Briefing

The determination of directors' remuneration in UK listed companies

Ruth Bender
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Introduction

This report presents results from a research project designed to find out how FTSE 350 companies determine the pay of their executive directors. Directors' pay is a very visible area of corporate governance, and one which has attracted much institutional and media concern. Most of the attention has been given to the amounts actually paid to the directors; the aim of this project was to examine how those amounts were determined.

The research approach was interview-based, and is discussed in the next section. Much of the work was carried out before the government published the Directors' Remuneration Report Regulations 2002 (The Report Regulations), and it was completed before the new Combined Code was introduced in July 2003. Where appropriate, I have tried to set these findings in the context of those regulations, in order to make them more relevant to the readership.

The work was carried out in listed companies. However, the processes described are applicable also to private companies, and indeed to any organisation where non-executives are involved in determining the remuneration of executives.

Methodology

This research is based on face-to-face interviews with people involved in the remuneration-setting decision in FTSE 350 companies. There were 35 corporate interviewees, from 12 companies; additional interviews were conducted with an institutional representative and two head-hunters. The research results were validated with a focus group of remuneration professionals. The first interviews were in December 2001, and the final company interview was in May 2003. The interviews lasted between 20 and 90 minutes, the majority being about an hour. All but three interviews were taped, with transcripts of the interviews being checked by the participants for accuracy.

The original research design, determined after a review of the academic literature and preliminary discussions with consultants, institutional investors and directors, was to interview five individuals from each company: the lead human resources (HR) professional, the CEO, the chairman of the remuneration committee, another non-executive director (NED) on the committee, and the consultant who advised on the remuneration. By interviewing these five individuals it was anticipated that a more complete picture of the process could be obtained than would be gained from just one interview.

In the event, the research design had to be altered to accommodate the willingness of companies to participate and the availability of different individuals for interview. Five companies only agreed to one person being interviewed. One company dropped out of the research sample after becoming involved in a significant corporate transaction. Another company agreed to participate fully but ultimately failed to make individuals available for interview.

Table 1 shows, for the corporate interviewees, the number of individuals by job category and by company.

Table 1 Details of company interviewees

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

Of the companies, four are utilities and eight are from other industrial sectors. At the time of the interviews, three of the companies were in the FTSE 250, nine were in the FTSE 100.

The individuals interviewed had wide experience, many being executive and non-executive directors of several companies, with the consultants, obviously, servicing several clients. Where appropriate, their comments on companies other than the 12 have been incorporated into this report. The HR professionals included seven HR directors (only one of which was a main board position); the rest were senior managers. The five consultants interviewed between them represented four different consultancies.

Some background on executive pay

The typical executive director of a UK listed company will receive a substantial remuneration package comprising several different elements. These will generally include a basic salary, an annual bonus award, a longer term award (often a share option scheme, a long-term incentive plan (ltip), or both), perks and a pension. This research project was focused on the first three elements of the package, not covering perks and pensions.

Of the package, the base salary is regarded as the fixed element, and the others are variable, in that the amount received by the executive varies with performance. For several years it has been seen as best practice for a certain amount of the pay to be variable.

The ways in which companies structure these elements of their pay vary considerably. The Appendix to this report sets out some of the practices seen in the case companies.

How companies determine directors' remuneration: the decisions

Two decisions need to be made in determining directors' pay: How much?; and How?

Remuneration committees have to determine the level of pay that they would expect an executive to earn for delivering on-target performance and also decide an appropriate structure for that pay. In this section are set out some of the findings on how these decisions are addressed. Although in practice there will be some interplay between the decisions, they are considered separately here.

How much to pay?

In considering the level of pay, remuneration committees have regard to the amount needed to attract and retain good directors. Therefore they will look to 'market rates' for companies of similar size and characteristics as a benchmark for their base salary levels and their total remuneration package.

