting. If the remuneration report is rejected by the shareholders, the company will be bound to re-consider how the remuneration package was determined. This process backs up the fact that the role of the law in the determination of executive remuneration is corrective.

Companies are required to disclose in their annual accounts aggregate directors' remuneration⁷⁶⁷. The rules relating to the disclosure of director's remuneration are contained in the CA 2006, the Small Companies and Groups (Accounts and Director's

⁷⁶³ Charlotte Villiers, 'Narrative Reporting and Enlightened Shareholder Value Under the Companies Act 2006' in Keay A and Loughrey J (eds), *Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis* (Edward Elgar Publishing 2013) 97.

⁷⁶⁴ Charlotte Villiers, *Corporate Reporting and Company Law* (Cambridge University Press 2006) 15.

⁷⁶⁵ Lee Roach, 'The Directors' Remuneration Report Regulations 2002 and the Disclosure of Executive Remuneration' (2004) 25(5) *Co. Law*. 141.

⁷⁶⁶ F Ferri and D Maber, 'Say on Pay Vote and CEO Compensation: Evidence from the UK' (2010) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420394 at 1.

⁷⁶⁷ CA 2006, s 412.

Report) Regulations 2008⁷⁶⁸ (for unquoted companies), and the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008⁷⁶⁹ (for quoted companies). Companies are required to disclose the highest paid director's emoluments and other benefits, excess retirement benefits of past directors and payment for loss of office.

Quoted companies (companies listed on the London Stock Exchange) are required to disclose more information on executive remuneration than unquoted companies. Quoted companies are required to produce a remuneration report⁷⁷⁰ which will be included in the company's annual accounts and reports and subject to shareholder approval in the annual general meeting.⁷⁷¹ The directors' remuneration report applies to all companies incorporated in the UK that are listed on major UK or foreign stock exchanges, and therefore does not apply to UK companies trading on the Alternative Investment Market (AIM), nor foreign firms listed in the UK.⁷⁷² Quoted companies are required to disclose under the remuneration report, all the information that is subject to audit (which include the single figure table, share options, long-term incentive schemes, excess retirement benefits, payments for loss of office and pension) and information not subject to audit (which includes composition of the remuneration committee and advisers, statement on director's remuneration policy, performance graph, service contract and compensation for past directors). This study will focus on quoted companies, particularly on FTSE 100 companies' disclosure requirements.

Quoted companies are required to produce a remuneration report that is split into three distinct sections, namely (i) a statement from the chair of remuneration committee; (ii) the policy report, and; (iii) the implementation report. The statement from the chair of the remuneration committee will summarise the major decisions on directors'

⁷⁶⁸ SI 2008/409.

⁷⁶⁹ SI 2008/410.

⁷⁷⁰ CA 2006, s420-422.

⁷⁷¹ CA 2006, s422A.

⁷⁷² CA 2006, s420; Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008//410, Sch. 11.

remuneration, any major changes made during the year on directors' remuneration, and the context in which those decisions were made.⁷⁷³

The policy report⁷⁷⁴ section sets out the proposed future remuneration policy which must be approved by a shareholder binding vote at least once every three years (this vote discussed in detail later in this chapter). The objective of the policy report is to provide shareholders with adequate information, in order to get involved in the remuneration setting process. However, the policy sets out the terms on which executives will be paid and not the actual amount (specific figure) that may be paid to an executive in any particular circumstances. For example the purpose of the termination policy is ensure that directors who are leaving the company for poor performance do not receive large pay, as this denotes payment for failure. However, setting out golden goodbyes may not have the desired effect of stopping payment for failure because the company only reveals the amount paid to the departing director in its implementation report which is only subject to an advisory vote.

The implementation report of the remuneration report will provide a detailed explanation on how the existing remuneration policy was implemented in the relevant financial year – the implementation report must be put to an annual non-binding shareholder vote⁷⁷⁵ (meaning that the company is not compelled to act upon it). This implementation report aims to provide the shareholders with an understanding of whether the remuneration policy was followed in the determination of executive remuneration, and whether it reflects the remuneration policy. Even though, this part of the remuneration report is only subject to a shareholder non-binding vote, it does enable the shareholders to compare the past remuneration policy and its outcome in relation to remuneration levels and the future remuneration policy which, as was discussed, is subject to a binding vote.

Quoted companies are required to divide disclosure information into two parts, which is audit related information related to payments actually made to executives in the

⁷⁷³ Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008 Sch. 8, Pt 2, reg 3.

⁷⁷⁴ *ibid*, Part 4.

⁷⁷⁵ *ibid*, Part 2.

financial year⁷⁷⁶ and non-audit related information relating to the company's remuneration policy.⁷⁷⁷ Failure to disclose the required information is a criminal offence. The disclosure requirements will now be discussed under two sub-headings, which are information subject to audit⁷⁷⁸ and information not subject to audit. The audited information is information which an independent body from the company has inspected to check its accuracy and relevance. Non-audited information is therefore information that has not been checked by an independent body for its accuracy.

Information subject to audit

It is information that is subject to independent third party verification. It relates to remuneration figures that were paid to the executives in the year.

The single total figure remuneration table

Before the coming into force of the Enterprise and Regulatory Reform Act 2013, there was no uniformity in disclosure of executive remuneration information in the UK. The CA 2006 had failed to set out how the companies should disclose the information. This therefore implied that each company disclosed information in the way that they deemed appropriate and thus creating a variety in disclosure patterns amongst companies. Consequently, it became very difficult to understand some of the information that was disclosed in the remuneration report and comparison with other companies was difficult as they all disclosed in different ways. This weakness in the law threatened to defeat the purpose of the law which was to give the shareholder access to more information and increase accountability in the pay setting process. It is worth noting here that outside of the single figure remuneration table, there still exists no uniformity in the disclosure of remuneration information.⁷⁷⁹ The technical and complex nature of remuneration packages together with the extensive disclosure requirements left the shareholders with too much information, which many found difficult to understand due to lack of the necessary expertise. This lack of uniformity in disclosure requirement may likely discourage shareholders from monitoring pay and voting on the issue.

⁷⁷⁶ Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008 Sch. 8, Part 3.

⁷⁷⁷ *ibid*, Part 2.

⁷⁷⁸ *ibid*, Pt. 5.

⁷⁷⁹ Supported by the findings in chapter 5 on performance measures.

The requirement of disclosing a single total figure⁷⁸⁰ of pay for each director is probably the biggest change to the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008, as this will probably attract the interest of the public and the media. The aim of the single figure table is to provide shareholders with clear and simple figures on each director's remuneration. The change was introduced because executive remuneration disclosure was not uniform, whilst most of the companies disclosed only base salary, bonus and benefits on a table, leaving the shareholders to work out the pay for share options and long-term incentive plans. It was very difficult for shareholders to work out how much an executive was paid because the complexity of share options and long-term incentive scheme required time and expertise for the shareholders to calculate. The provision of a single table figure means that the shareholder can get the required information at a glance and make comparisons easily. The amount disclosed on the single figure table, will enable the shareholder to judge whether or not the remuneration policy on the determination of executive pay was followed or not. The single figure table acts to the shareholders as a translation of the remuneration policy that was provided to them in words to be voted upon. If shareholders are dissatisfied with the single figure table, it may make them start to consider more what the remuneration policy means, if there are words or jargon that were not understood, and how to better tackle the next remuneration policy that would be needing their votes on. The remuneration report is required to show a single total figure of remuneration for each director⁷⁸¹, broken down into its various components (including base salary, taxable benefit, pension, bonuses, long-term incentive schemes and share options, denoted by the letters a-e in the table below)⁷⁸² and reported on a table format provided by the regulation. The form of the table⁷⁸³ required is:

⁷⁸⁰ Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt. 3, reg 4-10.

⁷⁸¹ *ibid*, reg 4.

⁷⁸² *ibid*, reg 7.

⁷⁸³ *ibid*, reg 5.

Figure 14: A template of a single figure remuneration table

<i>Single Total Figure Table</i>						
	a	b	c	d	e	Total
Director 1	xxx	xxx	xxx	xxx	xxx	xxx
Director 2	xxx	xxx	xxx	xxx	xxx	xxx

Below is an example of an actual table of United Utilities plc that implemented the single figure table in its annual accounts and report 2013.

Figure 15: An example of a single figure table from United Utilities plc

Aggregate remuneration

Table: Directors' emoluments and long-term incentive payments (audited information)

	Gross salary/fees for the year ended 31 March		Bonus earned for the year ended 31 March		Other benefits in the year ended 31 March		Total emoluments for the year ended 31 March		Long-term incentives with performance period ending during the year ended 31 March		Allowances paid in lieu of pension contributions in the year ended 31 March		Total remuneration for the year ended 31 March ⁽¹⁾	
	£'000		£'000		£'000 ⁽²⁾		£'000		£'000		£'000		£'000	
	2013	2012	2013	2012	2013	2012	2013	2012	2013 ⁽⁴⁾	2012 ⁽³⁾	2013	2012	2013	2012
Executive directors														
Steve Mogford	659.0	650.0	723.3	606.8	20.5	20.8	1,402.8	1,277.6	n/a	n/a	145.0	143.0	1,547.8	1,420.6
Russ Houlden	415.8	405.8	456.4	374.1	26.2	24.4	898.4	804.3	154.1	n/a	91.5	89.3	1,144.0	893.6
Non-executive directors														
John McAdam	267.3	260.9	n/a	n/a	0.9	0.5	268.2	261.4	n/a	n/a	n/a	n/a	268.2	261.4
Catherine Bell	62.8	61.4	n/a	n/a	0.7	0.4	63.5	61.8	n/a	n/a	n/a	n/a	63.5	61.8
Paul Heiden	72.8	71.4	n/a	n/a	0.0	0.6	72.8	72.0	n/a	n/a	n/a	n/a	72.8	72.0
David Jones ⁽⁵⁾	22.0	66.4	n/a	n/a	3.2	0.0	25.2	66.4	n/a	n/a	n/a	n/a	25.2	66.4
Brian May	34.1	n/a	n/a	n/a	0.7	n/a	34.8	n/a	n/a	n/a	n/a	n/a	34.8	n/a
Nick Salmon	67.8	66.4	n/a	n/a	0.7	0.4	68.5	66.8	n/a	n/a	n/a	n/a	68.5	66.8
Sara Weller	64.6	4.8	n/a	n/a	0.0	0.0	64.6	4.8	n/a	n/a	n/a	n/a	64.6	4.8

Source: United Utilities plc Annual Reports and Accounts 2013, pg 64

The single figure table aims to provide the shareholders with remuneration figures that will indicate the remuneration levels of each director of the company. If the level of pay is not closely linked to company performance, the shareholders can make informed judgment by voting on the future remuneration policy. The single figure table does not really provide the shareholders with enough information to determine whether or not pay is closely linked to company performance as it only shows what was paid out and not about the appropriateness of the performance conditions used.⁷⁸⁴ However, the shareholders, investors, public and the media will have to treat the

⁷⁸⁴ Point discussed in chapter 5 on performance measures and its effect on the pay for performance relationship.

single total figure carefully due to its volatility that may be caused by the inclusion of the long-term incentive schemes and share options. The constant change in number of share awards, the number of exercised share options, and the share price at a particular time may influence how much money a director can make. Furthermore, the achievement of performance conditions for long-term incentive schemes and share options at a particular time also determines how much the director will receive. This volatility in share price and long-term incentive plans can therefore influence the amount disclosed on the single figure table at any given time.

Share option awards stretches through many years to mature at a particular time and a single figure table may not be enough to provide detailed information on how the figure was arrived at. Therefore the disclosure of share options on a separate table in addition to the single figure table would provide detailed information and enable shareholders to better understand the share option figure in the single figure table. In the US, companies are required to disclose the grant of plan-based awards on a separate table in addition to a single figure table. This helps to explain more the amount the executives might have had under share options. SEC rules also require the following to be disclosed on separate tables in the remuneration report. These are: a table for options exercised and stock vested a table for outstanding equity awards at fiscal year-end, a table for nonqualified deferred compensation, a table for pension grants, and a summary compensation table which contains compensation of all the executives in the company in the last three years. The disclosure of all this information on a table makes it very easy for the shareholders to read and compare how executive remuneration has been changing over the years. This part of disclosure requirement is still lacking in the UK and it would be useful if the UK companies were required to disclose share option information in a defined way like the system used in the US.

Disclosing share options⁷⁸⁵ and long-term incentive plans⁷⁸⁶

Quoted companies are required to disclose information on share options in a tabular form for each person that served as a director at any time in the year covered by the report. Information such as number of directors subject to share options, shares exercised, granted, expired, performance conditions, the lowest and highest price of share during the financial year. The disclosure of this information together with the single figure table requirement aims to enable the shareholders to compare how much the executives are having in shares. The CA 2006 failed to include the disclosure of cost of each director's share options. This is because share options are granted to directors at a cost to the company. Thus, it would be very important that the company reports the expected value of the grant as this will enable the shareholders to monitor the fluctuations in value.⁷⁸⁷ The lack of disclosure on the cost of grant share option makes it very difficult to calculate the total executive remuneration package in reference to the company's profit.

The 25 companies under study have clearly demonstrated this weakness in the law before the coming into force of the Enterprise and Regulatory Reform 2013. The Table below gives some of the inconsistencies in the way the companies disclose information in the annual reports in relation to share options and LTIPs.

Table 13: Some Disclosure Differences amongst the 25 Companies under study

	Company	Disclosing all financial figures on remuneration on a table (including share options and long-term incentive plans)
1.	Antofagasta plc plc	X
2.	AstraZeneca plc plc	X
3.	Barclays plc plc	√
4.	BHP Billiton plc plc	√

⁷⁸⁵ Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8. Pt. 3, reg 14(2).

⁷⁸⁶ *ibid.*, reg 14(1).

⁷⁸⁷ Lee Roach, 'The Directors' Remuneration Report Regulation 2002 and the Disclosure of Executive Remuneration' (2004) 25(5) Co. Law. 141,146.

5.	Cairn plc plc	X
6.	GlaxoSmithKline plc	X
7.	HSBC plc	X
8.	ICAP plc	√
9.	J. Sainsbury plc	√
10.	Johnson Matthey plc	X
11.	Kingfisher plc	X
12.	Legal and General plc	X
13.	Lonmin plc	X
14.	Mark and Spencer plc	X
15.	National Grid plc	√
16.	Prudential plc	X
17.	Rio Tinto plc	√
18.	Scottish and Southern Energy plc	X
19.	Severn Trent plc	X
20.	Shire plc	X
21.	Smith and Nephew plc	X
22.	Tesco plc	√
23.	United Utilities plc	√
24.	Morrison plc	X
25.	Xstrata plc	X

Reading through the annual reports of the 25 companies under study, only eight companies disclosed remuneration figures that included share options and long-term incentive plans. From these annual reports, it was found that companies that disclose their information on tables rather than in plain words are more explicit and easy to understand. Disclosing the information on a table also makes it very easy to compare remuneration policies with other peer companies, while it is very difficult trying to read those that are not tabulated to pick up the relevant information and then compare with others. This difficulty will now be overcome by the single figure table disclosure requirement.

Eight companies in the sample population disclosed financial elements of the remuneration package for each director on a single table which also included share option awards and long-term incentive schemes, while the remaining seventeen companies disclosed only base salary, bonus and benefit on one table and the figures for share options and long-term incentive schemes separately. For those companies that disclosed their financial information in different sections, it meant that readers of the annual report must read through the whole report thoroughly to find out what the executives were rewarded as share options and long-term incentive plans. Furthermore, some of the companies (e.g. Scottish and Southern Energy plc) disclosed the amount received by the executives as share option and long-term incentive plans as notes to the tables containing information on share options (explaining how many shares granted, exercised, lapsed, share price). However, some companies disclosed information in a way that is similar to the new disclosure requirement - to demonstrate this change in disclosure method it is worth comparing the remuneration tables of two different companies. Legal & General's remuneration table provides an example of how companies were disclosing remuneration figures before the single figure remuneration table was introduced.

