Setting Executive Directors' Remuneration in Listed Companies

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Abstract

Prior research into executive directors' remuneration has focused on possible relationships between the remuneration paid to directors and variables such as company size and profitability, human capital and social comparison, and has theorised about the impact of different types of pay structure on directors' performance. Although this research has been useful in identifying factors that may influence directors' pay and performance it has not addressed the issue of how remuneration committees determine the remuneration of their companies' directors.

This paper seeks to rectify this limitation. Firstly, it synthesises prior research and presents the findings in a manner that demonstrates how researchers have addressed the five key questions faced by remuneration committees. Using this analysis, and drawing on discussions with key players in the remuneration-setting arena (such as members of remuneration committees and remuneration consultants), the paper then proposes a model to explain the process by which remuneration committees might determine their companies' remuneration policy and the packages of individual directors. The model comprises three elements – inputs, outputs and outcome. The inputs are factors (such as company size and performance, attributes of individual directors, and remuneration paid in comparator firms) remuneration committees might consider when designing their companies' remuneration policy and directors' packages.

The outputs are (i) the company's over-arching remuneration policy (the output of a first decision process) and (ii) the packages of individual directors, designed in accordance with the remuneration policy (the output of a second decision process). The outcome is the quantum, structure and form of remuneration actually paid to individual directors. If the company's remuneration policy and packages have been designed unambiguously, the outcome flows automatically therefrom: the remuneration committee is not involved in any additional decision process.

The proposed model provides insight into the process by which directors' remuneration is determined and the factors that affect the process. It is important for aiding the understanding of remuneration committees charged with setting their executive directors' remuneration, and of regulatory bodies seeking to achieve greater restraint and transparency in respect of directors' remuneration. It is also of value to researchers interested in investigating the questions the model prompts.

Keywords

Directors' Remuneration, Executive Director, Pay Structures, Remuneration Committees, Compensation.

Introduction

In many jurisdictions, including the United Kingdom (UK) and the United States (US), public listed companies (PLCs) are required

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to establish a remuneration (or compensation)[i] committee. This committee is a sub-committee of the board of directors, charged with determining the remuneration of the company's executive directors. In discharging this responsibility, the committee has to develop a remuneration policy that generates appropriate remuneration packages for the company's directors. To achieve this, the committee needs to consider the requirements of regulators, the strategic context of the business and the requirements of individual directors. More specifically, the committee must make decisions about the quantum of directors' pay and its form: for example, how much of it, if any, will comprise shares or share options as opposed to cash. It must also establish a remuneration structure (that is, the relative proportions of basic and performance-related pay) that will satisfy stakeholders (such as the shareholders and regulators as well as the directors themselves), and will also motivate the directors towards desired performance.

Regulation has had a significant impact on directors' remuneration in the UK and other jurisdictions. This phenomenon can be traced (in the UK) to the controversial salary increases and option awards that were given to the directors of (former) state-owned utilities after they were privatised in the late 1980s and early 1990s. These increases and awards resulted in adverse media comment and generated concern from government and the public at large about directors' remuneration generally. In order to address these concerns and prevent political intervention, in 1995 the Confederation of British Industry (CBI) established the Greenbury committee. The Greenbury committee's terms of reference were: "To identify good practice in determining Directors'[ii] remuneration and prepare a Code of Practice for use by UK PLCs" (Greenbury 1995, section 1.2). The committee's Code of Best Practice (Greenbury 1995, section 2) states, *inter alia*, that listed companies should:

- establish remuneration committees comprised of non-executive directors to determine the executive directors' remuneration; and
- make detailed disclosure of the company's remuneration policy and of each director's individual remuneration package.

The Greenbury Committee's recommendations represented the start of quasi-regulatory attempts to introduce measures designed to restrain increases in directors' remuneration. They have been carried forward as elements of the Combined Code (1998) – the Code with which companies listed on the London Stock Exchange are required to comply (or to qualify and explain aspects with which they have not complied). Thus, the Greenbury Committee's provisions for setting and disclosing executive directors' remuneration have been translated from recommended best practice into regulatory requirements. However, although it is accepted that companies are required to establish remuneration committees, the question remains as to how such committees are to arrive at a remuneration policy and directors' packages. Such remuneration policy and packages must be appropriate to the company's circumstances and acceptable to constituencies such as directors, shareholders and regulators.

Prior research into executive directors' remuneration has focused primarily on modelling the relationship between directors' remuneration and company variables such as size, profitability and return to shareholders. Researchers have sought to demonstrate the existence of a relationship between directors' pay and performance and have theorised about the implications of different types of pay structure. This research has been useful in identifying factors that may influence directors' remuneration and performance but it has not examined the processes by which directors' remuneration is determined. As Tosi and Gomez-Mejia (1989) have noted:

> All things considered, overreliance on archival data that treats the executive compensation process as a black box has led us into a blind alley. ... a more fruitful avenue to pursue in understanding executive pay issues is *to focus more on the process and less on the observed "objective" measures* ... How do compensation committees design executive pay packages? (p.185) *[emphasis added]*

Research Objectives

The objectives of this paper are twofold. Firstly, it sets out the five generic questions that need to be answered by remuneration committees and others seeking to devise companies' remuneration policies. It then synthesises the prior research into directors' pay, showing how researchers have addressed these five issues. As well as informing the second stage of the paper, one advantage of this presentation is that it makes the body of literature more accessible to practitioners wishing to understand the area.