In establishing an appropriate market rate, the committee will generally consider survey data supplied by the HR professional and/or compensation consultants. Sources used by the companies interviewed included:

- Bespoke reports commissioned from consultants.
- Generic reports prepared by consultants showing market data. (It is customary for data from more than one consultancy to be used.)
- Data gathered by the HR professional from various sources including other companies' published annual reports.
- Data gathered informally by committee members and others (for example, the company chairman). This might arise through other directorships they hold, or based on conversations with directors of other companies, initiated specifically to discuss pay levels.

There are many providers of survey data, covering a multitude of different sources, from annual reports to proprietary databases. Issues to consider when using compensation surveys include:

- The comparators being used. In addition to a size criterion, these will often be industry-based. For example a utility will have regard to the pay levels in other utilities, a retailer will look to the retail sector. However, it is frequently necessary to cast the net wider. For example, a finance director could work in any industry, and it may be more appropriate to benchmark such remuneration against finance directors in similar sized companies, rather than just against others in that industry.
- The timeliness of the underlying data. Wage rates have their own inflation, and it is important to understand when the data were gathered, to ensure that they provide a relevant comparison.

It is essential to realise that the choice of comparators has a major impact on the level of pay that a committee selects; using a different reference point may lead to radically different pay outcomes.

Many of the interviewees discussed the way in which executive salary inflation appears to be significantly higher than wage inflation lower down the organisation. One reason for this is that most companies aim to set their executive pay at median or upper quartile compared to their peers. By definition, if some companies set pay at upper quartile, the averages increase for the next period; this ratcheting up affects all executive salaries.

Survey data can also distort the trend in pay. For example, the overall wage rise for executive directors of the FTSE 100 companies will include any merit rise given to an individual developing in his/her job. It will also be inflated by any salaries pitched deliberately high to attract new directors to join a company. Both of these have the effect of increasing the average figures, which again leads to pay inflation. One of the CEOs interviewed for the research had rejected survey data as a benchmark for an executive pay rise, pointing out to the remuneration committee that his informal soundings from peers in other companies suggested that the surveys were misleading. The company had then applied a pay rise lower than the surveys suggested as appropriate.

Factors considered in determining remuneration

The interviewees were asked, in a questionnaire, how significant various factors (suggested by the academic literature) were in their decisions. Table 2 sets out the average rankings (out of a maximum of 5) of importance.

Table 2 Factors affecting remuneration decisions: average ranking of importance

Influences on level of remuneration	Score	Influences on structure of remuneration	Score
Company size	4.43	Investors' views	4.25
Shareholder returns	4.38	Shareholder returns	3.95
Company profitability	4.29	Company strategy/industry	3.86
Individual directors' experience and qualifications	3.57	Company profitability	3.71
Investors' views	3.55	Company size	3.38
Company strategy/industry	3.38	Financial accounting considerations	2.86
Cash flow	2.57	Tax (for the company)	2.81
Financial accounting considerations	2.10	Cash flow	2.52
Tax (for the company)	2.10	Individual directors' experience and qualifications	2.43
Tax (for the individual)	1.71	Tax (for the individual)	2.43

Table 2 shows scores for both the level of pay and for determining its structure. It will be seen that company size is the most significant influence on pay levels; this reflects the use of market surveys, discussed above, where size is always a factor in selecting comparators. As regards deciding the structure of pay, the views of investors play a large part. The decisions on structuring pay are now considered.