Figure 16: Legal & General plc executive remuneration table 2011

Directors' emoluments (audited)

The aggregate remuneration received by directors who served during the year, including remuneration paid through subsidiaries of the Company, was as follows:

	Base salary £000	Fees £000	Benefits ⁽¹⁾⁽²⁾ £000	Total (exc. pension) 2011 £000	Pension £000	Total (inc. pension) 2011 ⁽³⁾ £000	Total (exc. pension) 2010 £000	Pension £000	Total (inc. pension) 2010 ⁽⁴⁾ £000
Executive									
Alan Aubrey ⁽¹⁾	181	-	5	186	23	209	174	19	193
Alison Fielding	208	-	4	212	21	233	194	18	212
Mike Townsend	208	-	5	213	21	234	183	18	201
Greg Smith ⁽¹⁾⁽²⁾	76	-	1	77	8	85	-	-	-
Charles Winward ⁽¹⁾⁽²⁾	27	-	1	28	3	31	-	-	-
Non-executive									
Bruce Smith	-	60	-	60	-	60	41	-	41
Graham Richards	-	36	-	36	-	36	32	-	32
Roger Brooke ⁽²⁾	-	22	-	22	-	22	23	-	23
Francis Carpenter	-	36	-	36	-	36	32	-	32
Jonathan Brooks ⁽²⁾	-	13	-	13	-	13	-	-	-
Mike Humphrey ⁽²⁾	-	9	-	9	-	9	-	-	-
Total	700	176	16	892	76	968	679	55	734

Legal & General plc annual report and accounts 2011, pg 38

The table below is that of United Utilities plc which, as noted above, has already implemented the single remuneration figure table.

Figure 17: The single figure remuneration table of United Utilities plc 2013

Aggregate remuneration

Table: Directors' emoluments and long-term incentive payments (audited information)

	Gross salary/fees for the year ended 31 March £'000		Bonus earned for the year ended 31 March £'000		Other benefits in the year ended 31 March £'000 ⁽²⁾		Total emoluments for the year ended 31 March £'000		Long-term incentives with performance period ending during the year ended 31 March £'000		Allowances paid in lieu of pension contributions in the year ended 31 March £'000		Total remuneration for the year ended 31 March ⁽¹⁾ £'000	
	2013	2012	2013	2012	2013	2012	2013	2012	2013 ⁽⁴⁾	2012 ⁽³⁾	2013	2012	2013	2012
Executive directors														
Steve Mogford	659.0	650.0	723.3	606.8	20.5	20.8	1,402.8	1,277.6	n/a	n/a	145.0	143.0	1,547.8	1,420.6
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Non-executive directors														
John McAdam	267.3	260.9	n/a	n/a	0.9	0.5	268.2	261.4	n/a	n/a	n/a	n/a	268.2	261.4
Catherine Bell	62.8	61.4	n/a	n/a	0.7	0.4	63.5	61.8	n/a	n/a	n/a	n/a	63.5	61.8
Paul Heiden	72.8	71.4	n/a	n/a	0.0	0.6	72.8	72.0	n/a	n/a	n/a	n/a	72.8	72.0
David Jones ⁽⁵⁾	22.0	66.4	n/a	n/a	3.2	0.0	25.2	66.4	n/a	n/a	n/a	n/a	25.2	66.4
Brian May	34.1	n/a	n/a	n/a	0.7	n/a	34.8	n/a	n/a	n/a	n/a	n/a	34.8	n/a
Nick Salmon	67.8	66.4	n/a	n/a	0.7	0.4	68.5	66.8	n/a	n/a	n/a	n/a	68.5	66.8
Sara Weller	64.6	4.8	n/a	n/a	0.0	0.0	64.6	4.8	n/a	n/a	n/a	n/a	64.6	4.8

United Utilities plc Annual Reports and Accounts 2013, pg 64

The second table above gives a good example of a tabulated and easy to read disclosure pattern. The names of all the executives are listed, together with all the remuneration they have received for the current and past year. The table also include all the components of an executive remuneration package. As regards companies that do not disclose in this tabulated manner, readers of their remuneration reports will be required to go through the entire remuneration report to be able to come out with the information that could easily have been obtainable if the information were disclosed on a table as above.

From the two examples above, the single-figure table by United Utilities plc makes it easy to understand how much individual directors were paid under the various components and the total remuneration of the year. It is also easy to make a comparison of the pay increases from the previous year thereby facilitating its comparisons with company performance. However, the remuneration table by Legal & General plc only provides part of the information on directors' remuneration. This therefore means that the shareholders would have to go through the rest of the remuneration report to find out what the individual directors were paid under long term incentive plans and share options. The single figure table is therefore a positive change towards clarity in executive remuneration disclosure.

Information not subject to audit

Information not subject to audit refers to the non-financial information on executive remuneration which includes the remuneration policy. The law does not require companies to set up a REMCO however; it states that if executive remuneration was set by a committee, then members of such committee should be disclosed.⁷⁸⁸ This disclosure requirement is important as the REMCO has been criticised to be associated with higher remuneration levels.⁷⁸⁹ A study by the High Pay Centre reveals that the REMCO is associated with executive pay increases as the committee is mostly made up of executives and former executives of other companies.⁷⁹⁰ The law does not require companies to set up a REMCO however; it states that if executive remuneration was set by a committee, then members of such committee should be disclosed.⁷⁹¹

The UKCGC's⁷⁹² recommendation on the disclosure of RCONs has been adopted by the CA 2006 under the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. Quoted companies are required to disclose any person who provided the REMCO with advice and show how they judged the advice from the remuneration advisers to be objective and independent.⁷⁹³ This would include a director of the company who was not a member of the committee, and if the director was from the company, the report should state whether he was appointed by the committee and the nature of any other services provided to the company during that financial year. As a result of other services that the remuneration adviser's consultancy firm offers to the company, their remuneration advice may not be objective as they seek to keep their business dealing with the company.⁷⁹⁴ This is provision is intended to provide transparency in the pay setting process as

⁷⁸⁸ Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8. Pt. 3, reg 22(1)(a).

⁷⁸⁹ C. Vince, Association of British Insurers Conference, June 2011 <http://www.bis.gov.uk/news/speeches/vince-cable-association-british-insurers-2011> assessed on the 21st of January 2012.

⁷⁹⁰ High Pay Centre, *The New Closed Shop: Who's Deciding on Pay? The Make Up of Remuneration Committees* (High Pay Centre 2013) 9.

⁷⁹¹ Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8. Pt. 3, reg 22(1)(a).

⁷⁹² FRC, *The UK Corporate Governance Code* (FRC, 2012) D.2.1

⁷⁹³ Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008, Sch 8, para 22(1)(c)(iii).

⁷⁹⁴ Ruth Bender, 'Paying For Advice: The Role of the Remuneration Consultant in UK Listed Companies' (2011) 64 Vand. L. Rev. 361, 388.

remuneration advisers have been deemed to favour executives in their remuneration advice consequently resulting in high pay (discussed in detail in chapter 4). This disclosure requirement identifies all the individuals that took part in the remuneration setting process. The shareholders can use this information to assess the objectiveness of the members of the REMCO as well as the objectiveness of the advisers. This is because, if a company is using its CEO as the remuneration adviser for his own pay, the advice he will give will probably favour him as he will be faced with conflict of interest. Furthermore, if the adviser was external and also provided the company with other services, he may want to give advice that will favour the executives, so as to continue providing his other services to the company, which can amount to a clear conflict of interest.

Considering that the law does not require companies to set up a REMCO it means that as a strict matter of law, executives could set their own pay⁷⁹⁵ and disclose their names in the remuneration report. The law in this aspect, does not require independent and subjective oversight of the executive remuneration, rather it simply wants the REMCO to disclose whether they chose their advisors themselves or some other persons chose for them or make the decision themselves. There are no legal rules and requirements on who should appoint an adviser and who could be appointed as an adviser to the REMCO. The absence of these rules could mean that the executives could appoint advisers who will be sympathetic and thus affect their independent and the impartial advice to the REMCO. The limitation of the law in this respect therefore does not cover all the existing areas of the executive remuneration setting process consequently, not providing the shareholder with the appropriate information to enable them make informed judgement on the remuneration setting process.

Disclosing future remuneration policy

The future remuneration policy sets out the terms on which the executives will be paid. The future remuneration policy is required to be disclosed in a tabular form describing each component of the remuneration package for directors of the company.⁷⁹⁶ The policy should include for each director, a detailed summary of

⁷⁹⁵ This is the default position under the Companies (Model Articles) Regulation 2008, Pt 2, reg 19.

⁷⁹⁶ Large and Medium-sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt 4, reg 25(1).

performance conditions to which the director is subject to, in respect of his entitlements to share options or under long-term incentive scheme.⁷⁹⁷ The disclosure of remuneration policy in a table is intended to make information easy and clear to understand. This requirement was introduced because the complex nature of the remuneration reports made it difficult for shareholders to read and understand the remuneration policy. An example of how companies used to disclose their remuneration policy is from Scottish & Southern plc.

Figure 18: Remuneration policy disclosure of Scottish & Southern plc 2013

2013/14 and beyond

During 2013/14 the Committee will:

- consider the incoming CEO's views on what the long-term strategy means for the accountabilities of senior managers and for ensuring effective long-term performance;
- continue to review its Total Remuneration Policy to ensure it is aligned to the long-term needs of the business, shareholders and customers; and
- continue to engage with key stakeholders.

Total Remuneration Policy

Total Remuneration Policy is integral to overall HR Strategy and the SSE set of core values are supported in the objectives, plan design and application of the policy.

The principles

The core principles of the Company's remuneration policy are outlined in the 'At a glance' section on page 89 together with policy details and charts which illustrate performance variation between the target and maximum values of the packages.

The policy comprises:

- base salary and benefits;
- a defined benefit pension plan;

- an Annual Incentive Scheme; and
- a long-term incentive plan.

The current incentive plans are shown in the table on pages 92 and 93.

Total Remuneration Policy

Remuneration policy for Executive Directors is to remain below median of the FTSE 20-50, excluding financial services. SSE also monitors its generally conservative positioning against direct peers and UK listed companies in related sectors. SSE's goal is to retain Executive Directors who are motivated by the long-term success of the Company, rather than short-term remuneration.

This policy and goal reflect the SSE culture in which Executive Directors and Senior Managers are motivated by developing the Company for the future, and explains why long-term growth and sustainability of the business are of such importance when determining remuneration policy.

- The Committee reviews regularly the total compensation, including pensions, of the Executive Directors compared to FTSE benchmarks to make sure that the Company is not disadvantaged by the current position nor are there any adverse consequences stemming from the long service of the leadership team.
- A number of institutional shareholders were consulted on key aspects of the Total Remuneration Policy as part of a

regular dialogue between shareholders and the Remuneration Committee, and shareholder feedback was taken into account by the committee when making decisions.

- As a matter of policy the Committee takes account of any changing or increasing responsibilities when determining the appropriate remuneration.
- The Committee reviews the long-term total reward of the Executive Directors, to ensure that it is suitably aligned with the long-term performance of the business.

The balance of fixed and variable remuneration

Taking into account the SSE business profile, the Remuneration Committee believes that around 40% of the total remuneration should be performance-related, increasing up to around 60% for exceptional performance as shown in the table below as this rewards performance sufficiently without causing undue risk taking.

Senior executives, managers and employees

The Committee appreciates the importance of an appropriate relationship between the remuneration levels of the Executive Directors, senior executives, managers and other employees within the Group. There is a wider group of senior executives who have a significant influence on Group performance.

Scottish & Southern plc 2013 annual report and accounts, pg 94

An example of how remuneration policy should now be disclosed is from HSBC plc. The difference between the two examples is that HBOS's remuneration policy table is clear and easy to read, while Legal & General's is not and thus will require more time and understanding.

⁷⁹⁷ Large and Medium-sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt 4, reg 26(a)

Figure 19: The Remuneration Report of HSBC plc 2013

Purpose and link to strategy	Operation	Maximum opportunity	Performance metrics
Fixed pay			
Base salary			
<i>To attract and retain key talent by being market competitive and rewarding on-going contribution to role.</i>	<p>Base salary reflects the individual's role, experience and responsibility. Changes are reviewed and approved by the Committee within the context of local requirements and market competitiveness.</p> <p>Base salaries are benchmarked on an annual basis against relevant comparator groups as set out on page 388.</p>	<p>The annual base salary for each executive Director is set out in the table on page 404.</p> <p>Base salaries are set at an appropriate level within the range determined by the benchmark group, reflecting each Director's role, experience and responsibility.</p> <p>Other than in exceptional circumstances, base salary increases for each of the current executive Directors will not increase by more than 15% of current base salary levels during the duration of this policy (for three years to the conclusion of the Annual General Meeting in 2017).</p>	None
Fixed pay allowance¹			
<i>To deliver fixed pay required to reflect the role, skills, and experience of the Directors and to maintain a competitive total remuneration package for the retention of key talent.</i>	<p>Fixed pay allowances are non-pensionable and will be granted in shares that vest immediately on a quarterly basis or in such other frequencies as the Committee deems appropriate.</p> <p>These shares (net of shares sold to cover any income tax and social security) will be subject to a retention period. 20% of these shares will be released in March immediately following the end of the financial year in which the shares are granted. The remaining 80% will be subject to a retention period of at least 5 years. Dividends will be paid on the vested shares held during the retention period.</p>	<p>Fixed pay allowances are determined based on the role and responsibility of each individual.</p> <p>Other than in exceptional circumstances, the expectation will be that the maximum fixed pay allowance for each executive Director will be the difference between (i) 50% of target total remuneration of the executive Director under this policy as shown in the 'Remuneration scenarios' chart on page 389 and (ii) the aggregate of the base salary and cash allowance in lieu of pension for that executive Director².</p>	<p>No performance conditions are attached to the fixed pay allowance. However, to align the interest of the executives with the long-term interest of shareholders, the shares awarded will be subject to a retention period.</p>

HSBC Annual Report 2013, pg 381

The way the policy is set out on the table is clear regarding what component of the remuneration package is being considered, how it will be paid, the policy on that element whether performance measures are attached to it, if so, how it will be evaluated, the purpose of that element in the remuneration package and the timing. What has been included on a table covering only a single sheet of paper could take several pages to write it out.

In cases of performance related pay, the directors need to disclose which performance measure that was used, details of performance period, amounts that may be paid and why they chose the particular performance conditions and the methods of assessing

the performance.⁷⁹⁸ Disclosing past performance conditions and how they were assessed would give the shareholders an understanding on how performance targets are set and assessed, enabling them to better make informed voting decision on the future policy report of the remuneration report. Depending on the performance achievement of that year, the shareholders will be able to judge whether the targets were achievable and whether the executives are performing at their best ability. An explanation should be given as to why any remuneration component other than salary, fees, benefit and pension is not subject to performance measures.⁷⁹⁹ The implication of this provision is that executives could still be granted share options or long-term incentive plans without any performance conditions attached to it so long as the company explains why. Where the performance is measured with reference to an index or a peer company, the index or peer company must be identified in the report. Any significant changes to a director's terms and conditions for the entitlement to share options or long-term incentives scheme must be described and explained.

Out of the sample under study, 12 of the 25 companies disclosed their remuneration policy in a table. The remuneration policy was clear, simple and short, making it very easy to read and understand as opposed to three to four pages of the same information. The remuneration policy for each component of the pay packages and the performance target for those elements that are performance related all disclosed on a table. One company (Antofagasta plc) of the did not disclose information on share options or long-term incentive plans under the remuneration report, but rather under the directors' report notes to the company's financial statement. Although, it could be argued that the information was disclosed, the company failed to comply with the provisions of the CA 2006 which required the company to disclose such information under the remuneration report. However, following the coming into force of the Enterprise and Regulatory Reform Act 2013, all quoted companies are required to disclose their remuneration policy in a tabular form.

The 2008 Regulations⁸⁰⁰ requires companies to disclose information that will show the percentage change in the CEO's salary, fees, taxable benefit and annual bonuses

⁷⁹⁸ Large and Medium-sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt 4, reg 26(d)-27(a)

⁷⁹⁹ *ibid*, reg 27(b).

⁸⁰⁰ *ibid*, Pt 3, reg 19.

with the change in employee pay as a whole. The gap in the increase of executive remuneration and the remuneration of other employees of the same company has been greatly criticised.⁸⁰¹ The law aims to bring transparency and accountability through disclosing the percentage change between executive pay and other employees. In 2011, the average pay package for the CEO of a FTSE 100 company was approximately 140 times the income of the average UK worker. Within FTSE 100 companies, CEO pay has gone from being around 40 times that of the average employee in 1998, to 140 times in 2011.⁸⁰² FTSE 100 CEOs have seen a pay rise of about 480% whilst the average worker has seen a pay rise of about 15%.⁸⁰³ Disclosing this information might start to make the executives to have a rethink about their pay and that of the other employees of the company. It is obvious that the executives have more responsibilities to the company than the other employees. However, it does not seem right for executive remuneration to increase significantly in a year whilst the pay of rank-and-file employees remains the same or increases slightly. No specific format is indicated although it has to be in a form that enables comparisons.