The second objective is to address a gap in the remuneration literature – to investigate the 'black box' referred to by Tosi and Gomez-Mejia (1989). More specifically, it identifies the factors found by prior researchers to affect remuneration committees' decisions about the quantum, structure and form of directors' pay, and proposes a model that explains the process by which a committee might determine the remuneration policy and directors' packages for a company. The remuneration-setting model comprises three discrete but linked system elements, namely:

- inputs (factors considered by the remuneration committee when formulating the company's remuneration policy and directors' packages);
- outputs (the company's remuneration policy and directors' packages, and the decision processes engaged in by the remuneration committee when developing these outputs);
- outcome (the quantum, structure and form of remuneration actually paid to the executive directors).

It is suggested that the remuneration committee, operating under the constraint of bounded rationality, first formulates the company's over-arching remuneration policy, using some of the input factors available to it (such as company size, profitability, industrial sector and the remuneration of comparator groups). It then applies this policy to define the remuneration packages of the individual directors. This process will typically involve consideration of further input factors such as the attributes of individual directors (for instance, their age and experience). The final packages (generally including both basic salary and performance-related pay components) are tailored to suit the context of the firm and the requirements of the individual directors.

The remuneration packages determine the remuneration actually paid to the directors. This payment (whether it be in cash, shares and/or options) is the outcome of the remuneration-setting process. If the policy and packages have been designed unambiguously, the remuneration paid follows automatically and no further decisions by the remuneration committee are required.

The rest of the paper is structured as follows. In section two, the work of previous researchers is summarised to show the factors they have perceived to influence the quantum, structure and/or form of executive directors' remuneration. Section three proposes a model of the remuneration-setting process that incorporates the input factors identified in section two. Section four provides a further explanation of the model. It concludes that the model provides insight into, and a framework for further investigation of, the process by which directors' remuneration is determined and the factors that affect the process. The significance of the model is its value in aiding the understanding of companies charged with setting their executive directors' remuneration in a responsible manner, and of regulatory bodies seeking to achieve desired outcomes, in the form of greater restraint and transparency in respect of directors' remuneration, through the imposition of further regulations on public companies.

Factors that Affect Remuneration Decisions

Remuneration policies should be designed to generate remuneration packages that are congruent with the company's strategy. Furthermore, they must balance the needs of the shareholders, regulators and individual directors. A comprehensive review of relevant academic, professional and regulation literature reveals that in order to do this, remuneration committees need to address the following five generic questions:

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

Of these questions, the first relates to the quantum of remuneration, the second, third and fourth to its structure, and the fifth to the form of payment. As noted below, in each of these respects prior researchers have identified factors that influence remuneration committees' decisions.

Table One: Studies Examining the Relationship Between Company Size and Directors' Remuneration

Study	Remuneration Measure	Determination of Size	Sample	Results
Lewellen and Huntsman (1970)	Current income equivalent of all pay sources	(a) Sales and (b) Market value	50 large US companies, 1942 to 1963	Correlation between market capitalisation and pay but not between sales and pay
Deckop (1988)	Cash compensation	Sales	120 large US companies, 1977 to 1981	No correlation between sales and pay
Finkelstein and Hambrick (1989)	Cash compensation	Total assets	110 large US leisure companies, 1971, 1976, 1982 and 1983	Strong correlation between size and pay
Boyd (1994)	Cash compensation	Sales	193 large US companies, 1980	No correlation between sales and pay
Conyon and Leech (1994)	Cash compensation	Sales	294 large UK companies, 1983 to 1986	Strong correlation between sales and pay
McKnight (1996)	Salary tested separately to bonus	Sales	90 large UK firms 1992 to 1994	Salary correlated to size; bonus correlated to size and performance
Ezzamel and Watson (1997)	Cash compensation	(a) Sales and (b) Capital employed	199 large UK companies, 1992 to 1993	Strong correlation with both factors (stronger with sales)

Factors Influencing the Quantum of Remuneration:

Researchers have identified five key factors that appear to affect remuneration committees' decisions about the quantum of directors' pay, namely:

- company size;
- remuneration surveys;
- company performance;
- human capital;
- social comparison.

Each of these factors is discussed in turn.

Company Size: The importance of company size as a determinant of directors' remuneration has been examined by a number of researchers (see Table One), but with results that are inconclusive. For example, Finkelstein and Hambrick (1989), Conyon and Leech (1994), and Ezzamel and Watson (1997) found a strong correlation between company size (based on sales) and directors' pay. However, Deckop (1988) and Boyd (1994) had contradictory results. In their meta-analysis of the directors' remuneration literature, Tosi et al (2000) found that company size accounted for more than 40% of the variance in the pay of Chief Executive Officers (CEOs). Moreover, firm size was by far the greatest influence on directors' pay.

Remuneration Surveys: That firm size affects directors' remuneration is perhaps to be expected given current practice in determining the quantum of directors' pay. Ungson and Steers (1984), for example, highlighted that CEO pay levels are often based on comparative remuneration surveys (in which jobs are ranked based on company size). Thus, directors' remuneration would reasonably be expected to vary with company size, regardless of the directors' (and their companies') performance.