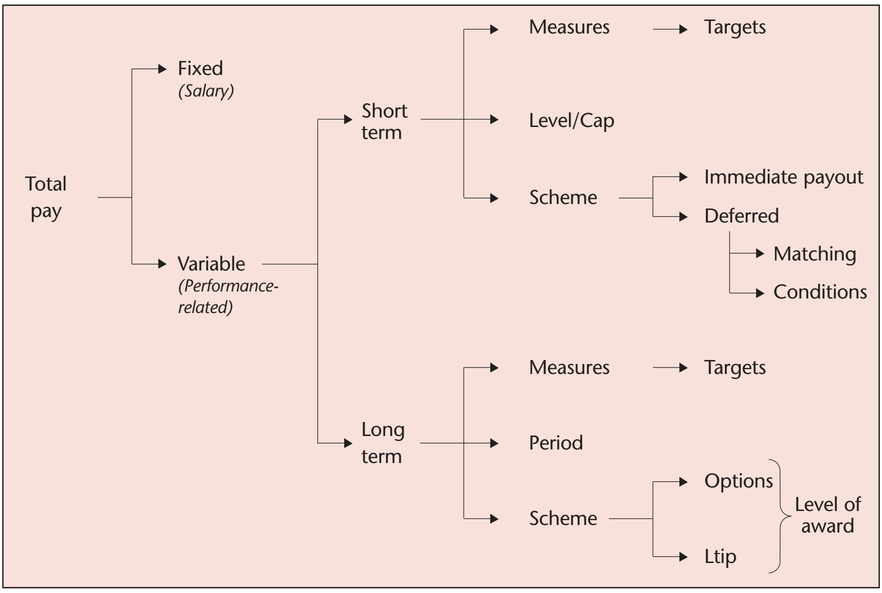
How to structure the pay?

Figure 1 below sets out the decisions that a company needs to make regarding the structure of its executive pay[1]. These are:

1. the level of gearing of the package, i.e. the balance between fixed and variable (performance-related) pay

2. the balance of the variable elements between short-term and long-term incentives

Figure 1 Decisions in structuring executive pay



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

3. for short-term schemes (annual bonus)

    a. the performance measures and targets to be used

    b. the level of bonus for target and maximum performance

    c. the type of scheme to be used (e.g. whether there is immediate cash payout, or a deferred element, and what conditions might be placed on the deferred element)

4. for long-term schemes

    a. the performance measures and targets to be used

    b. the period to be covered by the scheme

    c. the scheme design – for example, a share option scheme or another form of ltip; the amount of options/shares to be awarded.

These decisions are not made independently; there is considerable interplay in the design of all the elements, as the overall package has to work in the context of the company's strategy. In particular, the short- and long-term schemes must be integrated to provide a consistent incentive. In both long- and short-term schemes, interviewees considered the selection of performance measures and targets to be a key issue in determining the success of the scheme.

In this section the structuring decisions are discussed, particularly the aims of the remuneration committee and the way in which they make their choices. The Appendix puts this discussion into context, setting out the range of schemes and measures used in the case companies.

The balance between fixed and performance-related pay

As stated earlier, it is seen as best practice for companies to use an element of performance-related pay (PRP) in their executive remuneration packages. The requirement to do so has been a feature of governance regulations since the Greenbury report (1995). The Combined Code (2003) strengthened this requirement, stating in principle B that 'a significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance'.

In order to probe the 'taken-for-grantedness' of using performance-related pay, all the interviewees were asked why they used PRP. Their responses fell into two categories – those who used variable pay for what might broadly be called 'HR reasons', and those who did it because it was seen as good governance.

Reasons relating to the company's HR strategy were as follows.

1. *To motivate performance from the executives*. It is generally assumed that one reason for using PRP is in order to motivate a better performance from employees, encouraging them to work harder. However, the interviewees' views were mixed as to whether pay actually motivated performance at this senior level. Although some participants believed that pay did motivate, a majority asserted that at this level of the organisation other factors, such as a sense of achievement, provide the motivation, and pay is not an issue. However, all interviewees agreed that whilst pay may not motivate, a *lack* of pay certainly *de*-motivated executives. This related to the symbolic role of pay, discussed next.

2. Earning PRP is a symbol of the executive's worth. Most of the interviews saw PRP as being important as a symbol of success, rather than being valuable just in monetary terms. Top executives benchmark themselves against their peers in other companies, and being seen to earn a large bonus or options award can gratify their self esteem and demonstrate their worth. This has become even more significant given the very public disclosure of executive pay and bonuses: it's not the absolute amount of pay that is important, but the relativities to their contemporaries.