Disclosing the company's total shareholder return graph

Quoted companies are required to provide a TSR performance line graph.⁸⁰⁴ The company needs to come up with a table that will show the CEO's total remuneration and the percentage of his bonus or incentives that vested for the short and long-term incentive plans. This new graph or table will show the total pay for all employees compared to total dividends and share buyback and companies can choose to add more measures if they so desire. The name of the index selected and the reason for selecting that index should be stated. Due to the lack of guidelines or best practice on choosing comparator groups, a company could choose an index that would portray its company as performing well using total shareholder return. Going through the 25 companies used in this study, nine companies had already been disclosing their comparator groups. One of which is BHP Billiton plc. BHP Billiton has used the following companies since 2004 to 2010 as comparator groups.

⁸⁰¹ BBC News, 'Pay Gap Between Executives and Employees is 'widening' (2013) November 18th.

⁸⁰² High Pay Centre, 'Key Facts You Should Know About Executive Pay' (2014) January 29th.

⁸⁰³ *ibid.*

⁸⁰⁴ Large and Medium-sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt 2, reg 5(1).

Table 14: BHP Billiton comparator group between the periods 2003-2011

company	2003	2004	2005	2006	2007	2008	2009	2010	2011
Alcan	X	X	X	X					
Alcoa	X	X	X	X	X	X	X	X	x
Alumina	X	X	X	X					
Anglo America	X	X	X	X	X	X	X	X	x
Apache					X	X	X		X
BG Group		X	X	X	X	X	X	X	X
BP		X	X	X					X
Cameco		X	X	X	X	X	X	X	x
ConocoPhillips	X	X	X	X			X		
Devon Energy					X	X			x
Exxon Mobil		X	X	X					x
Falconbridge		X	X	X					
Freeport McMoRan	X	X	X	X	X	X	X	X	x
Impala		X	X	X					
Inco	X	X	X	X					
Marathon Oil	X	X	X	X					
Newmont Mining	X	X	X	X					
Norilsk		X	X	X	X	X	X	X	x
Peabody Energy					X	X	X	X	x
Phelps Dodge	X	X	X	X					
Rio Tinto	X	X	X	X	X	X	X	X	X
Shell		X	X	X					X
Southern Copper					X	X	X	X	X
Teck Cominco					X	X	X		X
Total		X	X	X					

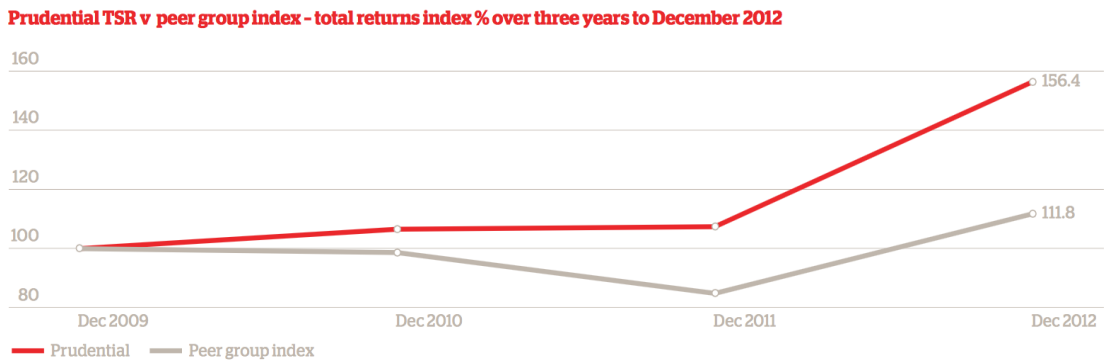
Vale	X	X	X	X	X	X	X	X	X
Woodside Petroleum	X	X	X	X	X	X	X	X	X
Xstrata	X	X	X	X	X	X	X	X	X

Comparator companies in executive remuneration benchmarking are an important determinant of executive remuneration. The choice of comparator group that a company uses could have a significant effect on the pay levels of that company.⁸⁰⁵ Although the CA 2006 requires companies to provide a TSR graph in reference to a named index (equity market index) giving reasons for selecting the index, it does not explicitly require companies to list the companies in their comparator group. This could be regarded as a limitation in the law due to the fact that executive remuneration benchmarking is an important determinant of executive remuneration level. There exists no best practice on the benchmarking of executive remuneration. This leaves companies with the choice to choose any company they deem appropriate as their comparator consequently, companies could chose comparator groups that will result in an increase in their remuneration levels. The determination of executive remuneration through the act of benchmarking has become very common as almost all the companies are engaged in remuneration benchmarking and disclosing this information will give the shareholder an increased chance of understanding the remuneration report. Disclosing this information can also enable the shareholder to notice any changes made in the list of comparator groups and enquire as to why such changes were made. The CA 2006 simply requiring a disclosure of TSR against any named index without requiring the companies to disclose their comparator group therefore fails to make provision for one of the most important determinants of executive remuneration- executive remuneration benchmarking.

⁸⁰⁵ Remuneration benchmarking and its effect on remuneration levels is discussed in details in chapter 4.

Figure 20: The Total Shareholder Return Graph for Prudential plc 2012

The line chart below compares Prudential's TSR during the three years from 1 January 2010 to 31 December 2012 with that of the peer group against which TSR is measured for the purposes of the GPSP.



Source: Prudential Annual Report and Accounts 2012, pg 127

The performance graph above shows that Prudential was doing very well in terms of their TSR as oppose to their peer group. The question requiring investigation here is how they selected the peer groups since they are not required to disclose this information.⁸⁰⁶ However, the effect of lack of best practice on choosing comparator groups may cause some companies to choose comparators groups that will portray how well the company is performing.

The performance graph does not include values of share options. The performance graph is meant to enable the shareholders to assess the performance of the company, and therefore the performance of the executives. Share options are a component of executive remuneration package and expected to be linked to shareholder return, therefore for share options not to be included in the performance graph because the comparator groups are different, will be holding back vital information that can enable the shareholders to effectively assess the company's performance which also means assessing the performance of the executives.

Disclosing performance measures and targets⁸⁰⁷

The Act requires quoted companies to disclose the performance targets and measures used as basis for their performance-related pay. Performance targets and measures are

⁸⁰⁶ The method of choosing comparator group is examined in chapter 4.

⁸⁰⁷ Large and Medium-sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt 4, reg 26-27.

very important tools in linking executive remuneration to company performance. The right performance target and measure can have a significant effect on the link between pay and performance (discussed in detail in chapter 5). The remuneration policy is required to contain details of the performance measures for the future, its weighting, and the specific performance targets set. The amount disclosed in the single total figure table would include;

- amounts from performance targets set at the beginning of the period and the corresponding value of the award achievable,
- details of actual performance relative to targets set and measured over the relevant period, and the resulting level of award; and
- in cases where discretion has been exercised in respect of the award, how discretion was exercised and how the resulting level of award was determined

This disclosure will enable shareholders when voting on the remuneration policy to consider whether the performance targets and measures set by the company favours the long-term or short-term interest of the company. This is because some performance measures can encourage directors to rely on the short term achievements of the company.⁸⁰⁸ The limitation of this requirement is the fact that companies might take advantage of the exemption that the information required is ‘commercially sensitive’ (information used in business which if disclosed to competitors is can affect the company significantly, and the company wished to limit the dissemination of this information)⁸⁰⁹. For instance, a company’s performance-related scheme may include measures such as operating cash flow and operating profits with targets drawn from the company’s budget, the disclosure will reveal whether or not certain budgeted amounts were achieved. However, companies who will not disclose the required information under the exemption clause of ‘commercially sensitive information’ will need to explain the reasons for omission and give an indication of when (if at all) they will make the information available to the shareholders.

⁸⁰⁸ discussed in p 174.

⁸⁰⁹ Freedom of Information Guidance: Exemptions Guidance 2012, s43(1).

*Disclosing recruitment policy*⁸¹⁰

Companies are required to disclose the principles they will use in recruiting an executive and agreeing on the executive remuneration package. This would include the pay components to be included and how each would be determined. The maximum potential salary, expressed as a percentage of the salary of the highest paid director, as shown on the single figure remuneration table. This disclosure requirement would limit the value of golden hellos that executives receive when being hired as shareholders will be able to react on the information by either rejecting or confirming the value of the golden hello. However, if the company sets a maximum salary that exceeds the highest paid director's salary in order to be flexible, the incumbent executive may feel undervalued or the market may feel the board believes that there is a better executive out there. As a result, new hired executives might end up with higher salary limit than what they actually worth. Also, if the company sets a salary level that is the same as the current highest paid director, they might not be able to hire someone that could perform even better with a little more pay. This disclosure requirement might also have the effect of limiting the REMCO in negotiating new hires which does not reflect the intention of the requirement.

The general effect of disclosure requirements

The main objective of the disclosure requirements is to bring transparency in the remuneration setting process. Disclosure also makes available information to the shareholders to be able to understand the remuneration policies of the company and to judge whether such arrangement is appropriately tailored to the company's objectives. The disclosure of executive remuneration information can have a significant influence on the levels of executive remuneration. Disclosure of information would mean that the REMCO will have to justify their choices publicly, causing them to be cautious in decision making particularly in circumstances where there is a potential conflict of interest. This therefore acts as a disciplinary tool for the REMCO as shareholders can in the AGM vote against the re-election of the directors who are members of the REMCO.

⁸¹⁰ Large and Medium-sized Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt 4, reg 29.

Disclosure of executive remuneration information lowers shareholder monitoring costs thereby encouraging shareholder activism.⁸¹¹ Before disclosure requirements were made mandatory in the UK, shareholders found it difficult to obtain the information that they needed to be able to make informed decisions on whether or not the executive remuneration levels were appropriate or not. Shareholders had to spend time and money to be able to obtain the information they needed from the company's board. With disclosure of this information becoming mandatory for all quoted companies means that shareholders can freely access this information without expending money and significant amounts of time. The disclosed information is aim to enable shareholders to make informed judgment on executive remuneration by voting. Depending on the outcome of the voting the REMCO may have to react accordingly which may include revising the remuneration policy or improving on disclosed information as the case may be.⁸¹² The shareholder being interested in making sure that executive remuneration is linked to company performance may increase pressure on the directors to adopt pay packages that are more sensitive to company performance.⁸¹³

Disclosure requirements can also cause the directors to be concerned about potential liabilities arising from erroneous statements, thus making the directors to think very well about what they are disclosing and how they are disclosing it. Section 463 of the CA 2006 imposes liability on directors to compensate the company for loss suffered by it as a result of any untrue or misleading statements in the directors' remuneration report. The liability arises only if the directors knew that the statement was untrue or misleading or was reckless as to whether it was true or not. Under the provisions of s463 the law seems inadequate as liability will arise only in deceit or negligence, and only to the company, and only for a loss suffered as a result of the statement.⁸¹⁴ The shareholders may also claim they suffer a loss as a consequence of the director's deceit or negligence, in which case they may seek redress on behalf of the company through shareholder remedies discussed later in the chapter. This section acts as a safe

⁸¹¹ David Kershaw, *Company Law in Context: Text and Materials* (Oxford University Press 2012) 294.

⁸¹² Peter Clarkson, Julie Walker and Shannon Nicholls, 'Disclosure, Shareholder Oversight and the Pay-performance Link' (2011) 7 *Journal of Contemporary Accounting and Economics* 47, 50.

⁸¹³ Edward Iacobucci, 'The Effect of Disclosure on Executive Compensation' (1998) 48(4) *U Tor LJ* 489, 504.

⁸¹⁴ Brenda Hannigan, *Company Law* (3 edn. Oxford University Press 2012) 360.

harbour for defaulted executives as it is difficult for liability to arise in deceit; the loss suffered in this case will be difficult to identify.

On a general note, the effect of disclosure is hoped to better align directors' interests with that of the company through the strengthening of the link between executive remuneration and company performance. The undesired effect of remuneration disclosure has been to increase pay levels rather than decrease them.⁸¹⁵ Clarke et al's⁸¹⁶ study of 342 company chairmen on listed companies of all sizes found out that half of the chairmen of UK companies were of the opinion that pay disclosure had resulted in an increase in pay levels. This is because the executives had used the availability of remuneration data through disclosure requirements from other companies to compare their pay levels of those of their peers. Executives may tend to demand for more pay in cases where they were paid less than their peers, or threaten to leave the company to other company that would offer a better pay level and structure than his current company.

The law intends to give the shareholder information on the remuneration policy to enable the shareholders to act on in the annual general meeting. The shareholders can exercise this power by voting on the remuneration policy or voting against the re-election of the directors. This chapter will now tend to the voting powers of the shareholder.

Shareholder vote on remuneration report

The second method in which the law influences executive remuneration pay determination is by giving the members the opportunity to vote on the remuneration report. The objective for giving members of the company voting rights on remuneration issues is for members to be able to hold the directors to account over the structure and levels of executive remuneration. It also invests members with more powers to prevent reward for failure and make sure pay is more closely linked to company performance. Members vote on executive remuneration may also increase transparency in remuneration reporting as it indicates what directors are earning and

⁸¹⁵ Robert Clarke, Martin Conyon and Simon Peck, 'Corporate Governance and Directors' Remuneration: Views from the Top' (1998) 9(4) Business Strategy Review 21, 21.

⁸¹⁶ *ibid.*

how it is linked to the company's strategy and performance. It is also intended to encourage a better relationship between the company and its members as voting may cause the executives to communicate more with the shareholders when determining pay to avoid a vote against the remuneration report. If the shareholders vote against the remuneration report, the REMCO would have to redress the situation by re-considering how the remuneration package was set. In this way the role of the law would be influencing the remuneration setting process without necessarily providing for what should and should not be the appropriate determination process. Before the introduction of shareholder binding vote shareholders were given only a non-binding vote on executive remuneration report to which we now turn.

Shareholder vote before the Enterprise and Regulatory Reform Act 2013

Under s 439 of the CA 2006, shareholders were only entitled to a non-binding vote on the remuneration report. This meant that if the shareholders voted down the remuneration policy of a company that company was not compelled to act on it. An example was the case of Lonmin plc where in 2005, the shareholders voted down the remuneration report on the ground that the ex-gratia bonus payment of £500,000 given to a retiring NED was too generous. Although the remuneration policy was voted down, the company did not act on the vote. Similarly, in Grainger plc, the shareholders also voted down the company's 2010 remuneration policy on the account that a £2.9 million payoff offered to the former CEO of the company was too generous, but the company did not reduce the payoff. Even though, companies were not compelled to act on the non-binding votes, many companies did react to the shareholders votes against the remuneration report to correct the point of disagreement. This was the case because members of the company can reject the remuneration report if they so desire, and also pass the ordinary resolution needed to remove the directors.⁸¹⁷

The table below gives examples of companies whose remuneration reports were voted down by the shareholders and the reaction of the company to that effect. The table also details the principal issue that caused the remuneration report to be voted down, and the changes the company made to the remuneration policy (if any changes were made).

⁸¹⁷ CA 2006, s168.

Table 15: Voted down remuneration reports from 2003-2013

Company	Year	Principal issue	Reaction
GlaxoSmithKline	2003	£22 million severance payment to the then CEO	The remuneration committee was replaced and the CEO termination provisions reduced.
Aegis Group	2004	24 months service contract	CEO resigned, and the contract term reduced
United Business Media	2005	£250,000 retirement bonus	Money voluntarily handed back to the company by the CEO
Goshawk Insurance	2005	£100,000 payment made to the CEO	None
MFI Furniture Group	2005	A parachute clause of 18 months liquidated damages	Provision removed from the remuneration policy
Lonmin	2005	£500,000 <i>ex-gratia</i> bonus to a retiring non-executive	None
Croda International	2006	CEO's contract provided for termination payment in excess of one year's salary and benefit	CEO's contract reviewed
Bellway	2008	Bonuses paid despite not meeting targets set	More objective future arrangements made although the remuneration

			committee still have some discretion over it
RBS	2009	Large pension for outgoing CEO while the company was experiencing a £40 billion loss	Pension payment re-negotiated and resulted in a lump sum payment
Shell	2009	Awarding bonuses as part of LTI despite missing performance targets	Additional performance measures introduced in the remuneration policy
Provident Financial	2009	High base salary increase for its executives and introduction of deferred bonuses	None
Punch Taverns	2009	Increased pension contributions and 9 times basic salary as payoff to departing directors	Increased communication with shareholders
Grainger	2010	£2.9 million payoff to former CEO	None
SIG	2010	Increase in CEO's basic salary	None
21 st Century Technology	2010	Generous bonuses to its directors	None
Easyjet	2011	£1 million fixed cash payment to the CEO	The CEO left the company
Robert Walters	2011	Awarded bonuses above its self-imposed guidelines	None
Aviva	2012	Increase in CEO basic	Review of golden

		pay and ‘golden handshake’ bonus to new executives	handshake packages, and CEO stand down
Cairn’s Ernergy	2012	Bonus pay of £3m to the chairman	Chairman voted out, increased dialogue with shareholders
WPP	2012	Increase in pay packet of CEO	None
Pendragon	2012	Proposed to raise performance related pay to 150% of base salary	Remuneration policy was not implemented, further consultations made with the shareholders
City of London Investment Group plc	2013	Payment to former CEO and finance officers leaving the company after three months of service	None

From the table above, 22 companies saw their remuneration report voted down within the periods 2003-2013. About 59% of the 22 companies above reacted to the shareholder remuneration votes, demonstrating that even though the shareholder vote was non-binding, companies still reacted to it, consequently influencing the pay setting process of the company. Some companies still changed their remuneration policy even after the remuneration policy was approved. For example in 2009, the shareholders of Mark & Spencer’s voted against the re-election of Louise Patten, the then chairman of the RC, after the company saw 10.41% of votes cast against the remuneration report and 89.59% votes cast in favour of the remuneration report.⁸¹⁸ This therefore implies that although shareholder votes were non-binding, it had a

⁸¹⁸ J Finch, ‘Race Hots Up to Succeed Stuart Rose as Marks & Spencer’s Chief Executive’ The Guardian 9th September 2009.

notable impact on the remuneration setting process as the directors were trying to avoid shareholders voting against their re-election in the annual general meeting.