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

The impact of comparative surveys on ever-rising remuneration levels is widely acknowledged. Hampel (1998), for example, referred to the danger of uncritical use of such surveys causing an "upward ratchet" in remuneration. Ezzamel and Watson (1998) presented strong evidence of the importance of such external pay comparisons in explaining rises in executive remuneration to meet the "going market rate". Similarly, Patton (1991) observed that the compensation survey "may well be the most important ingredient in rising executive compensation, for it lends itself to often well-meaning actions that lead to unwarranted compensation" (p.47).

Company Performance: Much of the prior research on directors' remuneration has focused on links between directors' pay and various aspects of corporate performance (Barkema and Gomez-Mejia, 1998). Table Two indicates that researchers have considered factors and combinations of factors relating to the performance of the business in accounting terms, and in terms of return to shareholders.

Numerous studies have examined the relationship between indicators of company performance and directors' remuneration, but no conclusions have been reached overall. Many studies, including those by Lewellen and Huntsman (1970), Murphy (1985), Deckop (1988), and Main, Bruce and Buck (1996) have found a strong relationship between company performance and directors' remuneration. However others, such as that by Ezzamel and Watson (1997), have not. The position was aptly summarised by Barkema and Gomez-Mejia (1998) who stated:

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

Table Two: Studies Examining Links Between Company Performance and Directors' Remuneration

Study	Remuneration Measure	Determination of Performance	Sample	Results
Lewellen and Huntsman (1970)	Current income equivalent of all pay sources	Accounting profit	50 large US companies, 1942 to 1963	Strong correlation between profit and pay
Murphy (1985)	Total compensation in all forms excluding pensions	Shareholders' returns	72 large US companies, 1964 to 1981	Strong correlation between shareholders' returns and pay
Jensen and Murphy (1990a)	Directors' wealth including current compensation, future revisions and benefits from stock ownership	Change in shareholders' wealth	1049 large US companies, 1974 to 1986	$1000 change in shareholder wealth led to $3.25 in directors' wealth, mostly from stock ownership
Deckop (1988)	Cash compensation	Accounting profit	120 large US companies, 1977 to 1981	Strong correlation between profit and pay
Main, Bruce and Buck (1996)	Cash compensation and share options	Shareholders' returns	60 major UK listed companies, 1989	Strong correlation between shareholders' returns and pay
Ezzamel and Watson (1997)	Cash compensation	Return on equity (RoE)	199 large UK companies, 1992 to 1993	No significant correlation between RoE and pay

One reason for the inability of researchers to find a consistent relationship between directors' remuneration and company performance may lie in the variety of methods adopted to test hypotheses and analyse results. Tosi et al. (2000) referred to:

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

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

Human Capital: The quantum of directors' remuneration is affected not only by contextual attributes of a firm, but also by attributes of the individuals themselves: for example, age, qualifications and experience. Gomez-Mejia (1994) suggested that human capital theory may provide an explanation for the relationship between directors' remuneration and company size, discussed

earlier. Larger organisations are generally more complex and, as a result, require directors with more enhanced management skills: such directors can command commensurately greater rewards.

Two studies investigating the influence of human capital on directors' remuneration are those of Agarwal (1981) and Watson, Storey, Wynarczyk, Keasey and Short (1994). Agarwal (1981) advanced the notion that executive compensation was a function of job complexity, employers' ability to pay, and executives' human capital and that these three factors explained much of the variance in executive pay. However, he suggested that human capital (comprising education level, field of study, and work experience) was a less important determinant of remuneration than the other two factors. Watson et al. in a study of smaller companies, also found human capital attributes to be a determinant of remuneration.

Palia (2000) also examined the influence of human capital on directors' remuneration. She found that the labour market placed executives with lower educational qualifications into more regulated business environments. Such environments have less growth potential, and this could explain the lower remuneration.

Social Comparison: Company size, remuneration surveys, company performance and the attributes of individual directors represent the 'hard' end of factors affecting directors' remuneration. However, softer, more subtle factors may be equally influential – for example, the pay remuneration committee members receive in their 'outside' jobs. Remuneration policy is set by remuneration committees comprising non-executives, some of whom hold executive positions in other companies (O'Sullivan 2000). Festinger (1954) suggested that individuals rely on social comparisons in order to evaluate their abilities, comparing themselves with others they perceive as being at their level. In the context of remuneration, social comparison theory indicates that members of remuneration committees will base their decisions on the pay they and others receive in their outside executive roles. The higher the pay of the committee members, the higher that awarded to the CEO whose remuneration the committee is determining. This proposition was supported by O'Reilly, Main and Crystal (1988) who tested a social comparison theory hypothesis on a sample of 105 listed US firms. They concluded that CEO pay was positively related to the outside pay of the compensation committee members.

Factors Influencing the Structure of Remuneration

In addition to determining the quantum of directors' remuneration, remuneration committees need to decide on its structure. In particular, they need to decide whether (and if so, the extent to which) directors' remuneration should be performance-related. The use of performance-related pay is commensurate with agency theory (Jensen and Meckling 1976) in that remuneration contracts can be used as a means to reduce or eliminate potential conflicts of interest between the agents (directors) and their principals (shareholders). The assumption of agency theory is that the greater the proportion of performance-related pay, the more the package might be seen as aligning directors' and shareholders' interests.

In order to incentivise both desired short- and long-term behaviour, it is common for companies to reward their directors on both annual and longer-term performance (Murphy 1999; PricewaterhouseCoopers 2000). Williams (1994, p.109) explained that annual schemes focus directors' attention on achieving defined objectives whereas longer-term schemes are intended to align directors' and shareholders' interests in the longer term. However, it should be noted that, in order for a company to use performance-related pay schemes successfully to reward its directors, there must be a clear view of the behaviour being sought from the directors and appropriate performance measures must be established to encourage such behaviour.

As may be seen from Table Three, researchers have studied a wide range of issues relating to the structure of directors' remuneration and, given the variety of issues examined, it is

Table Three: Studies Investigating Issues Relating to the Structure of Directors' Remuneration

Study	Issues Examined	Sample	Results
Balkin and Gomez-Mejia (1987)	Link between compensation strategy, organisation and environment	33 high-technology and 72 non-high-tech firms or business units in the US	Companies in the growth stage of their life-cycle had proportionately more incentive pay, and (in the opinion of managers responsible for pay policies) such pay was more effective for them than for mature companies
Gomez-Mejia, Tosi and Hinkin (1987)	Difference in remuneration structures between owner-controlled and manager-controlled companies	71 very large US manufacturers, 1980 to 1983	Owner-controlled companies pay relatively more for performance and less for size of business than counterpart firms with no dominant owner
Ely (1991)	Relationship between CEO pay and accounting-based firm performance variables in different industries	173 US companies in four industries (banking, electric utility, oil and gas, and retail grocery), 1978 to 1982	Different industries used similar performance measures but different pay structures
Beatty and Zajac (1994)	Relationship between firm risk and pay structure of the top team	435 US firms undertaking IPOs in 1984	High risk companies had lower pay-risk (i.e. less gearing)
Conyon & Peck (1998)	Influence of board composition on top management pay	94 major UK listed companies, 1991-1994	Boards dominated by outsiders are more likely to use performance-related pay
Daily, Johnson, Ellstrand and Dalton (1998)	Influence of compensation committee membership on CEO pay	194 Fortune 500 companies, 1992	No correlation between the number of non-independent directors and the level of CEO pay, small correlation with the gearing of CEO pay
David, Kochhar and Levitas (1998)	Influence of institutional investors on CEO compensation policy	Fortune survey of 200 largest US companies 1992 to 1994	Companies with significant outside shareholders are more likely to use performance-related pay
Finkelstein and Boyd (1998)	Relationship between managerial discretion and CEO pay	600 Fortune 1000 companies from 1987	CEOs with greatest potential impact on performance are paid more; greater relationship between CEO pay and managerial discretion in high- than low-performing companies
Bloom (1999)	Impact of risk on managerial compensation	536 large US companies, 1981 to 1988	High risk companies tend to de-emphasise the use of incentive pay. Organisations relying more heavily on incentive pay offer higher levels of basic pay to offset some of the directors' risk
Newman and Mozes (1999)	Influence of compensation committee membership on CEO pay	161 Fortune 250 companies, 1991 and 1992	Relationship between CEO pay and performance was biased in CEO's favour when firms had insiders on compensation committee

difficult to draw any general conclusions. For example, the studies by Gomez-Mejia et al. (1987), Conyon and Peck (1998), and David et al. (1998) supported agency theory in that they suggested, respectively, that the presence of a dominant owner, a majority of outside directors on the board, and significant outside shareholders was likely to result in increased importance being accorded to performance-related pay. Newman and Mozes (1999) found that in cases where insiders were members of the compensation committee, the relationship between company performance and the CEO's remuneration was likely to be biased in the CEO's favour.

Studies by Balkin and Gomez-Mejia (1987), Beatty and Zajac (1994), and Bloom (1999) suggested that the performance-related component of directors' remuneration was affected by the company's strategy and life-cycle stage, and the riskiness of its operations. Balkin and Gomez-Mejia (1987) found that performance-related pay was more important in companies in the early, rather than later, stages of their life-cycle when directors might be expected to have more influence over company performance. In contrast to this, Beatty and Zajac (1994) and Bloom (1999) found that higher-risk companies placed less emphasis on performance-related pay than did lower-risk companies. Bloom (1999) also found that companies that relied fairly heavily on performance-related pay tended to provide their directors with higher levels of basic pay as a means of offsetting some of the associated risk. A further finding was that of Ely (1991). She highlighted that while companies in different industries used similar performance measures (for example, return to shareholders and return on assets) the relationships between pay and the performance variables were similar within an industry but differed between industries.

Performance Targets: In addition to determining the proportion of directors' remuneration that is to be performance-related, remuneration committees need to ensure performance targets are set that will motivate directors towards desired performance. However, research by Healy (1985) and Holthausen et al. (1995) found that performance targets may not achieve their desired outcomes. This is discussed in Table Four. Both of these studies found that managers used accruals to manipulate profits downwards when the upper limit for bonuses was reached, thus 'banking' any additional profits for the ensuing year when profit targets may not otherwise be reached. Murphy (2001) also found that income-smoothing took place when companies used internal performance measures such as budgets, thus ensuring a more constant bonus payout year on year.