3. Provides a focus. Few of the interviewees thought that executives would work harder if they were given a bonus. However, many stated that an advantage of a bonus is that it provides focus: it reminds the CEO what the board sees as important, and demonstrates to the rest of the organisation what the CEO sees as important. Thus it is a tool for getting a focused performance out of the executives, and providing a clear message throughout the company.

4. PRP is fair. PRP was regarded as one way of providing a pay package that was fair, internally and externally. Within the company, PRP meant that individuals who had performed well were paid more than those who had not. Outside the company, PRP provided an element of fairness between executives and their peers; as executives in other companies were being given the chance to earn large sums of money through incentive schemes, executives in the case companies should have that same opportunities.

5. *PRP provides alignment.* Many of the interviewees stated that PRP was used to provide alignment between directors and shareholders. This issue is discussed later in this Briefing.

Although many reasons were put forward to explain the use of PRP, several interviewees expressed some scepticism as to its effectiveness. They stated a belief that it does not motivate at senior levels of the organisation. Additionally they pointed out the difficulties of designing a scheme that truly rewards the executives for driving business performance, whilst not creating any adverse behaviours and not being affected by external factors outside the executives' control.

Nevertheless, these companies still made use of PRP, and the interviewees invoked governance-related explanations for this. They asserted that it was adopted because it was expected by regulators and investors. It was suggested that companies adopted annual and long-term PRP schemes because they would attract disapprobation for not having such incentives in place. Conformance to 'best practice' was necessary, even though some interviewees saw no great business benefit, and recognised the difficulties in designing and implementing effective schemes.

For these reasons, HR and governance, PRP is used extensively by companies. As such, a decision the committee has to make is how much PRP to use: what proportion of the package should comprise variable pay, and how much should be fixed. Variable pay is perhaps more easily justified to the outside world, being in accordance with good governance principles and dependent on achievement. On the other hand, it is more risky for the executive.

The decision as to how much of the package should be PRP is based largely on market practice. It also reflects the company's industry and culture; some companies seek to attract individuals who will thrive in a challenging environment, working to achieve a large bonus. (Readers may note that this explanation appears to contradict the view set out earlier that pay does not motivate. This conflict was evident in the interview transcripts.)

Balancing short-term and long-term incentives

Given that a certain percentage of the package will be performance-related, the committee has to determine the balance between short- and long-term incentives. If only short-term incentives were in place, there could be a lack of long-term thinking, and a decrease in investment that might ultimately damage the company. However, focusing incentives solely on the long term carries its own difficulties: executives could turn in poor performance for several years, excusing it on the grounds that it would all come good when the 'long term' finally arrived.

The balance of short- and long-term incentives depends to some extent on industry characteristics, and the company's financial position. It also depends, as does everything else in this field, on what other companies are doing: remuneration committees are very conscious that packages need to be seen to be competitive, in order to attract and retain good staff.

It was agreed by the participants that generally short-term incentives provide a better focus for executives than do longer term ones. Over a longer time period, incentives become more blunt, and their achievement is more likely to be affected by external forces.

Companies often, but not always, use different performance measures for their short- and long-term schemes[2]. The next section discusses the advantages and disadvantages of these measures, as well as the design of the schemes themselves.

The schemes themselves: annual and long-term incentives

Performance measures

Probably the most important decision for any remuneration committee is the performance measures and targets to be adopted in its incentive schemes. These have to be relevant to the business objectives, and stretching without being impossible to achieve. Adopting inappropriate measures could drive performance in the wrong direction, destroying shareholder value.

In discussing performance measures it is useful to categorise them in two ways: team-based vs individual measures, and financial vs non-financial measures.

Performance measures can be team-based, or dependent on the individual.

[2] Some companies use eps as a measure for both short- and long-term incentives. The logic of this is that any accounting manipulation designed to increase short-term eps could have an adverse impact on the next year's eps, or on the trend in eps growth in subsequent years.