The advisory vote only allowed shareholders to separate remuneration issues from issues that were specific to the executives and express their dissatisfaction in a public way.⁸¹⁹ However, the law was limited because the outcome of the votes on remuneration report resolution had no effect on the validity of the remuneration policy as explained above. This meant that the non-binding vote was just for the shareholders to show their disagreement on the remuneration policy. The shareholders did not vote on the individual package of directors but on the report as a whole. The voting was to be decided by an ordinary resolution, meaning it needed only a simple majority for the vote to pass.⁸²⁰

The CA 2006 requires the results on the AGM voting on remuneration report to be published on the company's website.⁸²¹ Together with the information to be disclosed by quoted companies, also required are the date of the meeting, a description of the subject matter of the resolution,⁸²² and votes for and against and withheld votes.⁸²³ The purpose for this information is to enable the company assesses shareholders engagement in the company's decision making. Before 2013, companies were not required to disclose withheld votes making it difficult to assess shareholder involvement in the remuneration setting process. The disclosure of withheld votes on remuneration report could indicate shareholder activism in influencing the remuneration setting process of a company. The percentages of the votes for and against published on the company's website is calculated only on the amount of votes that were actually cast. Of the 25 companies over the period 2003-2011, all votes on executive remuneration were done by poll. The voting data could not be obtained for the periods 1996-2002 as at the time this information was not being disclosed by the companies. The poll results were disclosed on the company's website, with 24 of the companies disclosing the votes for, votes against and abstention votes. Only two of the 25 companies have had one of their remuneration reports rejected but many of

⁸¹⁹ Brenda Hannigan, *Company Law* (3edn. Oxford University Press 2012) 127.

⁸²⁰ CA 2006, s 439.

⁸²¹ *ibid*, s 341.

⁸²² *ibid*, s 341(1).

⁸²³ Large and Medium-size Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt 3, reg 23.

them having high dissent percentages although the resolutions passed. Ignoring the abstention votes, most of the companies had as high as 98% and above votes in favour of their remuneration report. This indicated a strong agreement of the shareholders with the remuneration report. But what these voting results did not explain was the fact that executive remuneration did not stop rising, with the shareholders and the public lashing out on excessive executive remuneration. For example, FTSE 100 executives experienced a 50% pay rise in the year 2010⁸²⁴ and the British Prime Minister, David Cameron reacted by calling on the big companies to be more transparent when they are deciding on executive pay.⁸²⁵ Executive remuneration has even been termed as ‘corrosive’ to the UK economy.⁸²⁶ Considering that the voting rights were given to the shareholders to enable them to influence the remuneration setting process, this result therefore leaves shareholder voting powers as a means of influencing the remuneration setting process questionable. This study will examine the shareholder non-binding voting on the remuneration report in the AGM of the 25 companies in the study sample within the periods 2003-2011.

The graphs below represents the dissent levels of the 25 companies individually and in their sectors from 2003 – 2011. Executive pay has been a contentious issue for over three decades in the UK and given the shareholder non-binding votes on remuneration reports it would have been expected for most companies to see high dissent levels on remuneration report. Furthermore, one would expect to see more companies having their remuneration reports voted down by the shareholders to demonstrate shareholders’ involvement in executive pay issues. The graphs tend to suggest two things: firstly, either the shareholders are mostly happy with remuneration reports and therefore voting in favour of it or secondly, shareholder are not using the powers vested upon them and thereby not voting on remuneration reports. From these two suggestions, the researcher tends to agree with the second point rather than the first because shareholders continue to complain about the lack of relationship between pay and performance. It is worth noting here that institutional investors are in a better position to influence the pay setting process as they hold the majority shares than individual shareholders. However, the graphs below do not provide evidence on the fact that executive pay is a contentious issue. The graphs does not provide a full

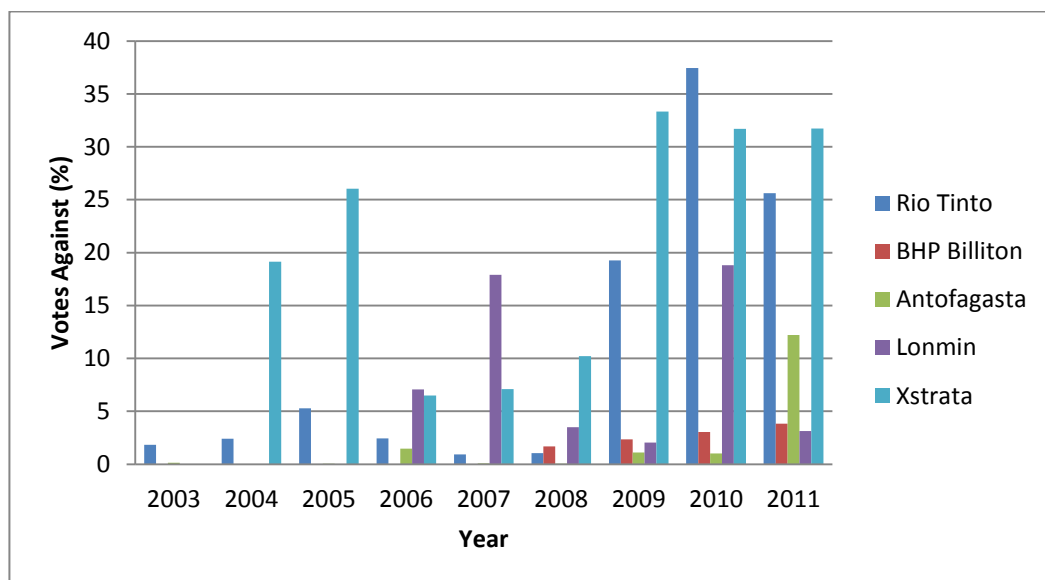
⁸²⁴ ‘Directors’ Pay Rose 50% in Past Year, Says IDS Report’ (2011) *BBC News* October 28th.

⁸²⁵ *ibid.*

⁸²⁶ ‘High Pay of UK Executives Corrosive, Report Says’ (2011) *BBC News* November 22nd.

picture of the dissent votes for all the companies as some companies did not disclose voting information on their company’s website. Therefore, the graphs represent the companies and years for which voting data was available. Figure 21 below represent the dissent levels of the five companies in the mining sector.

Figure 21: Shareholder vote against the remuneration report in the Mining Sector



Xstrata plc stands out as the company that has had the highest (37%) dissent level within the time frame while Xstrata plc stands out as the company whose dissent levels have been over 20% for four years out of the nine years examined. In the four instances, the rebellion was centred on executive bonus awards. For example, in 2011, the shareholder revolted against the remuneration report because executives were awarded excessive bonuses at a time when the company’s performance was taking a downturn.⁸²⁷ In 2012, which is not included on the graph, the company saw a 40% shareholder vote against the remuneration report on the grounds that executive pay structure was not linked to company performance.⁸²⁸ This suggest that Xstrata plc may not be considering company performance as a significant factor in the determination of executive pay (as discussed in chapter 4) or it might be based on the performance conditions of the company (as discussed in chapter 5).The Department of Business Innovation & Skills considers 20% or more shareholders failing to vote for

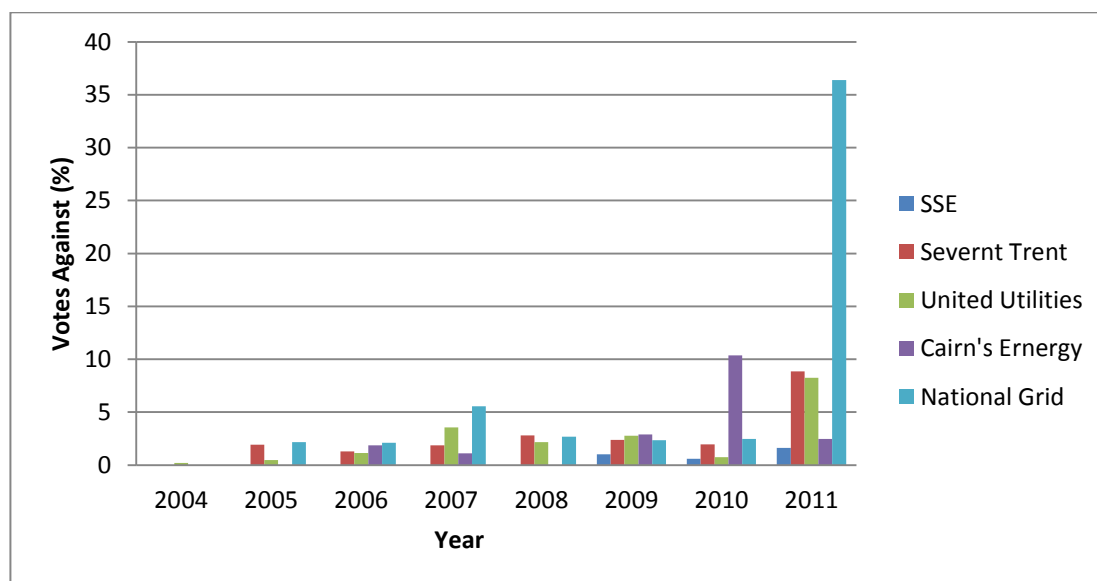
⁸²⁷ David Robertson, ‘Co-op Joins Investors’ Revolt Over Executive Pay at Xstrata’ (The Times, May 9 2011).

⁸²⁸ Emily Gosden and Emma Rowley, ‘Xstrata Investors Revolt Over Glencoe Merger and Pay’ (The Telegraph 01 May 2012).

the remuneration report as a high level of dissent.⁸²⁹ With the new disclosure requirement on voting, a 20% dissent vote would be regarded as a significant percentage against, and the directors would be expected to give a summary of the reasons for the votes and any actions taken in response to the shareholders' concerns.⁸³⁰ Although companies were not compelled to act on non-binding votes, consistent high dissent level of votes against the remuneration report was expected to communicate to the management the dissatisfaction of the shareholders. From the graph above, two companies in the sector had dissent votes of more than 20%.

Figure 22 below represents voting dissent of the five companies in the Utility sector. Between the periods under study which is 2004-2011, only one company (National Grid) had seen dissent levels above 20%.

Figure 22: shareholder votes against the remuneration report in the Utility Sector



The graph above indicates that the five companies in this sector between the years 2004-2011 have been satisfied with their executive remuneration packages except for National Grid plc in 2011. Shareholders of National Grid plc voted against the remuneration report on the grounds that executives' bonuses were increasing at a time

⁸²⁹ Department for Business Innovation & Skill, 'Executive Pay: Shareholder Voting Rights Consultation' March 2012, 14.

⁸³⁰ Large and Medium-size Companies and Groups (Accounts and Reports) Regulation 2008, Sch. 8, Pt 3, reg 23.

when the company was sending jobs to India.⁸³¹ Comparing the companies in this sector to those of the mining sector, there appear to be more shareholder revolt on pay in the mining sector than the utility sector.

Figure 23 represents the dissent levels of the companies in the retail sector. The companies in this sector includes: Tesco, Mark & Spencer, Morrisons, Sainsbury and Kingfisher. Two companies (Sainbury and Tesco) had seen their dissent levels go above 20%. Tesco plc’s shareholder revolted against the remuneration report in 2010 because the remuneration level of its CEO was set at the level of US executive pay. It is worth re-iterating again here that US executives are generally paid higher than UK executives. The shareholders of Tesco plc regarded this remuneration level as excessive and unnecessary.⁸³² In 2004, Sainsbury plc shareholders rebelled against a controversial 86% bonus share awarded to its former chairman despite a poor performance by the company which had been losing market share.⁸³³ The graph also indicates less shareholder revolt in this sector as oppose to the mining sector.

Figure 23: Shareholder Vote against Remuneration Report in the Retail Sector

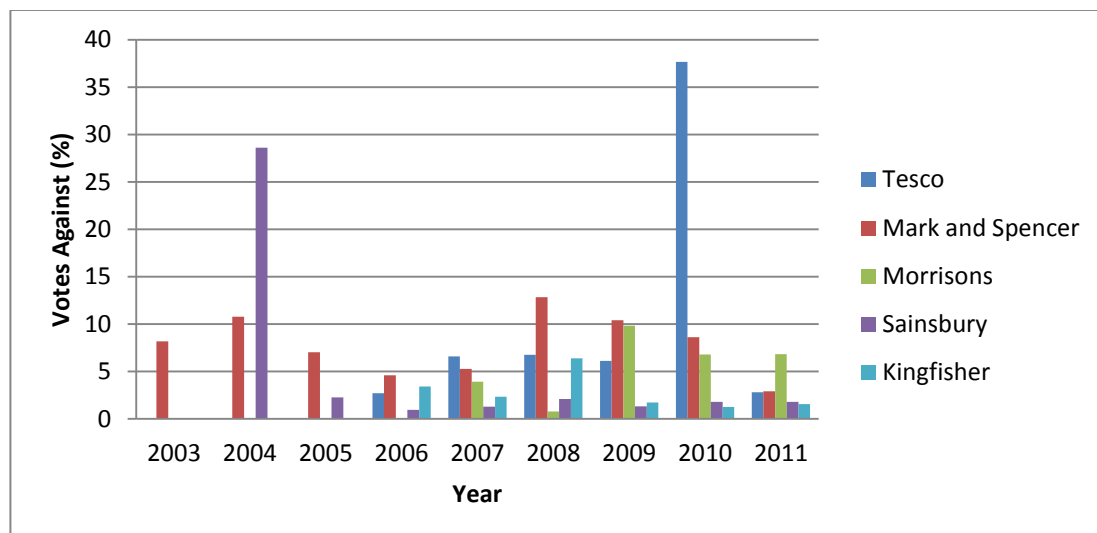


Figure 24 represents the five companies in the pharmaceutical industry. This was the only industry within the study period that had one of its company’s remuneration

⁸³¹ John O’Sullivan, ‘Power Supplier Admits Going Green Will Put the Lights Out in Britain’ (Co2 Insanity, 3 May 2011) <http://co2insanity.com/2011/03/05/power-supplier-admits-going-green-will-put-the-lights-out-in-britain/> accessed 30 May 2014.

⁸³² Marcus Leroux and Miles Costello, ‘Shareholders Deliver Slap Down to Tesco Over Executive Pay’ (The Times, 3 July 2010).

⁸³³ Mark Tran, ‘Sainsbury’s Faces Shareholder Anger’ (The Guardian, 12 July 2004).

reported voted down by the shareholders. In 2003 GlaxoSmithKline plc saw its remuneration report voted down by the shareholders of the company with a percentage vote of 50.72% against which was the first time a remuneration report was ever voted down by shareholders. The report was voted down because of its former CEO pay-off estimated at £22 million should he be sacked before the term of his two-year contract expires. Shareholders regarded the pay as payment for failure.⁸³⁴ Furthermore, Smith & Nephew has seen a remuneration dissent of more than 20% twice within the period under consideration.