Table Four: Studies Examining the Relationship Between Performance Targets and Directors' Behaviour

Study	Issues Examined	Sample	Results
Healy (1985)	Extent to which managers manipulate earnings, using total accruals, to maximise bonus payments	94 US companies, 1930 to 1980	Executives choose accounting procedures that manipulate profit downwards at upper bonus limit and upwards at lower limit
Holthausen, Larcker and Sloan (1995)	Extent to which managers manipulate earnings, using discretionary accruals, to maximise bonus payments	Data for 1982 to 1984 and 1987 to 1991 from two compensation consultants' surveys (443 firm-year observations in total)	Profits were manipulated downwards at the upper bonus limit, no manipulation found at the lower limit
Murphy (2001)	The impact of using internally-determined performance standards as against externally benchmarked ones	177 bonus plans for listed US companies, 1996 to 1997	Internal standards led to income smoothing and less variable bonuses

Factors Influencing the Form of Remuneration

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

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

Table Five: Studies Examining Factors Relating to the Form in which Directors' Remuneration is Paid

Study	Issues Examined	Sample	Results
Jensen and Murphy (1990b)	CEOs' ownership of company stock	1400 large US companies, 1974 to 1988	CEOs need to own substantial amounts of the company's stock in order for this form of reward to affect performance
Main, Bruce and Buck (1996)	Link between directors' pay and performance. Differences in the use of options in the US and UK	60 major UK listed companies, 1989	Share options provide a performance-sensitive connection between pay and performance
Yermack (1997)	Timing of managers' exercise of stock options	620 option awards by Fortune 500 companies, 1992 to 1994	Executives appear to manipulate the timing of exercising share options to benefit from favourable stock market movements
Murray, Smithers and Emerson (1998)	Accounting treatment of stock options	100 large US companies	Different accounting treatments of options makes it possible to avoid or reduce a charge against income
Cooper and Hraiki (1998)	Financial reporting for stock options. Differences in US and UK accounting practices	Impact of fair value reporting on 50 largest US companies by market capitalisation	Net income would be reduced (in some cases significantly) if options were fully charged against income

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

studies that examined issues pertaining to those factors which influence the form of payment of remuneration.

Yermack (1997) investigated companies' use of options to reward their directors and found that a "downside" of their use arises from the ability of directors to manipulate the timing of the exercise of their options in order to benefit from favourable stock market conditions that have nothing to do with their own performance. The Greenbury Committee (1995, section 6.28) similarly cited what it referred to as "windfall gains" as a key disadvantage of options as a form of remunerating directors. However, Hall (1997) acknowledged this disadvantage of options but still favoured their use over shares as a means of rewarding directors, observing that a properly structured option scheme can provide the leverage of a share scheme but at a lower cost to shareholders. On a related matter, Jensen and Murphy (1990b) questioned the value of shares as a means of motivating directors towards desired performance. Studying the behaviour of CEOs in large US companies, they concluded that, in order for this form of reward to affect performance, CEOs need to own a substantial amount of the company's shares.

A further issue relating to the use of share options is the tax environment of the company and the directors. Main (1997), for example, has traced the history of the use of share options in the UK and has noted that companies' propensity to use options has changed over time with changes in tax rules. Similarly, Main, Bruce and Buck (1996) have observed that differences in the tax environments of the UK and US may account for the lesser use of options by companies in the UK compared with their US counterparts. [The increasing 'globalisation' of US remuneration practices (see, for example, *The Economist* 2002) implies that differences in tax regimes may be reducing in significance, as other factors affect the remuneration debate.]

The use of share options to reward directors may also be affected by their treatment in companies' financial statements. The findings of Murray, Smithers and Emerson (1998) and Cooper and Hraiki (1998) show that the accounting treatment of options can affect reported earnings, and that if options were fully charged against earnings this could result in a significant reduction in reported net income. This factor is of particular relevance given proposals for international accounting standards to require options to be charged against income (*Financial Times* 2002). If options are to be charged against profits in the same way as other forms of remuneration, companies' decisions as to the form of payment for their directors may change to reflect fundamental issues rather than accounting convenience.

A Model of the Remuneration-Setting System

As noted earlier, prior research has focused on factors that may affect the quantum, structure and form of directors' remuneration. Little attention has been given to what Tosi and Gomez-Mejia (1989) refer to as the "black box" – the process by which remuneration committees determine their companies' remuneration policy and executive directors' packages. Other researchers have also drawn attention to the paucity of research addressing the issue of how remuneration committees reach their decisions. For example, Kerr and Bettis (1987, p.661) stated:

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

Thus, a model is proposed in this section as an initial step in explaining the remuneration-setting process. The model has been derived

normatively from a review of relevant literature and from interviews and informal discussions with individuals involved in the remuneration-setting process in UK listed companies[iv]. In advancing this model it should be noted that remuneration committees are usually aided in their deliberations by company insiders (such as HR professionals) and by outside remuneration consultants (Conyon et al. 2000; PricewaterhouseCoopers 2000). It should also be noted that the model remains to be tested in the field.

Developing the Model

The Combined Code (1998) of the London Stock Exchange specifies that:

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

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

Figure One: Illustrative Remuneration-Setting System

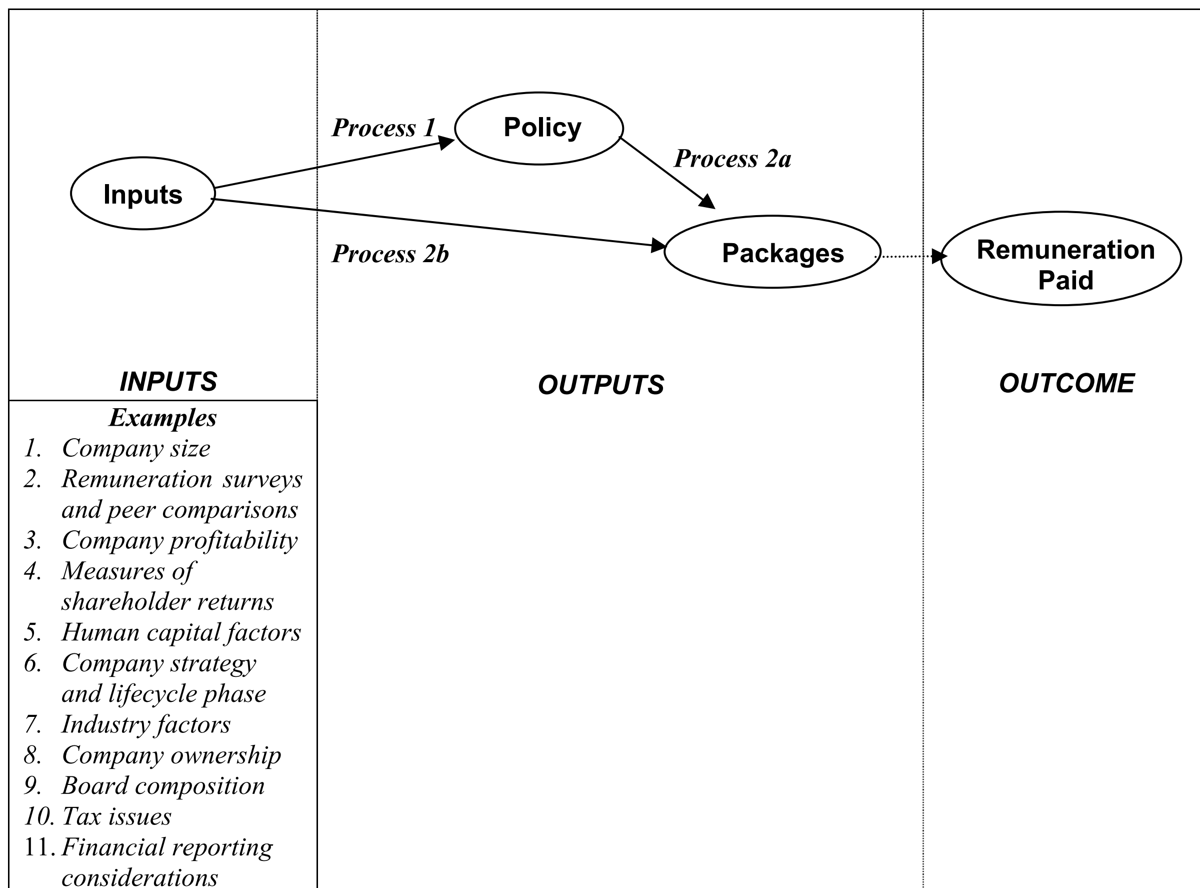


Figure One indicates that the remuneration-setting process commences with the remuneration committee gathering data (or 'inputs') to inform their decisions. Following from the discussion in section two, it is likely that these data will include, *inter alia*, information about the company's size, profitability,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

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

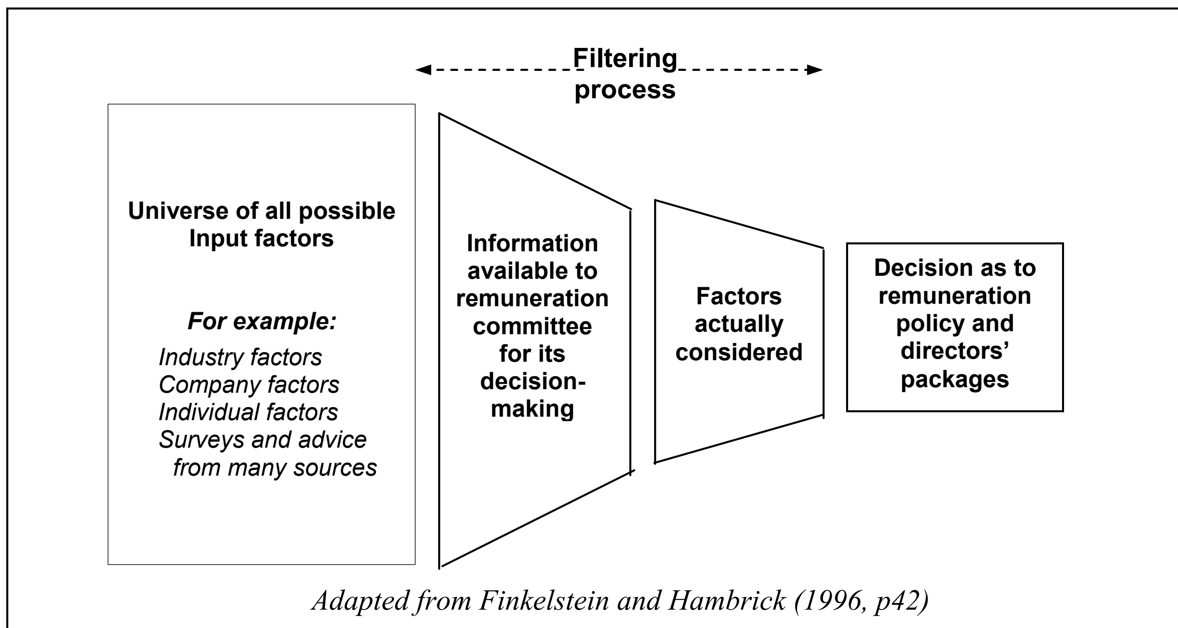
An example of bounded rationality in the remuneration-setting context is afforded by the setting of basic salary levels. As noted earlier, remuneration committees are usually assisted in their deliberations by remuneration consultants, and they also use survey data when determining appropriate salary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

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

Based on the sequence suggested in the Greenbury report (1995) and the Combined Code (1998), the remuneration committee next turns its attention to the remuneration packages of the individual directors. This represents Process 2 in the remuneration-setting system but, as Figure One reveals, it comprises two sub-processes. In the first, Process 2a, the remuneration committee applies its over-arching remuneration policy to the circumstances of each executive director. Simultaneously, the committee engages in Process 2b, that is, it considers some of the system's inputs that will directly impact individual directors' remuneration packages. For example, a remuneration committee may take into account the average level of executive directors' pay in the company's

industry (an input) when establishing its overall remuneration policy (in Process 1). Applying that policy (in Process 2a), would give an initial view of what that directors' packages should be. However, when determining the package of an individual director, the committee may (in Process 2b) consider other inputs such as the director's human capital – for instance, their age and experience, or the likelihood of their being 'poached' by a rival firm.

Figure Two: Bounded Rationality in the Remuneration Committee's Choice of Remuneration Policies and Packages



Adapted from Finkelstein and Hambrick (1996, p42)

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

Having presented the model of the remuneration-setting system, it is instructive to consider how the issues it addresses are reflected in the published remuneration reports of listed companies. The Greenbury report (1995) requires companies to publish a remuneration report that includes details of the company's general remuneration policy and the individual directors' packages. Further, it defines both policy and packages (see footnotes v and vi). However, Greenbury is not prescriptive about the format of the remuneration report, and although companies provide the relevant information in their remuneration reports, they tend not do so under the heading 'remuneration policy'. Instead, they use the phrase to cover broad general statements. This is reflected, for example, in Barclays Bank's 2001 remuneration report which states, under the heading "Our Remuneration Policy":

> *We are committed to using reward to support a strong performance-oriented culture in which excellence is expected at every level in the organisation. Employees can expect outstanding reward for outstanding performance. The remuneration policy for our executive Directors is:*
>
> - *to align the interests of employees and shareholders to create value;*
> - *to recognise excellent performance of the Group, business and individual;*
> - *to encourage the right behaviours to achieve excellent performance;*

- *that reward is to be commercially competitive; and*
- *that reward is to be transparent, well communicated and easily understood.*

The report then goes on to discuss the remuneration packages of executive directors.

This paper adopts the definition of remuneration policy use by the Greenbury report (1995). In Table Six, extracts from companies' remuneration reports are classified as 'policy' according to this meaning rather than the heading under which they appear in the relevant company's remuneration report.

Table Six provides extracts from the remuneration reports of a randomly selected sample of UK financial services companies and illustrates how their remuneration policies translate into the packages of individual directors. In the first three examples, the link between the stated policy and the directors' packages is fairly clear. However, this is not the case in the remaining two examples where insufficient detail is provided in the companies' remuneration reports to establish such a link. However, it is clear that the remuneration packages of individual directors vary, and one explanation for this variation could be provided in Process 2b of the proposed model.

Table Six: Examples Illustrating Translation of Elements of Remuneration Policies into Individual Directors' Packages

Company	Policy	Individual Packages
Standard Chartered (2000)	Basic salaries… "are reviewed annually by the Committee in relation to the latest available market data for the comparator groups…"	Executive salaries range between £305k and £606k
Legal & General (2001)	Executives are encouraged "… to grow a significant personal shareholding in the business"	The CEO is expected to hold shares valued at twice his salary; the multiple for other executives is one times salary
Legal & General (2001)	"Under the Restricted Share Plan executives may be invited to use up to half the value of their annual cash bonus to buy Legal & General shares…"	The remuneration report shows that the CEO used 100% of his cash bonus to buy shares. This was "to allow for the fact that he is no longer eligible for any new allocations under the long term incentive schemes"
Royal Bank of Scotland (2001)	The annual bonus focuses on "delivery of a balanced scorecard of appropriate Group and individual, financial and operational targets…"	No information is provided about the individual targets The bonus potential ranges from 60% to 100% of salary for different individuals, although for 'exceptional performance' bonuses of up to 200% of salary may be awarded
Lloyds TSB (2001)	The medium term incentive plan is "…subject to two performance targets based on the efficiency ratio and return on equity"	The remuneration report does not state whether the two stated performance targets apply equally to all directors The maximum award under the plan is 50% of salary for the CEO, and 25% for the other executives

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

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

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

Implications and Conclusions

The main objective of this paper was to provide some insight into how remuneration committees determine the remuneration to be paid to their companies' executive directors. It synthesises prior research in such a way as to highlight the practical issues faced by remuneration committees, and then draws on this research to identify factors that constitute the inputs to the remuneration-setting system. However, it goes beyond the work of previous researchers in that it presents a model, derived normatively from extant literature and discussions with key players in the remuneration-setting process (such as members of remuneration committees of large UK companies), to explain what may be taking place within the so-called 'black box'. It focuses on the decision processes of remuneration committees and the factors that inform the committees' decision-making. The proposed model suggests that the outcome of the remuneration-setting system (that is, remuneration paid) is the automatic result of two decision processes – the first defining the company's remuneration policy, the second determining the packages of the individual executive directors.

Such a model is of value to remuneration committees charged with determining the remuneration of their companies' executive directors; regulators who perceive the need to impose requirements on public companies in order to achieve greater restraint and transparency in respect of directors' remuneration; and researchers interested in investigating the remuneration-setting process. More particularly, the model should assist remuneration committees by providing insight into the remuneration-setting process apparently envisaged by regulators and adopted by a number of large public listed companies in the UK. Although many non-executive directors are members of more than one company's board, the way in which directors' pay is determined is often regarded as confidential, and remuneration committees

rarely know how their practices compare with those adopted in other companies. The proposed model provides a framework for remuneration committees to analyse their remuneration-setting practices and how they might be improved. Although the paper is grounded in the UK regulatory environment, its principal elements are relevant in many other jurisdictions – and, indeed, in any company where the remuneration of executive directors is determined by non-executives.

The outside world is not privy to the deliberations of remuneration committees and their advisers. However, each remuneration committee needs to address, every year, the questions that relate to the quantum, structure and form of executive directors' remuneration. They must do so while remaining cognisant of the company's changing commercial and competitive environment and the ever-increasing regulation governing the setting and disclosure of directors' remuneration. It may be anticipated therefore that all companies' remuneration committees will tend to follow a similar process in arriving at their remuneration policy and directors' packages. However, prior research in the domain of directors' remuneration has not examined such a process; instead it has focused on possible correlations between remuneration paid (the 'outcome' in Figure One) and input factors such as company size and performance.

The lack of knowledge about how remuneration committees approach their task is unfortunate. As interest in corporate governance grows, and the topic of directors' pay becomes more prominent, media comment and regulatory intervention are becoming more significant. Media comment, if ill-informed, can damage a company's reputation and thus its economic prospects. [*The Economist* (2000) provided a discussion about how press outrage about bonuses paid by Camelot (the UK lottery company) damaged the company's prospects of having its lottery licence renewed.] Equally, if not more importantly, additional regulations (such as those issued by the Department of Trade and Industry 2002) are costly and time-consuming for companies to implement. Further, if the regulations do not apply to matters that affect remuneration committees' decisions about their companies' remuneration policies and packages, and disclosure thereof, they may also be ineffective.

The paper has important implications for future research in the executive remuneration arena. It also highlights the need for further research into the significance of input factors incorporated into remuneration committees' decisions and the reasons for, and effect of, selecting such factors. It has also been noted that different constituencies (for example, non-executive directors and remuneration consultants) have different roles to play in the remuneration-setting processes. However, it remains to be investigated as to which parties are particularly influential (and at which stages) in the remuneration-setting system and the influence they may have. Given the growing concern about the quantum of executive directors' remuneration – and the magnitude of the increases they are reported to receive – research in the domain of directors' remuneration is timely and has the potential to play a significant role in shaping relevant policy decisions.

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ENDNOTES

[i] In this paper the terms 'remuneration', 'compensation' and 'pay' are used synonymously.

[ii] Implicit in the Greenbury report is that the term "Director" refers to executive directors. The report was not concerned with the pay of non-executive directors and refers separately to "Non-Executive Directors" where appropriate. The same convention is used in this paper.

[iii] Performance-related components of remuneration can be both short term, such as an annual bonus, and long term, such as a long term incentive plan (LTIP). The relationship between the performance-related components of remuneration and the basic remuneration is known as 'gearing'. In this paper, the gearing of pay and its division into short and long term elements are together known as the 'structure' of remuneration.

[iv] The interviews and discussions form part of a larger research project. Semi-structured interviews were conducted with over 20 individuals from 12 FTSE 350 companies and their compensation consultants. Interviewees included remuneration committee chairmen, non executive directors, HR directors and CEOs. Informal discussions have also been held with institutional investors and with other HR professionals.

[v] Remuneration policy: The Greenbury Committee (1995) uses this term to mean the framework within which the directors' individual remuneration packages are set: the company's stance on remuneration issues. For example: positioning of remuneration relative to a comparator group; level of gearing of the remuneration; choice of performance measures; choice of performance period. (A fuller list of items to consider in a remuneration policy is provided in the Greenbury report, 1995, section C.) The same meaning is adopted in this paper.

[vi] Remuneration package: The Greenbury Committee (1995) uses this term to mean the translation of the overall remuneration policy into terms for an individual director. For example, the level of basic salary and total remuneration, performance targets, form of performance-related pay. The same meaning is adopted in this paper.