Team-based measures might include group profits, or the achievement of a customer satisfaction target, whereas individual measures could relate to departmental profit, or the completion of certain actions (such as a finance director implementing a particular new system).

The advantage of team-based measures for executives is that they emphasise that management is a team effort and they encourage co-operation. However, their disadvantage is that individuals can 'free ride' on the efforts of others, and that some people might not feel fully responsible for the performance. Often, the choice of individual or team measures comes down to the culture of the company and what is deemed as acceptable. In some of the case companies, team-based measures had deliberately been adopted as a clear demonstration of the CEO's desire to change the company culture away from one of individual achievement and towards shared responsibility and collaborative behaviour.

Performance measures can also be differentiated between financial and non-financial. Of the case companies, three used only financial measures for their annual bonus schemes, whereas nine used a mixture of financial and non-financial. (All of the companies used only financial measures for their longer term schemes.) An advantage of non-financial measures is that they can be used to balance behaviour (for example, using a target of environmental performance ensures that behaviour will not be solely driven by short-term profit targets). However, the companies that did not use such measures took this position either because they believed that financial measures – and only financial measures – were the most appropriate for their business, or because of an expressed scepticism about the difficulties of measurement and calibration in non-financials.

Performance targets

Having set the performance measures, it is necessary to set appropriate targets, which will incentivise the executives and drive performance. Targets in the case companies were set in several ways, of which the most common were: by reference to the company's annual budget; as 'timeless' goals (such as an eps growth target of 10 per cent per annum); and, for non-financial measures, by reference to regulatory requirements. For long-term schemes with an eps growth benchmark, the lower level of the growth requirement was often set by reference to market practice – it is very common for schemes to start to vest if a company grows eps annually by 3 per cent above the inflation rate. There was no evidence that this level had been set by reference to the cost of capital and the profit needing to be earned to generate value for shareholders.

It can be difficult for non-executives, at some distance from the day-to-day workings of the company, to ensure that the chosen targets are suitably stretching, yet achievable. Most of the NEDs interviewed agreed that this was an issue, and stated that it was vital that there be a level of trust between them and the executives, otherwise the system could not work.

Setting the level of bonus

It is customary for companies to set bonus levels as a percentage of salary, with a policy, for example, of paying a bonus of 50 per cent of salary for on-target performance and 70 per cent for exceptional performance. Performance below target would attract a lower level of bonus, with a cut off point below which no bonus would be payable.

Market factors proved to be a significant influence on bonus levels, in the same way that they were on pay levels generally. If most of the companies in the peer group (which may be an industry group or a FTSE index) were setting the bonus cap at 50 per cent of salary, the remuneration committee felt a need to match that level. As some companies will inevitably pay more than the market in general, the level of bonus opportunity ratchets up in the same way that salary levels increase each year.

Industry characteristics have an influence on bonus levels, because executives' individual performance will have a different impact on corporate performance in different environments. It is common to see a utility, with a significant level of assets in place, having a lower bonus potential than a company in a high tech industry. The latter needs to attract people who are prepared to work in such a turbulent environment, and who seek rewards proportionate to that risk.

Another observation on bonus levels is pertinent. A company's remuneration policy will state the potential bonus in terms of the maximum percentage of salary that an executive could earn for high performance. However, for an executive (and for investors) what is significant is not the level of cap, but the amount of bonus likely to be paid. A company with a bonus potential of 70 per cent and a record of paying bonuses of about 30 per cent is not as generous as one with a cap of 50 per cent that regularly pays out that full amount. The way in which performance measures and targets are set will significantly impact the bonus payment.

Choosing the type of scheme

The mantra behind every remuneration committee's choices is 'attract, retain and motivate'. Companies need good executives, and it is important to remuneration committees that those executives see the chance to earn high remuneration for achievement. But they also need to be able to justify their choice of scheme to the outside world, in particular to the increasingly vocal institutional shareholders. Accordingly, it is necessary to demonstrate alignment of executives with the shareholders' goals. The choice of scheme parameters is one way of doing this.