Figure 24: Shareholder votes against the remuneration report in the Pharmaceutical industry

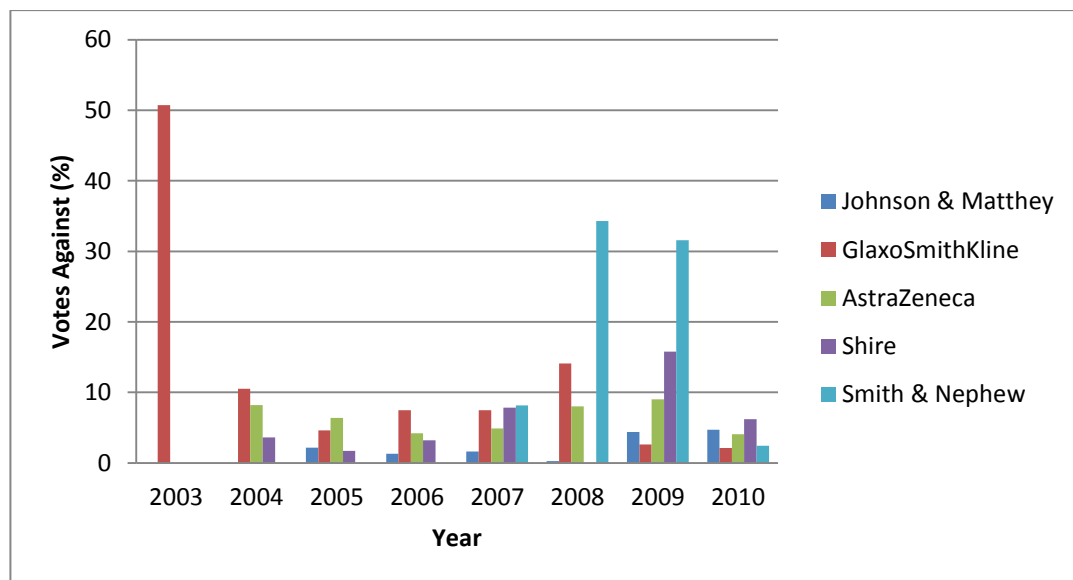
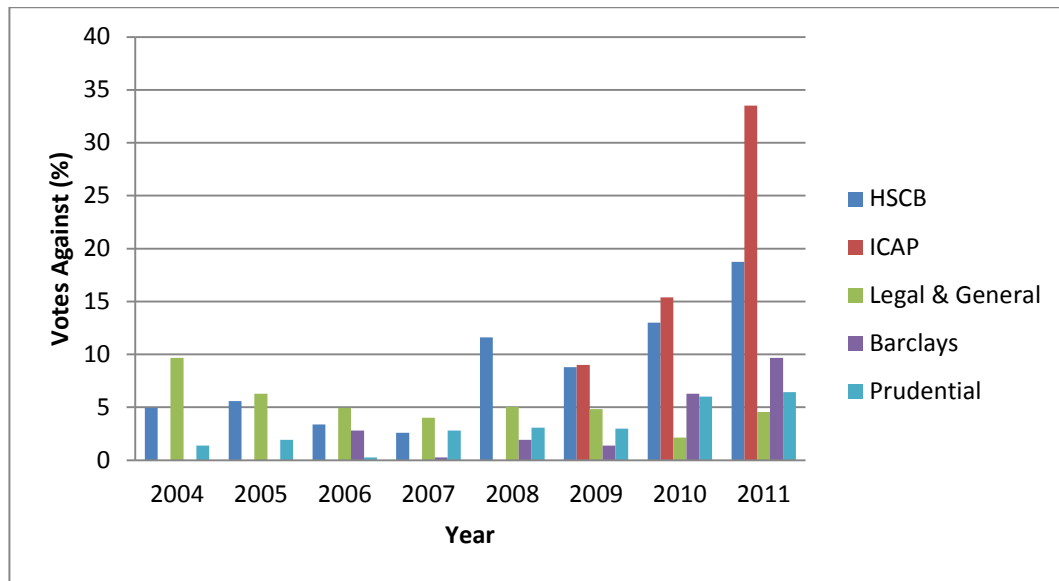


Figure 25 represents the voting dissent of the five companies in the financial sector. Only one company (ICAP) in this sector has seen voting dissent of above 20%. In 2011, the shareholders of ICAP plc voted against the remuneration report with concerns on board members earning bonuses that were many times their annual salaries, and also because there was no cap on bonuses. Some of its executives were receiving about 20 times their salaries.⁸³⁵ This graph also indicates less shareholder revolt than the mining sector even though one of its companies' remuneration reports was voted down.

⁸³⁴ BBC News, 'Glaxo Defeated by Shareholders' (BBC News, 19 May 2003).

⁸³⁵ Giles Turner, 'ICAP Investors Rebel Over Pay' (Financial News, 14 July 2011)

Figure 24: Shareholder Votes against Remuneration Report in the Financial Sector



The graphs indicate that dissent level in the Utility sector and financial sector over the period had been the lowest and the Mining sector seeing the highest dissent level. This findings tend to support the fact that shareholder were not using the voting powers vested on them on remuneration reports. This is because over the study period, the financial sector in particular suffered financial crisis and executive pay⁸³⁶ was partly blamed for the crisis. Naturally, more shareholder revolt would have been expected at least within the financial crisis period, but as indicated on the graphs, more than 65% of the shareholders in each company under the sector voted in favour of the remuneration report. Xstrata plc stands out to be the company with the most frequency of high dissent level under the study period. The main issue that causes Xstrata shareholders vote against their remuneration report being executive bonuses. The continues rebellion could mean that the shareholders from this company are more involved in remuneration issues that the shareholders of the rest twenty-four companies or it could indicate the company's lack of communication with its shareholders prior to setting remuneration policy. From the analysis of the graphs above, the lack of link between executive bonuses and company performance seems to be the main reason for shareholder discontent with remuneration reports. The remuneration committees award the bonuses on the basis that the performance conditions have been met, yet the shareholders regard the bonus as excessive and

⁸³⁶ Ian Tonks, 'Bankers' Bonuses and the Financial Crisis' (2012) VOX January 8th.

unrelated to company performance. This may be confirming the findings in chapter 5 to the effect that different performance measures have different effects on the pay for performance link thereby emphasising the need for uniformity in the performance measures used by companies in the determination of company performance. A further aspect to consider would be abstention votes on remuneration reports.

The voting results published on the company's website did not take into account the abstention votes, therefore, making it very difficult to assess the real level of shareholder engagement. Although the shareholder votes were only advisory, having a high level of abstention votes was expected to communicate to the company the shareholders dissatisfaction with the remuneration policy. For example, in 2009, the shareholders of Antofagasta's votes on remuneration report revealed that 930,856,310 votes were cast in favour of the remuneration report, 10,366,043 votes against and 106,877,823 votes abstained. The abstention votes are more than 10 times the votes cast against. Disclosing this information could make the shareholders to have a rethink about using the powers they were vested with. Also these figures could make the remuneration committee to want to consider why more than 10 times the number of shareholders who voted against abstained from voting.

Some of the shareholders could have abstained from voting because they thought their vote was not going to make any difference to the decision that the company made. In a study carried out by Ian Gregory-Smith et al,⁸³⁷ they considered abstention votes to broadly mean dissent votes. They made this assumption as many shareholders felt reluctant to vote considering that the company was not compelled to act on the outcome of the vote. Consequently, shareholders demonstrated this dissatisfaction and frustration with an act of withdrawal as they felt voting or withdrawal did not have any effect on the implementation of the remuneration policy. Ian Gregory-Smith et al worked with the dissent (votes against and abstention votes) to find out the effect of shareholder outrage on executive pay. They found out that shareholder dissent did not have an impact on the levels of executive pay. This contention of attributing abstention votes to dissent votes was followed by BIS.⁸³⁸ BIS⁸³⁹ pointed out that it

⁸³⁷ I Gregory-Smith, S Thompson and PW Wright, 'Outrage or Mild Irritation: Don't Shareholders Care About CEO Pay?' 2010, Conference Paper Presented at the 9th International Corporate Governance Conference Birmingham.

⁸³⁸ BIS, 'Executive Pay: Shareholder Voting Rights Consultation' (BIS 2012).

was common for shareholders to abstain from voting on remuneration report to signal their dissatisfaction. It went further to say that abstention votes were very important as it could represent a large number of shareholders refusing to vote for the remuneration report. The consultation paper also indicated that:

between 2007 and 2011, there were 11 companies in the FTSE All-Share Index that saw 50% of votes cast going against the remuneration report, but including abstention shows that 19 companies actually failed to get a simple majority of all shareholders. In one FTSE 250 example, the company ostensibly received 97% support for its remuneration report at the 2011 AGM. However, a closer look at the figures shows that a substantial number of shareholders abstained and taking this into account, almost one third of shareholders failed to back the report.⁸⁴⁰

If this assumption of Ian Gregory-Smith and BIS are true, then the number of abstention votes would be expected to reduce with the provision of the new law giving the shareholders a binding vote on remuneration policy.

However, shareholder abstention from voting could indicate shareholder unwillingness to be involved in matters of executive remuneration. Consequently, the desired outcome of influencing the remuneration setting process through shareholder votes would not be achieved. This therefore indicates that the policy makers would have to come up with other ways of getting the shareholders to be involved in the remuneration setting process, or find ways other than through the shareholders to influence the executive pay setting process. Before the shareholder vote on the remuneration report was introduced in 2002, the Cadbury Committee⁸⁴¹ had expressed their scepticism on more powers given to the shareholders on remuneration issues. They predicted that many of the shareholders will simply abstain from voting, and those that vote to defer in almost every case to the judgment of directors and the REMCO.

More than 50% of the sample population under study have seen higher abstention votes than the votes cast against the remuneration report. This seems to support the

⁸³⁹ *ibid*, para. 87.

⁸⁴⁰ *ibid*.

⁸⁴¹ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing 1992) para. 4.43.

early academics sceptism on vesting shareholders with voting powers on remuneration issues. Before 2002, this reaction could be attributed to the fact that the shareholders were unable to access the information they needed to react to executive remuneration.⁸⁴² The CA 2006 disclosure requirements are extensive requiring the companies to disclose far more information in the remuneration report than before, implying that the lack of information is no longer an excuse for shareholder inaction. It is worth noting that although the lack of information may not be an excuse, but the way it is set out may be (especially if it is set out in a complex manner). However, the percentage of abstention votes by the shareholders is still high and even higher than the votes against in some companies.

General effects of shareholder non-binding voting rights

The shareholder vote on the remuneration report was one of the opportunities given to the shareholders to express their views and concerns and to ask questions in the general meeting on executive remuneration. Since the introduction of the shareholder non-binding vote on the remuneration report there seemed not to be much downward adjustment in remuneration level. This is justified by the fact that executive remuneration tends to be on the increase each year. The table below indicates executive pay increases between the periods 2002-2013 which is the period within which shareholder have been voting on remuneration report.

Table 16: Trend executive pay rise from 2002-2013

year	Percentage (%) increase
2002	23 ⁸⁴³
2003	13 ⁸⁴⁴
2004	16 ⁸⁴⁵
2005	28 ⁸⁴⁶
2006	37 ⁸⁴⁷

⁸⁴² Lee Roach, ‘The Directors’ Remuneration Report Regulation 2002 and the Disclosure of Executive Remuneration’ (2004) 25(5) Comp. Law. 141,144.

⁸⁴³ Julia Finch, Britain’s Soaring Boardroom Pay Revealed, *The Guardian*, Monday 2nd October 2006.

⁸⁴⁴ *ibid.*

⁸⁴⁵ *ibid.*

⁸⁴⁶ Julia Finch, ‘The Boardroom Bonanza, Vote: Are They Worth It?’ (2007) *The Guardian* August 29th.

⁸⁴⁷ *ibid.*

2009	10 ⁸⁴⁸
2010	55 ⁸⁴⁹
2011	49 ⁸⁵⁰
2012	12 ⁸⁵¹
2013	14 ⁸⁵²

The table indicates that executive remuneration has continued to increase over the sample period. However, highest pay increases was seen in 2010 with 55% increase and 2011 with 49% pay increase. There is no hard fact and evidence to justify the high pay increases. However, Ferri and Maber⁸⁵³ study on the effect of shareholder non-binding vote and CEO pay revealed that shareholders' say on pay reduced 'reward for failure' by strengthening the pay performance relationship.⁸⁵⁴ This finding demonstrated the fact that even though the shareholder vote was non-binding and companies are not compelled to act on it, companies still acted upon the outcome of the vote. One reason why companies reacted on the voting outcome was because the shareholder's right to vote against their re-election in the AGM if dissatisfied with their performance. Therefore, directors' acted upon the shareholder vote on remuneration report so as to avoid being voted against their re-election by the shareholder. Carter and Zamora⁸⁵⁵ study suggested that the board responded to shareholder votes by strengthening the pay for performance link, but not changing the salary. Even though the link between pay and performance has been strengthened, it is still weak and in need of further strengthening as demonstrated by the findings in chapter 5.⁸⁵⁶ Although, the shareholder vote is only an advisory vote, evidence suggests that voting on remuneration report has had an influence on company's executive remuneration setting process. As demonstrated in table 15 above (page

⁸⁴⁸ Julia Finch and Simon Bowers, 'Executive Pay Keeps Rising Guardian Survey Finds' (2009) *The Guardian* September 14th.

⁸⁴⁹ 'FTSE 100 Executive Pay Rise 55% Survey Says' (2010) *BBC Business News* October 29th.

⁸⁵⁰ Jill Treanor, 'FTSE 100 Directors' Earnings Rose by Half Last Year' (2011) *The Guardian* October 28th.

⁸⁵¹ 'Executive Pay: UK's Top Bosses 'See 12% Rise' (2012) *Sky News* December 3rd.

⁸⁵² High Pay Centre, *Has Excessive Pay Gone Too Far?* (High Pay Centre 2014).

⁸⁵³ F Ferri and D Maber, 'Say on Pay Vote and CEO Compensation: Evidence from the UK' (2011) Review of Finance, Forthcoming, http://www.nber.org/public_html/confer/2008/si2008/CL/ferri.pdf 3, assessed 29 December 2011.

⁸⁵⁴ *ibid.*

⁸⁵⁵ Mary Carter and Valentina Zamora, Shareholder Remuneration Votes and CEO Compensation Design (2008) AAA Management Accounting Section Meeting Paper 1-37

⁸⁵⁶ The link between pay and performance is examined in chapter 5.

245), most of the companies responded to the shareholder votes by reviewing the remuneration policy as necessary. Deloitte's⁸⁵⁷ study on the impact of shareholder non-binding vote found out that there had been enhanced disclosure and accountability by the companies on remuneration issues, with some changes in policies and practices on executive remuneration (e.g. a greater percentage of the executive pay package made up of more performance related pay). They also found out that there was more communication between the shareholders and the company as compared to pre-2002 vote on remuneration reports. To avoid shareholders from voting down on remuneration reports, there has been significant increase in the level of variable pay with meaningful performance conditions attached to incentive remuneration in UK with most share options being replaced with share grants tied to performance, with a drop in pay-out for average performance in response to investor pressure.⁸⁵⁸ Limits to the amount of share options any one executive may be granted and golden parachute packages shrunk to the equivalent of one years' pay. The quality of reporting on pay had improved with more explanation and disclosure.⁸⁵⁹ However, there seemed to be no corresponding leap forward in company performance which was described by Ed Miliband ,the leader of the Labour Party in UK, as a 'something for nothing'.⁸⁶⁰ Carter and Zamora⁸⁶¹ found out that shareholder disapprove of higher salaries, weak pay-for-performance sensitivity in bonus pay and in response companies respond to negative shareholder vote by reducing excess salary and improving of pay performance relationship. Companies react to adverse shareholder votes on remuneration report in different way. This indicates that although shareholder voting powers were non-binding, it had great impact on the remuneration setting process.

⁸⁵⁷ Deloitte, 'Report on the Impact of the Directors' Remuneration Report Regulation: A Report for the Department of Trade and Industry' (2004) Deloitte, Research Report http://www.deloitte.com/view/en_GB/uk/services/tax/c2ef344d9a0fb110VgnVCM100000ba42f00aRCRD.htm assessed 20 November 2011.

⁸⁵⁸ S Davies, 'Does 'Say on Pay' Works? Lessons on Making CEO Compensation Accountable' (2007) 1 Policy Briefings 1, 11.

⁸⁵⁹ *ibid.*

⁸⁶⁰ 'Directors' Pay Rose 50% over Past Year, Says IDS Report' (2011) *BBC News* October 28th.

⁸⁶¹ ME Carter and V Zamora, 'Shareholder Remuneration Votes and CEO Compensation Design' (2009) Boston University Working Paper https://www2.bc.edu/~carterma/cz_vote_071708.pdf assessed 6 January 2012.

Shareholder voting after the Enterprise and Regulatory Reform Act 2013

The response to the shareholder non-binding vote was not impressive with only 22 remuneration reports voted down within the period 2003-2013. It was argued that there was therefore a need to strengthen the shareholder voting rights, which is now a binding vote on remuneration policy. Section 439A of the CA 2006 requires that the remuneration policy of quoted companies be approved by the members of the company by an ordinary resolution. Considering the effect that the shareholder non-binding vote introduced in 2002 had on executive remuneration, the government wanted to improve shareholder involvement in voting on directors' pay. The BIS consultation paper⁸⁶² on executive pay suggested that a threshold of between 50% and 75% shareholder vote would have to be required in favour of the remuneration policy before they could be approved. It also suggested that giving the shareholders a binding vote on exit payments worth more than one year's salary.⁸⁶³ The purpose of these suggestions was to empower the shareholder to prevent reward for failures and not to decrease executive pay. Payment for a director whose contract has been terminated early and without due notice (may be due to poor performance) and leaving the company with large sums as exit payment has been regarded as payment for failure. Therefore a shareholder binding vote on exit payment exceeding the equivalent of one year's salary would have given the shareholders a real say over payments for failure and potentially reduce drawn-out negotiations between companies and departing directors.

However, the proposals were criticised by the CBI, which warned that giving the shareholders too much voting rights would be damaging as strategic decision making would be left in the hands of the minority rather than the majority.⁸⁶⁴ It also argued that giving the shareholders a 75% vote on remuneration policy would be damaging and would mean that the decision making about the company strategy would be in the hands of a minority of shareholders who may not represent the wider group of shareholders. The government also recognised that in a very small number of UK quoted companies, a single shareholder owns 25% or more of the total share value and

⁸⁶² BIS, *Executive Pay: Shareholder Voting Rights Consultation* (BIS 2012) para 94.

⁸⁶³ *ibid.*, para 122.

⁸⁶⁴ CBI, *CBI Response to launch of BIS Executive Pay Consultation* (CBI 2012) <http://www.cbi.org.uk/media-centre/press-releases/2012/03/cbi-responds-to-launch-of-bis-executive-pay-consultation/> accessed 10 March 2014.

could potentially, singlehandedly reject a special resolution on remuneration policy. A binding vote may not empower shareholders as they could still choose to abstain from voting if they fear that their vote may have a negative knock-on effect on the share price or if their votes would cause executives to resign. Considering the analysis made above on the effect of shareholder non-binding vote, it could be argued that a 75% shareholder voting right might not make a difference from the shareholder ordinary resolution on executive remuneration policy. This is because (as explained above) shareholder vote has a great influence on the pay setting process but the problem is that most of the shareholders are abstaining from voting. Furthermore, most of the FTSE 100 companies usually obtained more than 75% vote in favour of the remuneration policy. For example, a study conducted by Deloitte⁸⁶⁵ revealed that in 2013, all the FTSE 100 companies received more than 75% votes in favour of their remuneration policies.

The shareholder vote on directors' exit payment was also criticised by CBI⁸⁶⁶ based on the following arguments. First, that if the shareholder votes on exit pay were to be enforced, companies may introduce higher salaries so as to increase the threshold amount for a termination payment. Second that the directors would seek to achieve higher payment during employment with the knowledge that exit payments will be reduced. Third, that giving the shareholder the powers to vote on exit pay would shrink the role of the REMCO to the detriment of intelligently designed pay packages. Fourth, that the proposal would risk placing UK-incorporated companies at a competitive disadvantage in relation to foreign-incorporated companies who have more freedom to negotiate termination packages. Fifth, that making exit payments a source of dispute would likely result in a protracted tribunal dispute which would be costly for the company. Lastly, that the binding vote on exit payment would require the company to wait for the next AGM or call an EGM to approve any settlement beyond one year's base salary would be impractical, costly and time consuming for the company. The CBI also criticised the binding vote on exit payment on the grounds that a binding vote would make it difficult for companies to remove underperforming directors quickly and therefore will lose the flexibility of getting the right person needed for the job. Accordingly, these two proposals of shareholder

⁸⁶⁵ Deloitte, Directors' Remuneration in FTSE 100 Companies – The Story of the 2013 AGM Season So Far (Deloitte 2013) 4

⁸⁶⁶ CBI, CBI Response to BIS Consultation on Shareholder Voting Rights (CBI 2012) paras 13-20.

supermajority (75%) binding vote on executive remuneration policy and shareholder binding vote on directors' exit payment were rejected. The binding remuneration policy vote requires an ordinary resolution, whilst the exit payment is regulated through the advisory shareholder vote on the future remuneration policy.

Shareholders have been given a binding vote only on the policy part of the remuneration report. The policy part of the remuneration report sets out the remuneration policy of each executive for the future. All quoted companies are required to give notice to its members of its intention to move an ordinary resolution to approve the director's remuneration policy at the annual general meeting.⁸⁶⁷ The main aim of the binding votes on remuneration policy is to encourage better quality engagement between companies and shareholders at an early stage in the process of devising policy.⁸⁶⁸ Quoted companies are expected to seek shareholder approval on remuneration policy at least every three years or at the next meeting following one where the advisory vote on the remuneration report was not passed,⁸⁶⁹ or where the remuneration policy has been amended.⁸⁷⁰ The original proposal was for shareholder vote to take place annually. This was changed to three-yearly when the Enterprise and Regulatory Reform Act 2013 was passed.

The proposal of one year voting right was watered down by BIS with the hope that allowing companies and shareholders the option of agreeing a three-year remuneration policy would encourage longer-term thinking on pay.⁸⁷¹ Companies will also have the option of an annual vote if that is what the companies and shareholders want'.⁸⁷² Annual votes as oppose to three-year votes might destabilised management teams and encourage short-term thinking which will consequently affect the long term success of the company.⁸⁷³ Annual voting might cause shareholders to be more cautious about voting against pay schemes to avoid a destabilised management and

⁸⁶⁷ CA 2006, s439A.

⁸⁶⁸ BIS, *Executive Pay: Shareholder Voting Rights Consultation* (BIS 2012) para. 65.

⁸⁶⁹ Companies Act 2006, s439A(1)&(2).

⁸⁷⁰ *ibid*, s 439A (7)(ii)

⁸⁷¹ Nick Thornsby, 'Shareholders to get Binding Votes on Executive Pay under Cable Reforms' (2012) *Liberal Democrat Voice* June 21st.

⁸⁷² Nick Thornsby, 'Shareholders to get Binding Votes on Executive Pay under Cable Reforms' (2012) *Liberal Democrat Voice* June 21st.

⁸⁷³ Kate Burges, 'ABI Backs Plan for Binding Vote' (*Financial Times*, 2012) <<http://www.ft.com/cms/s/0/afacd8fe-93a5-11e1-baf0-00144feab49a.html#axzz3DUrCj3Ot>> accessed 23 January 2014.

thereby risking their investments in the company.⁸⁷⁴ This three-year flexibility over binding votes would allow companies to demonstrate how remuneration is aligned with company strategy.⁸⁷⁵ Furthermore, the three-year shareholder voting is intended to link pay to the success of the company as a whole and reduce the annual ratcheting up of pay.⁸⁷⁶ This deviation from the original proposal has been criticised⁸⁷⁷ on the grounds that shareholder activism will be diluted in the long run and a three-year remuneration report might be difficult for shareholders to understand in terms of what executives were paid annually and why. The Labour Party criticised the deviation on the grounds that the three-year shareholder vote would not achieve the purpose of giving shareholders as binding vote on pay. It was argued that shareholder vote on pay should have been annually to be able ‘to hold directors’ feet to the fire and ensure there is constant engagement with shareholders’.⁸⁷⁸ More worries were expressed that such votes may degenerate into a box-ticking exercise with shareholders voting on vague policies rather than policies on specific elements.⁸⁷⁹ Furthermore, it was argued⁸⁸⁰ that the administrative costs involved in arranging a general meeting for the board to re-submit a remuneration report that failed may cause shareholders to vote in favour of remuneration policies just to avoid the cost. This is a change that could be regarded as unmerited because the three-year binding vote might not be able to curb executive remuneration as expected. The three years binding vote on remuneration policy might make companies to draw up policies that are broad and generous as a means of avoiding any significant changes to the remuneration policy that might require shareholder vote within the three years.⁸⁸¹ This reaction by the executives could only lead to greater increases in remuneration levels. Furthermore, within three years executives might have come and gone from the company. If the shareholders do

⁸⁷⁴ David Oakley and Jim Pickard, ‘Cable to Water Down Top Pay Plan’ (2012) *FT Business* June 9th

⁸⁷⁵ *ibid.*

⁸⁷⁶ Catherine Potter, ‘Binding Shareholder Vote on Executive Remuneration – Do the Government’s Recent Proposal Go Far Enough?’ (2012) November 13th <http://prezi.com/nd8gjdzhgf77/binding-shareholder-vote-on-executive-remuneration-do-the-governments-recent-proposals-go-far-enough/>.

⁸⁷⁷ *ibid.*

⁸⁷⁸ Steve Tolley, ‘Labour Says ‘Crafty’ Cable is Watering Down Shareholder Power Rules’ (2012) *Money Marketing* June 13th.

⁸⁷⁹ Nick Thornsby, ‘Shareholders to get Binding Votes on Executive Pay under Cable Reforms’ (2012) *Liberal Democrat Voice* June 21st

⁸⁸⁰ Catherine Potter, ‘Binding Shareholder Vote on Executive Remuneration – Do the Government’s Recent Proposal Go Far Enough?’ (2012) November 13th <http://prezi.com/nd8gjdzhgf77/binding-shareholder-vote-on-executive-remuneration-do-the-governments-recent-proposals-go-far-enough/>.

⁸⁸¹ Ruth Saunderland, ‘Three-year Binding Votes Won’t Curb Executive Pay, But Public Outrage Just Might’ (Mailonline, 21 June 2012) <http://www.dailymail.co.uk/debate/article-2162707/Three-year-binding-votes-wont-curb-executive-pay-public-outrage-just-might.html> assessed 5 March 2014.

not approve the remuneration report, the company is required to continue to use the last approved remuneration policy and seek a separate approval for any specific remuneration or loss of office payment which are not consistent with the policy; or call another meeting and put the remuneration policy to shareholder approval.⁸⁸² Companies are required to abide by the approved remuneration policy and to change it only with the approval of the shareholders. Any director of the company who goes contrary to this provision would be liable to the company for any loss and the director who receives any payment must hold it on trust for the company.⁸⁸³

Although the shareholder binding vote forms part of the major changes on executive remuneration, its effect on remuneration levels might not be different from when shareholders had only a non-binding vote on the remuneration report. As discussed above, the non-binding vote had notable impact on the remuneration setting process of executive pay packages rather; the problem was the disengagement of shareholders in the voting process. Directors acted upon the outcome of shareholder non-binding votes to prevent the shareholder voting against their re-election in the annual general meeting. Binding shareholder votes would mean that the company must act on the outcome of the voting, meaning that they will likely be less worried about shareholder voting against their re-election because they are already bound to act on shareholder votes. This argument therefore suggests that shareholder binding votes may not have a massive impact on the executive remuneration setting process. Rather what would make a difference to the executive remuneration setting process would be shareholder activism. The next section would discuss shareholder activism in remuneration issues.

Section 226B provides that a quoted company may not make a remuneration payment to a person who is, or is to be or has been, a director of the company unless the payment is consistent with the remuneration policy or approved by the members by a resolution. This provision will tend to limit the amount of generous pay package offered to executives when hiring an external executive. As discussed in chapter one, one of the main drivers of executive remuneration is the executive labour market. Companies tend to offer generous pay packages when hiring an external executive

⁸⁸² CA s439A (2).

⁸⁸³ *ibid*, s226E.

and this drives up average executive pay which is also compounded by benchmarking practice. By limiting the negotiation of service contract of external hires to shareholder approval, directors may slow down on the rate of increase of executive remuneration. This could also encourage companies to engage more in promoting internal staffs to the desired positions which would be cost effective for the company than hiring an external executive.

Section 226C provides that payments for loss of office can only be made if it is consistent with the remuneration policy or approved by the members of the company by an ordinary resolution. This provision aims to ensure that executives who are leaving the company for poor performance not leave office with large exit payment.

Shareholder activism

The shareholder binding vote together with other powers⁸⁸⁴ given to the shareholders under the CA 2006 represents an important mechanism of the shareholder voice in the UK. This is to enable shareholders of quoted companies to have a direct voice on the pay determination process of the company. The increased powers given to the shareholders is aim to encourage dialogue between the shareholders and the executives on the remuneration determination process. The shareholders would need to understand the remuneration report to be able to make informed decision when voting on remuneration issues. This comes at a cost to the shareholder as many of them lack the time and expertise needed to understand the report. Consequently, an average shareholder who owns only a tiny percentage of the company's shares will need to incur the cost (time and money to pay experts to interpret the report) to be able to make informed decision on the remuneration policy when voting or, as is most likely, will simply abstain from voting.⁸⁸⁵ Shareholders who do not understand the remuneration process could only probably look at the level of remuneration and what they get as dividends to cast a vote for or against a remuneration report. Consequently, this means that for the shareholder to have a reasonable understanding of the remuneration report, information must be disclosed and in a way that will ease

⁸⁸⁴ Such as the requirement of shareholder approval for service contracts over two years in length (s 188), the ability to remove a director from office by ordinary resolution (s 168), and the requirement that certain payments for loss of office obtain shareholder approval (s 217).

⁸⁸⁵ Lee Roach, 'The Directors' Remuneration Report Regulation 2002 and the Disclosure of Executive Remuneration' (2004) 25(5) Comp. Law. 141,144.

the understanding of the shareholder. The 21st century remuneration packages have developed to be more complex and technical as opposed to the past century remuneration packages. The complexity and technicality of these remuneration packages is almost defeating the very purpose of the disclosure requirements which was to provide shareholders with information on executive remuneration. The REMCO and the RCONs have expert knowledge in the field, and they spent a lot of time on this, meaning it cannot be easily understandable by shareholders unless they have some expert knowledge or pay experts to explain the remuneration report to them. Further, before the enactment of the Enterprise and Regulatory Reform Act 2013, the absence of a standard format disclosure meant that companies could swamp shareholders with complex information.

Shareholder's voting on remuneration policy has been facilitated by the disclosure requirement introduced in 2002. However, only few companies saw their remuneration reports voted down with many shareholders not using the voting powers they have been given. Furthermore, shareholders' ability to have an influence on management will depend on the proportion of the votes which they can exercise and the use they make of these votes. This proposal is therefore predominantly aimed at institutional investors as they hold large numbers of shares in a company more than an ordinary shareholder. Institutional investors are large organization, such as a bank, pension fund, labour union, or insurance company that makes substantial investments on company's shares. The UK Stewardship Code⁸⁸⁶ states that institutional investors should seek to vote at all AGMs where practicable, Thus, there is an expectation on the institutional investors to use their shares in voting to be able to influence the directors' pay setting process.

Most of the FTSE 100 company shares are owned by large institutional investors and with the concentration of voting rights in their hands; they can have an impact on executive remuneration more than an ordinary shareholder.⁸⁸⁷ These advantages that the institutional investor possess over an ordinary shareholder means that they can use their expertise in assessing the remuneration report, use their money to form a coalition with other institutional investors, and use their votes to either vote for or

⁸⁸⁶ FRC, *The UK Stewardship Code* (FRC 2012) Principle 6.

⁸⁸⁷ M Dong and A Ozkan, 'Institutional Investors and Director Pay: An Empirical Study of UK Companies' (2008) 18 *J. Of Multi. Fin. Manag.* 16,19.

against the remuneration report. Their votes will have a great impact on the remuneration report as they hold large percentage of equity shares in the company.

However, despite the concentration of equity ownership in the hands of institutions, shareholder voting on executive remuneration report has not increased a great deal. Only a small proportion of FTSE 100 companies shares are held by UK long-term investors. The majority of FTSE 100 companies' shares are in the hands of overseas shareholders (as shown on the table below) or short-terminist investors such as hedge funds that do not really care about what the executives take home as remuneration.⁸⁸⁸

Table 17: Beneficial ownership of FTSE 100 companies and others 2012

Sector	Percentage of total UK quoted shares		
	FTSE 100	Other companies	All
Rest of the world	54.5	45.9	53.2
Insurance companies	6.2	6.5	6.2
Pension funds	4.7	4.6	4.7
Individuals	9.0	20.3	10.7
Unit trust	9.3	11.2	9.6
Investment trusts	1.7	1.9	1.7
Other financial institutions	6.6	6.5	6.6
Charities, churches etc.	0.6	0.5	0.6
Private non-financial companies	2.6	0.1	2.3
Public sector ¹	2.9	0.1	2.5
Banks	1.8	2.4	1.9
Total	100.0	100.0	100.0

Source: Share Ownership – Share Register Survey Report 2012

From the table above, it indicates that more than 50% of FTSE 100 shares are held by overseas shareholders who may not be able to monitor the board due to the large number of companies they have in their portfolio.

⁸⁸⁸ Ruth Saunderland, 'Three-Year Binding Votes Won't Curb Executive Pay, But Public Outrage Just Might' (Mailonline, 21 June 2012) <http://www.dailymail.co.uk/debate/article-2162707/Three-year-binding-votes-wont-curb-executive-pay-public-outrage-just-might.html> assessed 5 March 2014.