It will be seen from Figure 1 that there are several decisions to be made as to the structure of both short- and long-term schemes. The Appendix gives some of the detail behind those schemes, illustrating the sort of policies in use. This section sets out some of the issues considered by companies in making those decisions.

- There is a distinct tendency for companies to adopt schemes that are already in use in other companies, rather than to be trend-setters in designing novel schemes. Part of the reason for this is the fear of adverse media and institutional reaction to new schemes, which may not be fully understood. There is an assumption in many companies, particularly the utilities (who suffered from the 'fat cat' scandals of the mid-1990s), that introducing a novel scheme could damage the company's legitimacy in the public eye. Having said this, some of the comments received suggested that NEDs would be more open to suggestions of different schemes than either the HR professionals or the consultants believed.

- One measure of the alignment of directors with shareholders is the level of the director's shareholding in the company. Two of the case companies had a requirement that directors hold shares equivalent to a certain multiple of salary, and in two other companies executives could only participate in the ltip if they held shares. Two further companies had a voluntary guideline for executive ownership. For those companies with no shareholding requirement, in some cases executives already held a lot of shares (received through earlier long-term incentive schemes).

- Nine of the companies encouraged share ownership through a bonus scheme whereby all or part of the bonus was invested in company shares, held for a period. In seven of these, deferral of part of the bonus was compulsory; in the others, it was at the executive's discretion. Again, the reason given for using these schemes was to create alignment between executives and shareholders.

- In making the choice between using an option scheme or an ltip (or both) remuneration committees were mindful of market practice. It is common practice (followed by about two-thirds of companies) for ltips to use total shareholder return (TSR) as their main performance measure, and options to use eps growth. Often, it appeared that companies had chosen an ltip because they preferred TSR, or an option because they liked eps, rather than for reasons to do with the schemes themselves. They were also conscious of market trends – share option schemes were out of favour after the Greenbury and Myners reports in 1995; they started to feature again in the late 1990s, and it is now becoming common to see companies having both types of scheme available for their executives, albeit only using one scheme in any one year. This is reported to give operational flexibility. Having both schemes available also means that the company does not need to go back to shareholders for approval if it wants to change the scheme in use.

- Committee members were very conscious of the difference between executives owning (restricted) shares and owning options. Shares were perceived as creating more alignment, although they were also seen by some as being 'options at a zero exercise price'.

- Although schemes are designed to 'attract, motivate and retain', many interviewees were conscious of the fact that unvested options and restricted shares act as a retention tool only to the extent that a prospective new employer will not be prepared to buy them out.

- Many of the participants emphasised the fact that incentive schemes needed to be simple in order to be understood by the participants, and therefore to be effective. They commented that schemes where performance is benchmarked by TSR can be too complex to act as a true incentive.

How companies determine directors' remuneration: the process

The previous section discussed the decisions that have to be made in determining executive compensation. These decisions need to be made in every company. However, the way in which they are made differs considerably between companies.

The protagonists in the remuneration-setting decision include the remuneration committee, the HR professional, the company's chairman and its CEO, and the consultants employed to advise the parties. The company secretary may also play a significant part, administering the committee.

In some companies it was clear from the interviews that the main force behind decisions was with the remuneration committee. In others it became evident that although all the corporate governance boxes could be ticked, the source of influence was the executive rather than the committee chairman and the non-executives. Some ways in which this might be determined are set out below.

1. Who sets the agenda for committee meetings?

The nature of the remuneration committee's work means that at the start of the year a draft agenda can be prepared, to align with the corporate cycle, dealing with standard issues such as pay rises, bonus and option awards, etc. It makes sense for this standard work to be mapped out by the HR professional or company secretary supporting the committee. However, during the year other issues will arise. In some companies the agenda for each meeting was drafted by the HR professional and then forwarded to the committee chairman for approval or amendment. It may also have been sent to the CEO or company chairman at the same time. However, in other companies the draft agenda was dealt with by the HR professional and CEO, with the committee chairman having little input into what was discussed by the committee.

2. How many meetings are there a year?

The number of remuneration committee meetings in the case companies varied between two and 10 a year. Whilst 10 meetings might be seen as excessive (although some of them were ad hoc, lasting only 20 minutes at the end of a board meeting), the complexity of executive remuneration suggests that it would be difficult for a committee to do it justice in only two. In companies which had very few meetings, a substantial amount of discretion was given to the HR professional, who tended to work closely with the CEO.

3. Who employed the consultants?

The Report Regulations state that companies should name the consultants used to advise the remuneration committee and should state whether they were appointed by the committee. Committees should consider how involved they have been in this appointment. In some of the companies interviewed, the committee members made suggestions as to which consultants should be included in the beauty parade to decide advisors, and they themselves then conducted that beauty parade and set terms of reference for the consultants. In others, the choice of consultant was largely down to the preference of the HR professional, with little committee input. Nevertheless, the 'formal' decision was taken by the committee, which could then report that it had made the appointment. The remuneration reports of these companies read the same, but qualitatively there was a significant difference in process.

4. Who attends the meetings?

In many companies it is customary for the CEO to attend remuneration committee meetings except when his/her own remuneration is being discussed. Executive pay is an important HR issue for the company, and it makes sense that the CEO have a say in the pay strategy, stating what is needed operationally in order to achieve objectives. Likewise, it is appropriate that the company chairman has an involvement, and he or she may also attend meetings. However, committee members need to consider whether the decisions they make are unduly influenced by these attendees at their meetings. They should also consider whether it would be worthwhile to have meetings of just the committee members, without any executives being present.

5. Who drafts the published remuneration report?

The Report Regulations state that it is the duty of the directors to prepare the remuneration report; the directors as a whole, not just the remuneration committee. Nevertheless, as the party most closely involved in the setting of executive pay, the remuneration committee (and particularly its chairman) should give close attention to the drafting of this report. Practices seen in this research ranged from one company where the report appeared on the agenda for several consecutive meetings, in various stages of draft, through to another where the almost-final report was given to the committee chairman a few days before the printing deadline.

It is worthwhile to make one final point regarding the process of determining directors' pay. This is a very complex area and it is difficult for a layman to maintain an up-to-date knowledge of market practices, tax and accounting implications, and the advent of new schemes into the market. Nevertheless, members of remuneration committees should spend time upgrading their skills in this area. Supporting principle A5 to the Combined Code (2003) states that directors need to update their skills in order to fulfil their roles on board committees. Several of the NEDs and committee chairmen in this study had attended seminars on executive remuneration, given by compensation consultants, or had read around the area.

Implications of this research

Given the research findings discussed above, what does this mean for practitioners, both executives and NEDs? Well, the first thing to point out is that when looking at executive pay there is no right answer. Many different schemes are in operation, and each has to be tailored to suit the strategic and operational needs of the particular company, and the characteristics of its executives. Remuneration committee members need to understand the possibilities available to them, keep an open mind on what might be appropriate, and be prepared to change their remuneration schemes as the company's strategy alters to meet a changing environment.

The second point that comes across strongly is that executive pay is very clearly based on 'the market'. The market is not clearly defined – it represents the companies or individuals against whom a firm benchmarks its pay. What is crucial to understand is that the choice of comparators will influence the ultimate pay packages selected. Companies should ensure that they receive information from a wide variety of sources and that they have a valid reason for the selections they make.

A third finding of this research was that remuneration committees are all different. Every company in this project complied with governance regulations. However, the ways in which they operated varied greatly. In some companies the non-executives took the lead in matters of remuneration; in others it was very clearly an executive-driven process. However, in all cases the published remuneration reports could state compliance. This has two implications. Firstly, members of committees, and the staff that support them, should give consideration to how those committee actually operate, and whether processes need to be improved. And secondly, it implies that further layers of regulation may not serve a useful purpose. Regulation can be useful to set minimum standards, but once these are implemented it is impossible to regulate the human relationships that underlie the committee structures.

Appendix A: Features of the schemes in use in the case companies

This appendix sets out some of the features of the pay policies and packages in use in the case companies.

Base salaries

Set by reference to 'the market', which is benchmarked in terms of size (determined by turnover or market capitalisation), industry and FTSE sector. All of the companies had a policy of benchmarking at median or upper quartile. In practice, the term 'median' can mean +/- 20 per cent of the calculated median point; the salary point chosen depends to some extent on where salaries currently lie.

Annual bonus schemes

- Cash bonus, the amount potentially available being based on a percentage of base salary. Often, the bonus available to the CEO is greater than that available to other executive directors.
- Often, part of the cash bonus may or must be deferred. Deferred bonus is used to buy shares in the company, which will vest after two or three years. Some companies have an additional performance condition on the vesting (such as eps growth); others do not. Many companies will match the executive's investment in such shares, granting additional shares. Such matches are often on a 1:1 basis, with the company giving an additional share for each share acquired with the deferred bonus. Some companies match net:gross (i.e. the company invests an amount equivalent to the gross bonus that the executive had to earn in order to buy the shares out of his/her net.) Matched shares are forfeited if the executive leaves the company during the vesting period.
- Sometimes part of the bonus is placed into a bonus bank, with one third of the bank balance available for withdrawal each year.
- In most companies, bonus is not pensionable.

Longer term schemes

Options

- Annual grant of share options at current market value. The amount of the grant is based on a multiple of salary and/or performance in the year.
- Vesting is generally after three years, subject to a minimum performance condition. The amount of options that vests will depend on the performance achieved; for example, only 30 per cent of options may vest if eps grows at RPI+3 per cent, rising to full vesting for growth at RPI+8 per cent.
- Some companies allow retesting of performance conditions at four or five years if the minimum target is not met after three years.
- Most, but not all, options have a 10 year life.

Ltips

- Annual award of restricted shares. The amount of the award will be based on a multiple or percentage of salary and/or performance in the year.
- Vesting after three years based on a performance condition. (Vesting on a sliding scale, similar to that for vesting of options.)
- Some companies allow retesting of performance conditions at four or five years.

Performance measures in use

For short-term schemes:

- Various, including: business unit financial targets, sales value, group operating profit, new business contribution, cashflow, personal targets, health and safety targets, risk targets, strategic objectives, EBITDA[3], cost control, financial ratios, environmental targets and corporate social responsibility targets.

For long-term schemes

- TSR (total shareholder return) relative to a peer group, or relative to a combination of peer groups. Generally, no vesting will occur if performance is less than median compared to the group; maximum vesting occurs for upper quartile performance.
- Eps growth based on a percentage above inflation (an RPI+X per cent formula).
- Eps growth in absolute terms.
- Return on capital.

Share ownership requirements

- Some companies combine participation in their incentive schemes with a requirement that the executives hold shares in the company, to a value based on a multiple of their base salary. Some schemes allow for cash bonuses to be paid in shares to encourage this.

[3] Earnings before interest, tax, depreciation and amortisation.

About the author

Ruth is a lecturer at Cranfield School of Management, where she teaches accounting and finance on a range of degree and executive programmes. She is undertaking a PhD at Warwick Business School, researching the way in which FTSE 350 companies set their executive directors' remuneration.

Ruth joined the Cranfield faculty in 1994, having completed her MBA there, and having won the Henry Ford II Scholar Award as top student.

She was previously a partner in Grant Thornton, specialising in corporate finance. During her time there she undertook secondments to various organisations, including a year as an investment manager at Legal & General Ventures.

Ruth is a member of the committee of the Faculty of Finance and Management of the ICAEW, and until recently was editor of their flagship publication, *Management Quarterly*. She sits as a member of the Independent Remuneration Panel for Bedford Borough Council. She is the co-author of *Corporate Financial Strategy*, Butterworth Heinemann, 2002.

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Briefing

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