In the banking sector, many of the banks performed poorly in recent years, but the sector received high support on their remuneration reports casting doubts on the effectiveness of institutional investors in using their voting rights on executive remuneration issues. For example, Barclays Bank in 2011 received a 75% approval for its remuneration report from investors despite their poor performance in stock and dividend returns.⁸⁸⁹ However, Dong and Ozkan⁸⁹⁰, studying institutional investor and executive pay in UK companies found out that there exist two classes of institutional investors - one being dedicated (in remuneration context meaning voting) and the other transient (not voting). Their findings showed that the dedicated institutional investors do restrain the level of executive pay and strengthen the pay performance relationship. These dedicated institutional investors use their expertise and votes to monitor the management. The transient institutional investors make no appreciable difference neither to the pay levels of the executive remuneration or strengthen the pay performance relationship indicating that they have failed to regulate executive remuneration.⁸⁹¹

Shareholder pro-activism can greatly reduce the influence shareholder could have on the pay determination process in a company. This disengagement by the shareholders also reduces the importance of the voting powers vested on the shareholders on remuneration matters. Consequently, shareholder binding vote may not be more effective than a shareholder non-binding votes and the setting of executive remuneration would still be inappropriately regulated.

Other shareholder remedies

This section discusses other remedies that are available to the shareholders in cases of excessive executive remuneration. These remedies are general shareholder remedies that can, in limited cases; result in the award of a remedy where pay is excessive. To better understand other shareholder remedies and to what extent they influence the pay setting process this part would be divided into three sections. First, directors' duties would be discussed and its possible influence on the pay setting process.

⁸⁸⁹ M Clarke, 'Banks Remuneration Report Highlights Failure of Institutional Investors' (2011) <http://www.freshbusinessstinking.com/news.php?NID=11106> assessed 30 December 2011.

⁸⁹⁰ M Dong and A Ozkan, 'Institutional Investors and Director Pay: An Empirical Study of UK Companies' (2008) 18 J. of Multi. Fin. Manag. 16 – 29.

⁸⁹¹ Charlotte Villiers, 'Controlling Executive Pay: Institutional Investors or Distributive Justice?' (2010) 10(2) JCLS 3029-342.

Secondly, derivative claims would be examined and lastly the unfair prejudicial remedy.

Directors' duties

The fiduciary relationship of the executive and the company precludes the executives' entitlement to remuneration or profit making out of their duties while in office unless remuneration is properly authorised.⁸⁹² However, a company's articles of association often provide authority for executives to be remunerated. The executive remuneration is either set in the articles of association or, as is usually the case, in a separate service contract. The court will rarely find executive remuneration excessive because the courts do not want the directors' to be hauled to court at every given opportunity.⁸⁹³ Directors have general duties that they owe to the company which are set out in CA 2006, ss 171-177. Enforcement of these general duties is a matter for the company and not of its members.⁸⁹⁴ Directors have the duty to act in the company's interest.⁸⁹⁵ In reference to excessive executive remuneration, it is difficult to see how executives are acting in the interest of the company when executive pay has no link or weakly linked to company performance (discussed in chapter 5). The directors' are required to act with care, skill and diligence which might be exercised by a reasonable diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company.⁸⁹⁶ This implies that the courts defer on the particular facts of any given case, accepting their merits on the remuneration decision taken.⁸⁹⁷

Also the courts are reluctant to deal with issues of remuneration as they assume that the level of executive pay denote the responsibility that goes with the job, thus the higher job responsibilities the higher the pay level.⁸⁹⁸

The courts have indicated that in most cases excessive executive remuneration will not constitute a breach of directors' duties.⁸⁹⁹ This is because executive remuneration

⁸⁹² *Guinness Plc v Saunders* [1990] 2 AC 663 (HL).

⁸⁹³ Saleem Sheikh, Taylor & Francis Group Sheikh and Rees, *Corporate Governance* (Cavendish Publishing 1995) 193

⁸⁹⁴ CA 2006, s 170(1).

⁸⁹⁵ CA 2006, s 172.

⁸⁹⁶ *ibid*, s 174

⁸⁹⁷ *Knox J in Smith v Croft* (No 3) [1987] 3 BCC 218, 236.

⁸⁹⁸ *Re Barings plc* (No 5).

is set in advance and shareholders approve it by ordinary resolution before it is implemented.⁹⁰⁰ In *Smith v Croft*⁹⁰¹, Walton J. rejected the claimant's contention that the directors' salaries were excessive and warned that in certain areas of business, such as the entertainment business, salaries were justifiable though far in excess of what could be earned in other professions.

However in the case of *Re Halt Garage*⁹⁰² although the court refused to interfere in the determination of executive remuneration, it rejected payment that was made to a director after she ceased working for the company. The court labelled the pay as gratuitous distribution of the company's capital rather than a genuine remuneration. Generally, the courts have a natural disinclination to find remuneration excessive and will not, generally, interfere with matters which require the commercial judgment of the board.⁹⁰³ Where the directors breach their duties, the shareholder can seek relief through a derivative claim.

Section 206(1) of the CA 2006 defines derivative claims as proceedings brought by a member of a company in respect of a cause of action vested in the company seeking relief on behalf of the company. A breach of directors' duties (discussed above) could only be enforced by a member via derivative claim. Such claims must be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of a company.⁹⁰⁴

However, it would still be difficult for a claim on excessive remuneration to succeed as executive remuneration determination are regarded by the court as management issues and are not ready to interfere.⁹⁰⁵ The rule in *Foss v Harbottle*⁹⁰⁶ and its exceptions made it difficult for shareholders to bring derivative action on claims of excessive remuneration to court. The rule in *Foss v Harbottle* was set on the premise

⁸⁹⁹ *Smith v Croft* [1986] 1 W.L.R. 580; *Smith v Croft* (No. 2) [1988] 1 Ch. 114; *Smith v Croft* (No. 3) [1987] B.C.L.C. 355.

⁹⁰⁰ Charlotte Villiers, Maria Isabel and Huerta Viesca, 'Controlling Directors' Pay in English Law and Spanish Law' (1995) 2(4) Maastricht Journal of European and Comparative Law 377, 379.

⁹⁰¹ [1986] 1 WLR 580.

⁹⁰² *Re Halt Garage* (1964) Ltd [1982] 3 All ER 1016.

⁹⁰³ *Re George Newman & Co.* [1895] 1 Ch. 674.

⁹⁰⁴ CA 2006, s260(3).

⁹⁰⁵ *Re Halt Garage* (1964) Ltd [1982] 3 All ER 1016, 1023.

⁹⁰⁶ (1843) 2 Hare. 461.

that a company is a separate legal entity, distinct from its owners and has corporate personality of its own.⁹⁰⁷ Therefore only the company had the power to redress a wrong against it. Directors' duties to the company are enforceable by the company, which in the ordinary course of event are the directors. This is because directors are generally responsible for enforcing all legal claims held by the company, consequently giving rise to a conflict of interest when the claims that are against the directors themselves.⁹⁰⁸ However, under the common law shareholders could not bring a derivative claim on the company's behalf unless it came under one of the four exceptions to the rule in *Foss v Harbottle*. The exception includes where the act complained of was illegal or ultra vires, or where the act required special majority sanction, or where the members personal rights were infringed, or where the act constituted fraud on the minority and the wrongdoers were in control of the company. Shareholder could bring a derivative claim of excessive remuneration under the exception that the act constituted a fraud on the minority shareholders of the company and the wrongdoers were themselves in control of the company.⁹⁰⁹ However, for the claim to succeed the shareholder would have to prove fraud on the minority and the fact that the wrongdoer is in control of the company. The burden of proof of fraud by the shareholder is difficult as the court consider executive remuneration to be set in advance and approved by the shareholders.⁹¹⁰

The statutory derivative claim CA 2006, s206 abolished the rule in *Foss v Harbottle* and its exceptions and replaced it with a more flexible and accessible criteria for determining whether a shareholder could bring a derivative claim. The purpose was to provide members of the company with fair and cost effective mechanisms for resolving disputes between members of the company and those running the company (directors). The derivative claim does not require the member to prove fraud or that the wrongdoer is in control of the company as was the case under the common law. However, the member would have to make an application to the court for the claim⁹¹¹, in which the court would decide whether to grant permission for a derivative action to

⁹⁰⁷ *Salomon v Salomon & Co Ltd* [1097] AC 22.

⁹⁰⁸ Williams Richard, 'Enlightened Shareholder Value in UK Company Law' (2012) 35 U.N.S.W.L.J. 360, 368.

⁹⁰⁹ Mahmud Samad, *Court Applications Under the Companies Acts* (A & C Black 2013) 275.

⁹¹⁰ *Re Halt Garage* (1964) Ltd [1982] 3 All ER 1016, 1023.

⁹¹¹ CA 2006, s261.

be brought to court.⁹¹² However, s 263 requires permission to be refused where the matter complained of was authorised in advance or ratified. This provision makes it difficult for the courts to grant members of the company permission to bring a derivative claim on excessive executive remuneration because executive remuneration policy is voted upon and authorised in advance by the shareholders of the company.

Unfair prejudicial remedy

Shareholders are provided with the principal form of statutory protection of bringing an action in court for unfair prejudicial conduct under s 994 of the CA 2006. This section provides the shareholder with the right to petition the court for relief where the company's affairs are being, or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself), or that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial. As mentioned above, the determination of executive remuneration is a matter for the company's management in accordance with its articles of association or a separate service contract for the director. The payment of excessive remuneration to directors, to the detriment of the members of the company, could constitute unfairly prejudicial conduct. Where the directors' remuneration is determined lawfully, to succeed in a claim of unfair prejudicial conduct the petitioner would have to prove unfairness. *O'Neill v Phillips*⁹¹³ is the leading case, where Lord Hoffmann came up with a two-fold test of unfairness:

1. Unfairness arises where there has been a breach of terms which it was agreed the company's affairs would be conducted
2. Or where the majority has exercised a power in a manner regarded by equity as contrary to good faith.

Going by this two-fold test, to establish a claim of excessive remuneration under s 994, there should be a breach of an agreement (remuneration policy) concerning directors' entitlement to remuneration, or process by which it is determined falls under the first test of unfairness. This first test was followed in the case of *Andrew v*

⁹¹² *ibid*, s263.

⁹¹³ *O'Neill v Phillips* [1999] 1 WLR 1092.

*Hogg*⁹¹⁴ in which the court held that the petitioner was not entitled to a claim as there was no agreement on how the affairs of the company should be conducted. Furthermore, in *Fish v Cadman*⁹¹⁵ it was held that the director's failure to provide substantive explanation about their remuneration in the correspondence to the petitioner constituted unfairly prejudicial conduct because this act denied the petitioner of information about the company's affairs.

Excessive remuneration would constitute unfairly prejudicial conduct where, in breach of agreement between shareholders, one shareholder pays himself out of the company's fund considerable sums in excess of that recovered by other shareholders.⁹¹⁶ In *Re McCarthy Surfacing Ltd*⁹¹⁷ a managing director awarded himself 45% of the company's profits because he felt that he was receiving less than what he was worth in the company. The court held that his act amounted to unfairly prejudicial conduct. It could be argued that the decision of the court could have been different if the company was a public company where remuneration policy would have been determined and approved by the shareholders before implementation.

In *Re Cumana Ltd*⁹¹⁸, where the respondent was alleged to have received, during a period of 14 months in the region of £160,000 to £365,000 by way of bonus and £190,000 by a way of pension contributions, Vinelott J found that the remuneration paid was plainly in excess of anything the respondent had earned and was so large as to be unfairly prejudicial to the petitioners. In *Re a Company ex p Burr*⁹¹⁹ Vinelott J went further to say that there must be sufficient evidence to show that the directors are paid in the aggregate more than the company would have had to pay to secure suitable replacements or that the level of remuneration was out of line with that paid to executive directors of other companies of comparable size and turnover. As the court is not prepared to scrutinise the reasonableness of director's remuneration under s 994, having regards to the company's turnover and the remuneration level of other companies is crucial in determining whether excessive executive pay constitute unfair prejudicial conduct.

⁹¹⁴ (2000) SLT 634.

⁹¹⁵ *Fish v Cadman* [2006] 1BCLC 499, 98.

⁹¹⁶ Victor Joffe QC, David Drake, Giles Richardson, Daniel Lightman and Tim Collingwood, *Minority Shareholders: Law, Practice and Procedure* (Oxford University Press 2011) 294.

⁹¹⁷ *Re McCarthy Surfacing Ltd* [2009] 1 BCLC 622.

⁹¹⁸ (1986) 2 BCC 99, 485.

⁹¹⁹ [1992] BCLC 724 at 735f.

Failure to ensure that the disclosed information on executive remuneration in the remuneration report is properly recorded can amount to unfairly prejudicial conduct, even if the remuneration is reasonable, authorised or the act was not deliberate.⁹²⁰ A remuneration policy of paying executive remuneration to directors and not distributing profits as dividends can constitute unfairly prejudicial conduct to shareholders who are not directors.⁹²¹ Furthermore, failure of directors to consider where dividends should be paid to other shareholders will constitute unfair prejudicial conduct to the shareholders who are not directors.⁹²²

Many of the cases discussed above concerned private companies. With regards to public companies, the courts are especially reluctant to regard excessive executive remuneration as unfairly prejudicial conduct.⁹²³ In *Smith v Croft (No. 2)* the court argued

That although excessive remuneration paid to directors might be an abuse of power, where the power to decide remuneration was vested in the board, it could not be ultra vires the company; and that in view of the uncontradicted evidence about the specialised field in which the company operated and the high levels of remuneration obtaining there it was more likely that the plaintiffs would fail...⁹²⁴

The courts have argued that the mere quantum of remuneration compared to other companies of the same size and turnovers may not necessarily be indicative of excess or unfair prejudicial conduct. Vinelott J in *Re a Company, ex p Burr*⁹²⁵ said;

There is no evidence that the directors are paid in the aggregate...more than the company would have had to pay to secure suitable replacement or that the level of remuneration is out of line with that paid to executive directors of other companies of comparable size and turnover.

⁹²⁰ *Re Sunrise Radio Ltd* [2010] 1 BCLC 367, 224.

⁹²¹ *Re a Company* (No 004415 of 1996) [1997] 1 BCLC 479.

⁹²² *Re McCarthy Surfacing Ltd* [2009] 1 BCLC 622.

⁹²³ Lee Roach, 'The Directors' Remuneration Report Regulation 2002 and the Disclosure of Executive Remuneration' (2004) 25(5) Comp. Law. 141, 144.

⁹²⁴ Lee Roach, 'The Directors' Remuneration Report Regulation 2002 and the Disclosure of Executive Remuneration' (2004) 25(5) Comp. Law. 141, 144.

⁹²⁵ *Re a Company, ex p Burr* [1992] BCLC 724, 735f-735g.

In most cases of excessive remuneration the judgment of the case is reached considering the totality of the petitioner's complaint. In *Fowler v Gruber*⁹²⁶, Lord Menzies used 'objective commercial criteria' and 'out with the bracket that executives carrying the sort of responsibility and discharging the sort of duties that the respondent would expect to receive'⁹²⁷ to reach his decision on remuneration constituting unfair prejudicial conduct. In Fowler's case, a minority shareholder (the petitioner) argued that the company's majority shareholder and sole director (the respondent) had conducted the company's affairs in an unfairly prejudicial manner. The petitioner's claims included exclusion from management of the company, the respondent failing to run the company in the best interest of the shareholders, the payment of disproportionate and excessive remuneration which endangered the company's financial position, the non-payment of dividends and the issuing of shares with the intention of destroying the petitioner's proportionate interest in the company. Lord Menzies' considering the totality of the complaints found that the company's affairs were conducted in an unfairly prejudicial manner. Using his test 'objective commercial criteria' he found that the respondent remuneration rising from £50,000 in 2001 to £307,000 in 2006 could not be justified.

Conclusion

Over the past two decades, executive remuneration has continued to rise with very weak pay-for-performance relationship (discussed in detail in chapter 6). The Companies Act 2006 tends to regulate executive remuneration through implementing disclosure requirement and empowering the shareholders with voting powers to exercise on executive remuneration. The law is generally reluctant to meddle in corporate affairs, as they consider that the management of the company is in the best position to make informed decisions about the company. Therefore, by making the companies to disclose more information on remuneration, shareholders will be informed and be able to use their voting powers to indicate their views on remuneration matter. However, before the coming into force of the Enterprise and Regulatory Reform Act 2013, disclosure requirement was seen to be far from constraining excessive executive remuneration because there was no set format on how the information should be disclosed. As a result, shareholders found themselves

⁹²⁶ (2009) CSOH 36.

⁹²⁷ (2009) CSOH 36, Para 132.

with sump of information which they could hardly understand. Furthermore, shareholders had only a non-binding vote on remuneration report which meant that the company was not compelled to act on the voting outcome. Many shareholders abstained from voting on remuneration issues consequently not making use of their voting powers. With the introduction of a shareholder binding vote on remuneration policy, and the disclosure requirement format by the Enterprise and Regulatory Reform Act 2013, shareholders are expected to use the disclosed information which is expected to be easy to read, and exercise their voting rights in curbing excessive executive remuneration. The effect of the new disclosure requirements and shareholder binding vote is yet to be observed, whilst the mandatory non-binding voting right given to the shareholder before the Enterprise and Regulatory Reform Act 2013 seemed not to have affected the levels of executive remuneration. Furthermore, the courts reluctance to adjudicate on executive remuneration issues and its none use of the 'reasonable man's' test in executive remuneration cases provides a safe harbour for executives to get away with excessive remuneration to the detriment of the company and its stakeholders.

Conclusion and Recommendations

To conclude this research project, a summary of the main findings will be highlighted, contribution to knowledge, limitation of the study, opportunities for further research (where applicable) and possible recommendations.

Executive remuneration has been a prominent issue of corporate governance in the UK since the early 1990s. executive remuneration package has developed from a simple salary and benefits in the 1980s to a complex package made up of several components which include, base salary, annual bonus, long-term incentive plans and share options. Executive remuneration has continued to increase (e.g. in 2011, executive remuneration was seen to increase by around 5000% since 1980).⁹²⁸ The increase in executive remuneration was initially driven by privatization of some utility companies in the early 1990s. After that executive remuneration is seen to be driven by factors like globalisation, executive labour market, transnational mergers, the growth of multinational companies, board independence, remuneration disclosure, shift to incentive pay and executive remuneration benchmarking.

In an attempt to curb on the excessive increase in executive pay, the UKCGC makes recommendations of how executive remuneration should be determined. Conversely, the CA 2006 does not make provisions on how executive remuneration should be determined; rather it takes a corrective measure to curbing excessive executive pay.

The UKCGC recommends that companies should set up a REMCO made up of wholly independent NEDs to be responsible for the setting of executive remuneration. The purpose of this recommendation is to bring transparency and accountability in the executive remuneration setting process. However, as was discussed in chapter 4, the REMCO has been seen to be ineffective in discharging their responsibilities mainly because of their composition (mostly made up of executives and former executives of other companies) and their lack of independence from the board. The NEDs on the REMCO are often and chief executive officers of other companies. This similarity in job role and interest may cause the REMCO to act more in favour of the executives than the company and its stakeholders at large. Furthermore, in most companies, the

⁹²⁸ Ben Heineman, 'The Political Case Against Out-sized Executive Pay' Harv. L. R. 10th December 2011

CEO of the company still sits on almost all of the REMCO's meetings and make proposals on remuneration arrangements, which does not accord with the recommendations of the UKCGC. However, the Code operates on a 'comply or explain' basis, meaning that the RCs of listed companies need to disclose whether or not they comply with the Code. And if they do not, then they have to explain. The shareholders of the company are therefore encouraged to act on the disclosed information to hold the REMCO to account at the annual general meeting. If the shareholders are not satisfied they have the option of voting against the re-election of the directors, or voting against the remuneration report.

A means of enhancing the effectiveness of the REMCO may be through the involvement of members from more diverse backgrounds. This means that not only members from business background but from other backgrounds like academia. The diversity of the REMCO could potentially reduce the extent to which the REMCO would be seen as acting in favour of the executives rather than the company. These committee members could be selected by nomination committee in conjuncture with the shareholders of the company to minimise the feeling that the members of the REMCO owe their seats to the executives of the company. An opportunity for further research in this area would be to select companies that have diverse members on the REMCO, and find out whether this diversity has influenced the way executive remuneration is determined, and whether the executives' pay is closely linked to company performance as a results of diversity of members on the REMCO.

The UKCGC also allows the REMCO to appoint any consultant in respect of remuneration for support and advice. Most FTSE 100 companies engage the services of RCONs to advise them on executive remuneration benchmarking. The twenty-five companies considered in this study all used the services of RCONs to provide them with market data on executive remuneration that they may use to determine the pay of their executives. However, the UKCGC and the Companies Act 2006 does not make any recommendations/provisions on what factors to consider when benchmarking executive remuneration. In this study, six prominent RCONs were interviewed on the methodology of benchmarking. The study found out that there was lack of uniformity in the factors used when selecting comparator groups and elements of the remuneration package considered for benchmarking. The study also found out that the

consultants expressed different views as to their objectivity in the nature of advice they offer to the REMCO and the effect of benchmarking on executive remuneration. The study identified in general seven factors that are considered when selecting comparator groups which were: company size, sector, geographical location, company performance, role of the executives, company remuneration policy and complexity. From the findings, company size, company sector and geographical location of the business were more influential than the rest. Furthermore, remuneration benchmarking could be done by considering the total remuneration package or on an element-by-element basis depending on the consultant. The study also found out that RCONs may be bias in the nature of advice they provide to the REMCO if they also offer other services to the company as a means of keeping their business relationship. A majority of the consultants interviewed (five) were of the opinion the executive remuneration benchmarking drives executive remuneration, whilst one of the respondents was of the opinion that it curbs excessive remuneration. This study gives a detail understanding of executive remuneration benchmarking which no past study has explored before. It is therefore setting the foundation for further qualitative and quantitative research on the subject area by involving more RCONs, REMCO, shareholders etc. views on benchmarking methodology.

The UKCGC also recommends that the REMCO should set pay so as to be linked to individual and corporate performance but it does not recommend specific performance measures for companies to use. It is therefore left to the company to decide on which performance measure they deem necessary is to use. This study found a wide array of factors used, with each company using a different selection of performance measures. This demonstrated a lack of uniformity in the use of performance measures and by extension a lack of uniformity in the information disclosed in the remuneration reports by companies. This lack of uniformity makes it difficult for shareholders to understand pay packages and compare them across companies. Performance measures can be financial or non-financial. In this study two financial performance measures and one non-financial (market performance) was used to determine the link between executive pay and company performance; and also the effect of different performance measures on the pay for performance link. The three performance measures were EPS, TSR and ROA. TSR was chosen as its reflect the shareholders interest, EPS was chosen as more than half of the companies in the study

used it, and ROA was chosen because less companies and few past studies used it. These were chosen to give an understanding of the effect different performance measures could have on the pay for performance link. As noted earlier, there exist a wide range of performance measures, all having different limitations thereby acknowledging the limitations of the chosen performance measures used in this study. The study was based on nineteen companies selected from the FTSE 100 companies 2010. The important results were obtained from the study were as follows

First, the results demonstrated that there existed a positive relationship between executive total remuneration and company performance in most of the companies using EPS as the performance measure. EPS is a short term performance measure that measures earnings available to shareholders divided by the number of ordinary shares outstanding. Fourteen out of nineteen companies demonstrated a positive weak, moderate or strong relationship between executive pay and company performance. Six out of the fourteen companies demonstrated a strong significant relationship, three demonstrated a moderate relationship and five demonstrated a weak relationship between executive total remuneration and company performance using EPS as the performance measure. This result indicates that, in relation to EPS, the link between executive remuneration and company performance is stronger than the link obtained by most past studies on the subject. The results obtained for executives were very similar to the results obtained for CEOs. Contrary to the significant relationship obtained between executive total remuneration and company performance using EPS as the performance measure, the results obtained using ROA and TSR suggested that there existed a very weak positive or negative relationship between executive total remuneration and company performance using ROA and TSR as the performance measures. Only six companies out of the nineteen demonstrated a weak positive relationship between executive total remuneration and company performance using ROA as the performance measure. The other thirteen companies demonstrated a negative relationship indicating that executive total remuneration is not related to company performance. Whilst only five demonstrated a weak positive relationship between executive total remuneration and company performance using TSR as the performance measure and the other fourteen demonstrated a negative relationship. This result suggests that in the case of ROA and TSR, most companies do not consider company performance as a factor for determining executive remuneration. It

also supports the findings discussed in chapter 4 to the effect that five RCONs did not consider company performance as a factor for selecting comparator groups for executive remuneration benchmarking. The results obtained for executive performance-related pay and company performance was very similar to the results obtained for executive total remuneration. This therefore indicates that there exist a significant link between executive remuneration and company performance using EPS as the performance measure, and there is very weak or no link between executive remuneration and company performance using ROA and TSR as the performance measures. This suggest that executives rely on short-term performance measures which consequently leads to short term profits rather than the long term success of the company. This might be as a result of the pressure from the shareholders and investors on the executive for the company to yield profits. As a means of appeasing the shareholders and investors, the executives may rely on performance conditions that will yield short term profits as demonstrated by EPS at the expense of the long-term success of the company.

Secondly, the results demonstrate that different performance measures have different effects on the pay for performance link and could also relay a message on company's long/short term dealing. EPS demonstrated a significant positive effect on the pay for performance relationship. However, EPS is a short term performance measure indicating that most companies are relying on the short term performance of the company rather than the desired long term success of the company. TSR and ROA are a longer term performance measures than EPS. Therefore the result indicates that most companies are not focusing on the long-term success of the company as more than 50% of the companies considered in this study use EPS as the only performance measure or in conjuncture with other performance measures.

Lastly, companies use increase in company size and company performance as a justification for high executive remuneration. This study therefore hypothesised that if executive pay is strongly correlated with company size and company performance, then it is expected that company size should be strongly related to company performance. This hypothesis is derived from the assumption that a good performing company tends to increase in size which will then justify executives high pay levels. This hypothesis was confirmed in this study with most of the companies

demonstrating a strong positive relationship between company size and company performance. This result therefore suggest that the lack of a strong relationship between executive remuneration and company performance may be due to other factors that influence company performance and executive determination process, e.g. drivers of executive remuneration discussed in chapter1. The study therefore may be confirming the literature discussed in chapter 1 & 4 where drivers of executive pay and theories that influence RC's pay setting process.

This study on pay for performance link builds on existing literature by confirming that there exists a weak or no relationship between executive pay and company performance (considering TSR and ROA as the performance measure). However, the study also indicates that there exist a significant relationship between executive pay and company performance (using EPS as the performance measure) contrary to the findings of past studies. This study recommends further research on the subject area that would consider a larger sample (more than nineteen) of companies, more performance measures both from financial and non-financial to determine the pay for performance link and the effect of the performance measure on the link. A further qualitative study could also investigate the various performance measures that company use and the reason behind their choices.

The Companies Act 2006's provisions on executive remuneration have an indirect influence on the determination process of executive pay. The Act requires companies to provide extensive disclosure on the process involved the determination of executive pay. The purpose of the disclosure requirement is to make the pay setting process transparent. The shareholders are encouraged to use this information to make an informed judgement on executive remuneration in the annual general meeting. However, executives have used the availability of this information to compare their pay with those of their peers resulting in a demand for more pay or a threat to move to a different company that will pay more. The disclosure requirement is achieving its aim of making information available to the shareholders. Furthermore, the Act has provided the shareholders of quoted companies with a three-year binding vote on remuneration policy and an annual vote on the implementation report. It is unsure how well the shareholders will use the voting powers to curb excessive executive remuneration. Before the shareholder vote on remuneration report was made binding

in 2013, shareholders had a non-binding vote on remuneration report. Although, companies were not compelled to act on the outcome of the vote, many did because they were avoiding the shareholders from voting against their re-election. With these powers to curb excessive executive remuneration only about 22 companies saw their remuneration reports voted down between the periods 2002-2013. Looking at the voting attitude of the twenty-five companies considered in this study, the data indicated that many shareholders were abstaining from voting, with some companies having more abstentions votes than votes cast against. It therefore implied that many shareholders are not using the voting powers vested upon them to curb excessive pay. Doubts are cast on the introduction of binding votes by the government in 2013 as to whether it would make any difference. In my opinion, I do not think that a binding vote on executive remuneration would change the voting attitude of shareholders. Furthermore, considering that the binding vote is not annual but rather a three-year vote, it is most unlikely that it will make a difference. Further research is encouraged in this area to determine the effect of the three-year binding vote on pay-for-performance link (whether it has strengthened or weakened), its effect on shareholder voting (whether it has made more shareholder to be involved or not) and the remuneration committee style of setting a three-year effective remuneration policy.

Finally, the aim of this study was to examine the regulation on the determination of executive remuneration in the UK. This aim has been met by taking a mixed method approach to investigate the various phenomenon involved. The study as noted in chapter one has demonstrated the complex nature of the present day remuneration package and the difficulty in determining such complex pay packages. This study demonstrate the importance of getting the pay setting process right, and until that is achieved, executive pay may continue to be a prominent issue of corporate governance.

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Appendix

INTERVIEW INVITATION LETTER

University Letterhead

Dear (Name of potential Participant),

Re: An Invitation to participate in a research study titled: Executive Remuneration: Methods of Regulation in FTSE-100 Companies

I wish to invite you to participate in a research study on Executive Remuneration. I am a PhD student at the University of Portsmouth, School of Law. I am engaged in research concerning executive remuneration to gain an understanding of the criteria that remuneration consultants employ in benchmarking executive remuneration.

This study involves remuneration consultants from the following consultancy firms: Towers Perrin, Hewitt, Pricewaterhousecoopers, Newbridge Street, Monks, Deloitte, Mercer Human Resource, KPMG, BDO, Grand, Ernest and Young and accountancy firms. You were chosen based on the information provided on your firm's website.

I have attached a full information sheet about the study and a consent form for you to sign if you are interested in participating in the study. You can contact me or my supervisor (Dr. Lee Roach) either by phone, fax, or the email address below.

Participation in this study is entirely up to you and, should you decide during the course of the study to withdraw, you can without any problems at the interview stage. But it can be a little difficult if your data has already been analysed to withdraw your personal contribution.

Thank you for taking the time to read through this letter and I hope you are able to help me with my research.

Sincerely

Ernestine Ndzi

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INTERVIEW INFORMATION SHEET

Executive Remuneration: Methods of Regulation in FTSE-100 Companies

My name is Ernestine Ndzi, and I am a registered PhD student at the School of Law, University of Portsmouth. I would like to invite you to take part in a research study that I am undertaking. Before you decide, I would like you to understand why the research is being conducted and what it would involve for you.

The study is aimed at acquiring a deeper understanding of the criteria remuneration consultants use to benchmark executive remuneration, to understand to what extent they implement any existing regulation, and how the information they provide affects executive pay in general.

This study will hopefully involve remuneration consultants from the following consultancy firms: Towers Perrin, Hewitt, Pricewaterhousecoopers, Newbridge Street, Monks, Deloitte, Mercer Human Resource, KPMG, BDO, Grand, Ernest and Young and accountancy firms. You happen to be a compensation consultant from one of these firms and your information was accessed from the firm's website.

The research will last for three years and will involve a 20 – 30 minutes interview. I seek to obtain your personal opinion on benchmarking and not your firm's opinion, although the firm's opinion will be important as well. This information will be strictly confidential and used only for the purpose of the study. Participation in this study is voluntary and should you decide to withdraw during the course of the study, you can without any problems at the stage of interview. But it can be a little difficult if your data has already been analysed to withdraw your personal contribution. When this study is finished, the results will be published.

This study will not pose a major disadvantage to you while you are participating. But this study will take up some of your time, and the inconvenience of participating. This study seeks to understand the policies that can make a difference to Regulatory methods of Executive remuneration and consequently the remuneration package as a whole. If you have any concern about any aspect of this study, you should speak to the researcher or my supervisor, who will do their best to answer your questions. If

you are not satisfied and wish to complain formally, you can do this through, The Head of Department, Department of Law, University of Portsmouth.

The study is supervised by the University of Portsmouth. Also research in the University of Portsmouth is looked at by independent Research Ethics Committee, to protect your interests. This study has been reviewed and given a favourable opinion by the University of Portsmouth Research Ethics Committee. Should you require further information on general or specific issues of the study, we can be contacted through phone or email as provided.

Thank you so much for taking out the time to read through the information sheet. Should you decide to participate in the study, you will be given a copy of the information sheet to keep and a consent form to sign to indicate you are happy to participate in the study.

Thank You

EXECUTIVE REMUNERATION INTERVIEW CONSENT FORM

Please
initial box

1. I confirm that I have read and understood the participant information sheet. I have had the opportunity to consider the information, ask questions and have had these questions answered satisfactorily.
2. I understand that my participation is voluntary and that I am free to withdraw at any time without giving reasons up to the point when the data is analysed.
3. I agree to the data I contribute being retained for future, Research Ethics Committee approved research.
4. I agree to take part in the above study.

Name of
Participant:

Signature:

Date: