

Research report

December 2015

The power and pitfalls
of *executive*
reward: A behavioural
perspective



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Foreword

Over the past few years, the CIPD has published a number of reports to further understanding of human behaviour at work and develop guidance to improve people management and public policy decisions. This can be seen at cipd.co.uk/behaviouralscience.

Building on this programme of research, this report draws lessons from behavioural science to develop ideas on how we can better reward chief executive officers (CEOs). It does this by asking three questions: firstly, what do we need from our CEOs, in terms of behaviours, skills and motivations; secondly, how should these be appropriately rewarded and recognised; and finally, if we are not rewarding CEOs for the right things in the right way, what are the barriers preventing this and how can they be overcome?

The research team have used a variety of sources to help answer these questions, including a review of current and relevant academic literature, a stakeholder workshop, a survey and follow-up conversations with experts and interested parties. They find that there are no quick, easy and simple solutions to this complex issue, but we can be clear on some of the misplaced assumptions about how remuneration motivates CEO performance.

For example, while this study finds that there are a variety of factors that drive CEOs to succeed, the way we currently reward CEOs focuses mainly on the financial aspects and is underpinned by the limited view of principal agent theory.

This report shows that we as individuals don't respond to financial incentives in the way that traditional economic theory expects and, as a consequence, smaller, simpler and more immediate rewards for CEOs may be more appropriate than the large, complex and deferred rewards currently on offer.

Not only does the structure of reward need to change, so too do our – often unrealistic – expectations of what makes for a successful CEO and their qualities, which has implications for recruitment and selection and training and development practices. In addition, our understanding of corporate performance and how it is achieved also needs to be more fully understood.

As this study points out, the time is ripe to re-evaluate our approach to executive reward. Not only are we not rewarding CEOs for the right things in the right way, this is also sending a message to the rest of the workforce who, at a time when their own living standards have suffered since the financial crash, may feel less engaged at work because of the perceived unfair way in which rewards are distributed. We hope that this study helps inform the debate about how we can reward CEOs in a way that is good for the workplace, the workforce and the country.

Charles Cotton
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'This report shows that we as individuals don't respond to financial incentives in the way that economic theory expects.'

Executive summary

This report addresses executive rewards in the UK and beyond, exploring questions including to what extent current reward structures encourage the right kinds of CEO characteristics and how CEO reward practice may need to change in the future. The report draws upon:

- a thorough evaluation of academic literature to outline the relevant theories, research and findings, which also included a consultation of experts in the field
- a workshop and follow-up consultations with a sample of senior leaders, reward specialists and reward consultants
- a survey of over 50 top HRD specialists, reward specialists, CEOs and reward consultants.

The key findings reveal that the gap between CEO pay and other employees' pay continues to increase; even during times of economic recession this is true for baseline salaries as well as long- and short-term incentives. CEO reward is rarely sufficiently adjusted to reflect a decline in company performance, while shareholders and social influences such as board dynamics also push up rewards. Financial metrics still dominate in determining variable rewards; other measures have less of an influence and need more attention in the research literature.

A psychological and economic perspective is needed to fully understand the behavioural perspective on executive rewards. There is weaker foundation for the motivational aspects of CEO

rewards than might be assumed, as human thinking is liable to bias, including the tendency to devalue delayed rewards. Also questioned is whether those who advise on and determine CEO compensation are free from vested interests or are appropriately trained, for instance to avoid common decision-making biases.

With regards to the impact of CEOs' behaviours on rewards and vice versa, a CEO's performance varies over their tenure, with implications for selection, succession planning and reward. The literature cautions that CEOs who have more self-serving tendencies negotiate higher rewards. This report also identifies a need for rewarding more shared leadership, with a more balanced distribution of accountability and reward across the executive team. In short, the characteristics of the CEOs deserve closer attention as organisations need to profile the leaders they want now and in the future and then reward accordingly.

The report also identifies a number of barriers to change for CEO reward practice, including the social dynamics of boards and the decision-making context for remuneration committees (REMCOs), which deserve closer attention in research and practice. Organisations are likely, for instance, to set CEO rewards based on previous data without questioning the absolute levels set, increasing the likelihood of rewards increasing year on year regardless of actual performance or value created. Greater diversity

and more emphasis on coaching and organisational learning at the most senior levels are important to leverage future change. All of these initiatives should adopt an evidence-based approach, taking heed from the behavioural science literature, but also gathering local organisational data about executive rewards to ensure a wider stakeholder perspective.

The report concludes that CEO reward practice has reached a crisis point. It needs to become evidence-based, underpinned by more holistic metrics, building on sound enforceable policy to encourage sustainable business performance and a culture where organisational learning and innovation happen. These aspects are important for sustainable business performance. CEO salaries need to be commensurate to performance but not inflated. Incentives should play a smaller role and reward good performance, perhaps counterintuitively, without a long time lag, where non-financial aspects of performance need to be given greater weight in the allocation of rewards. Taken together, it is hoped that these initiatives will help to curb excess, while concurrently maximising individual and organisational performance.

Introduction

There is no doubt that the UK has witnessed examples of highly unsuccessful, if not downright destructive, CEO leadership. High-profile examples have raised questions about performance at the top, and whether current organisational practice encourages the right kinds of behaviours, attitudes and aspirations. In particular, with the size of executive rewards continuing to grow, yet for reasons not easily attributed to economic factors alone, the link between CEO rewards and their respective performance has become a topic for hot, and often fraught, debate.

Many myths surround executive reward practice, including misconceptions about the motivating value of certain approaches and decisions regarding compensation and incentives, as well as erroneous assumptions about how much effect CEOs really have in organisational performance (Dorff 2014, Pepper 2015). Social dynamics are considered to have played a role in preventing any capping of CEO pay, resulting in a situation in which *'shareholder wealth and stakeholder wealth may not march together'* (Dorff 2014, p265). As a result, calls have been made for a drastic restructuring of how CEO pay is allocated, combined with a cultural shift to encourage risk-taking and innovation and organisational learning when things don't work out as planned (Dorff 2014).

Recent work in the UK points to the need for better evidence on the drivers and consequences

of executive reward to improve sustainable solutions for the reward of executives, also questioning the link between pay and performance (Campbell and Pepper 2014). Reiterating the strong influence of social context on pay and reward, Lupton et al (2015) emphasised how the value that individuals place on rewards depends strongly on comparisons with others, highlighting the need for reward research and practice to address bias in decision-making. Unfortunately, though, the academic literature on executive compensation remains strongly dominated by economic and financial perspectives (see Pepper and Gore 2015, Pepper 2015), neglecting full consideration of the social and behavioural influences on reward considered necessary to advance the field (Lupton et al 2015). As expressed by Pepper (2015), *'The challenge now is for academics to come up with better theories of executive compensation, for practitioners to design less highly-leveraged executive reward strategies, for remuneration committees to put forward pay proposals which break out of the cycle of pay inflation, and for government and regulators to provide an institutional environment which encourages these things to happen'* (p13).

Objectives of the current report

Taking up this challenge, with the aim of generating a better evidence base for executive reward practice, the current report addresses these key questions:

- Do current approaches to CEO reward support the performance, behaviours, skills and attitudes needed for sustainable performance?
- How can we better reward chief executives (compared with current practice) to make CEO reward practice more equitable and sustainable?

Despite consensus among such interest groups as investors, the media and politicians about the need for changes in executive reward practice, much less agreement exists on how such change might be achieved. Building on earlier CIPD reports (Lupton et al 2015, Campbell and Pepper 2014), the objective of this report is to outline how CEO rewards in large firms are currently determined, structured and allocated, and to discuss the implications of this in light of evidence from the behavioural sciences and data from senior leaders, HR directors and reward specialists collected specifically for this report. We intend to stimulate debate about this important yet increasingly fraught topic, providing concrete suggestions for organisational practice and overarching policy, but also flagging where knowledge appears limited and warrants further research.

The report draws on a multi-method approach which initially focused on material relevant to FTSE 350 companies, but branched out as necessary to include organisations similar in size and other data. The overall approach is set out in Figure 1. Further details are available in a separate appendix, which can be found with this report on the CIPD website (see cipd.co.uk/behaviouralscience).

An assessment of the literature, including a consultation of academic and practitioner experts, is integrated into this report. A range of research papers were identified through a thorough screening process, prioritising high-quality peer-reviewed journal articles across different disciplines, as well as including reports such as those published by the CIPD. The findings from the literature informed topics for discussion and interaction at a targeted workshop

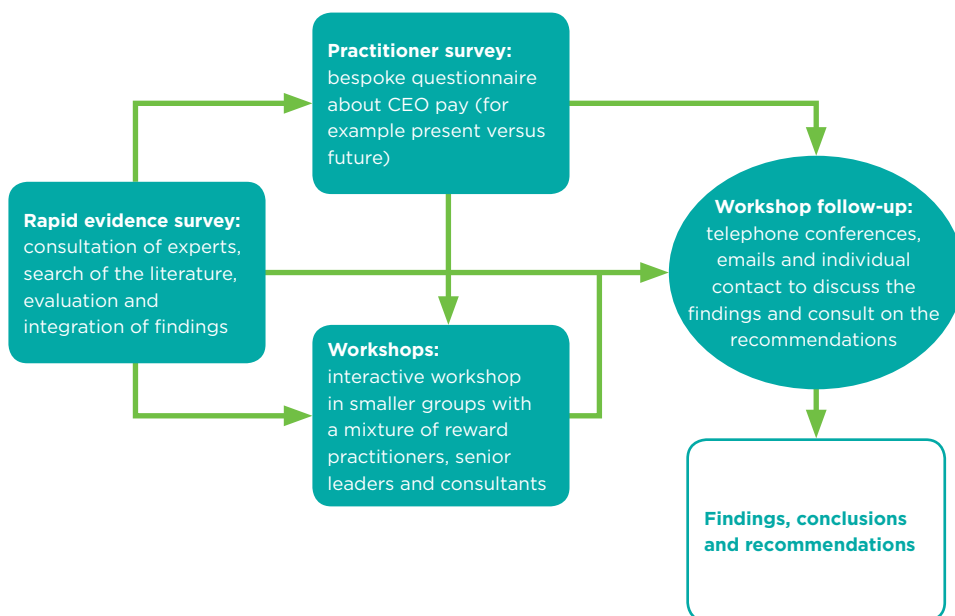
and design of a focused survey. The participants in each stage of the research were selected to represent the view of a wide range of stakeholders including reward practitioners, business leaders, consultants and investors. The in-depth workshop involved 14 participants, and 52 practitioners took part in the survey. Seven individuals with specialist knowledge, including professionals and academics, provided their comments on the findings and the draft content of this report. Further detail can be found in the appendices, which can be downloaded from the CIPD website.

The sections of the report are structured as follows:

- a summary of previous CIPD research on reward
- an analysis of how rewards are allocated in practice, including different stakeholder perspectives on reward practice

- insights from behavioural sciences research and data from practitioners collected specifically for this report, relating to the following key themes:
 - the need to understand CEO rewards in the context of time; including a long- versus short-term perspective and variations across CEO tenure
 - a consideration of CEO characteristics and the role of rewards
 - potential barriers to change, such as ‘doing what has been done before’, lack of diversity and the role of remuneration committees
- a conclusion, which identifies recommendations relating to both policy and organisational practice.

Figure 1: The research and consultation approach



An overview of current CEO reward structure and allocation

While some may take the position that CEO pay is entirely justified because of the responsibility they shoulder and the risks they take, this doesn't necessarily explain why executive pay has accelerated in relation to the pay of the workforce in general. Recent reports on executive pay trends highlight that:

- In 2000, the average FTSE 100 CEO earned 47 times more than the average full-time employee; by 2014 this had increased to 120 times more than a full-time employee (IDS 2014).
- Analysis of the 'single figure' for CEO pay declared by companies in their annual reports suggests that mean FTSE 100 CEO pay was almost £5 million in 2014 (High Pay Centre 2015).

Despite attempts to tie a greater percentage of executives' pay to company performance, some CEOs still receive weighty reward packages that are significantly out of sync with the returns delivered to shareholders. In fact, only one of the ten highest paid CEOs in the 2014 *Wall Street Journal's* annual pay survey ranked among the top 10% by investor performance (WSJ 2015). This evidence denotes a fast rate of change in executive pay over the last two decades, which can also be viewed in relation to earnings of the highest-paid employees in the UK more generally. According to tax records produced by HMRC¹ during the period 2003–12 (see Figure 2):

- The number of people in the UK earning more than £1 million increased from 4,000 in 2003 to 9,000 in 2012, peaking at 13,000 in 2009.
- The mean income of those earning more than £1 million has remained in the band £1.4 million to £1.8 million for the whole period, averaging £1.6 million and peaking at £1.8 million in 2004 and £1.7 million in 2010.

In contrast, CEO pay in FTSE 100 corporations increased from a median of around £1.4 million in 2003 to around £2.4 million in 2009 and by 2014 this had increased to around £3.3 million.²

This analysis suggests:

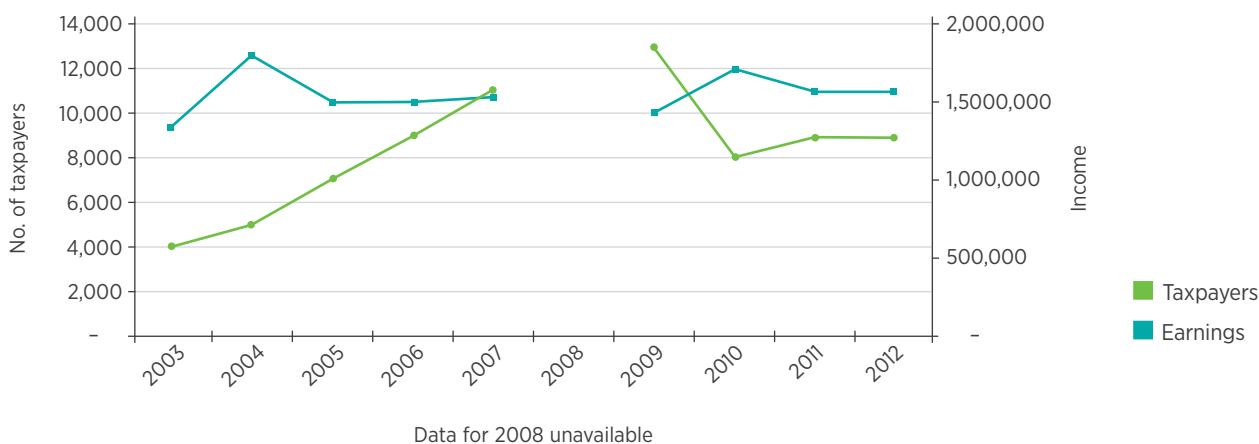
- The increasing value of CEO pay in relation to average pay can be seen in part against a background where the number of millionaire earners has increased significantly. This lends support to the premise that the UK, in common with other developed countries, has experienced a general pattern of wealth concentration.
- In 2003, CEO reward was typical of those employees earning more than £1 million per annum, but 12 years later it had reached a level where it was around twice as high as other £1 million-plus earners. Exactly why CEO pay should have doubled in relation to other high-earners in society requires further investigation.

'Despite attempts to tie a greater percentage of executives' pay to company performance, some CEOs still receive weighty reward packages that are significantly out of sync with the returns delivered to shareholders.'

¹ Personal Incomes Statistics (2003–04 to 2012–13).

² 2003 and 2004 data presented in 'Executive Remuneration' discussion paper produced by the Department for Innovation and Skills in 2011; 2014 data sourced from IDS (2015).

Figure 2: Taxpayers and earnings with income greater than £1 million per annum



The linkage between firm-level performance and executive reward is mainly achieved through short-term (annual) and long-term incentives, most commonly measured in purely financial terms. For long-term schemes, earnings per share (EPS) and total shareholder return (TSR) are almost universally present. A recent report from the High Pay Centre (2015) identified that:

- Bonus payments increased at around double the rate of (EPS).
- Only 1.3% of the disparity in payments could be attributed to differences in pre-tax profits, despite this being the main measure used in bonus schemes.
- 73% of the change in long-term incentive payments could not be credited to changes in either EPS or TSR for any year in the period 2004-13.

The authors concluded that:

‘The net result is that CEO pay growth has dramatically outpaced pay increases across the wider economy, without any corresponding increase in company performance.’

In other words, CEO pay has continued to increase, even in times of economic recession, indicating there is no direct link to company performance, an issue to which the report returns in its concluding section.

Box 1: Key terms for this section

| Term | Definition |
|--|---|
| Earnings per share (EPS) | Net income earned in a given reporting period (usually quarterly or annually) divided by the total number of shares outstanding during the same term. |
| Total shareholder return (TSR) or total return (TR) | A company performance indicator which combines share price appreciation and dividends paid to show the total return to the shareholder expressed as an annualised percentage. |
| Long-term incentive plan (LTIP) | A plan which rewards participants for attaining results over a long measurement period. For this purpose, long term generally means more than one year and typically is between three and five years. The form of payment from a long-term incentive plan is normally equity but can be cash. |
| Gross domestic product (GDP) | Represents the monetary value of all goods and services produced in any one particular country, usually calculated on an annual basis. |

Turning to the economy as a whole, comparisons between the growth of CEO pay and gross domestic product (GDP), using indices with a common base year of 2002, show that CEO pay increased some 2.25 times faster than GDP, as shown in Figure 3. The clear conclusion is that performance at both the firm level and the whole economy level fails to explain the increase in CEO pay. Therefore the inference is that other factors are at play.

The urgent need to unearth what these factors are, and to review

and identify potential alternative approaches to executive pay, is emphasised by numerous parties. Economist Andrew Smithers, for instance, argues that the design of current performance-related pay packages encourages behaviour that threatens companies' long-term market share and even the productivity of the wider UK economy (High Pay Centre 2015). Simon Walker, head of the UK's Institute of Directors, argued that it has been the *'greed of those who demand and secure rewards for failure in far too many of our large*

corporations' that has done the most damage to the reputation of business and the free market in recent years (High Pay Centre 2015). While there is much debate in the popular press regarding the controversies surrounding executive pay, there is regrettably far less talk about solutions and recommendations.

How CEO pay is determined

In order to inform the readers' understanding of how CEO reward decisions are made, the following section outlines some of the basic processes in overview.

Figure 3: Growth in CEO pay and GDP



Box 2: Key terms for this section

| Term | Definition |
|---------------------------------------|---|
| Compensation committee | See remuneration committee. |
| Duality | Situation where the CEO is also the chairman of the board. |
| Non-executive director (NED) | Director who is responsible for a range of duties and can vote at board meetings but has not been granted executive powers; some directors are elected, some co-opted. |
| Remuneration committee (REMCO) | A board committee established to ensure that remuneration arrangements support the strategic aims of a business and enable the recruitment, motivation and retention of senior executives while also complying with the requirements of regulation. |
| Remuneration consultant | Third-party experts who provide advice to the remuneration committee on compensation packages for employees, executives and directors. |
| Say on pay | A rule in corporate law whereby a firm's shareholders have the right to vote on the remuneration of executives. |

‘This report shows that we as individuals don’t respond to financial incentives in the way that economic theory expects.’

In essence, the CEO and the directors on the board (and its chairperson) are responsible to the shareholders and thus for the overall direction of the company, relevant decisions and quarterly reporting. The CEO and the chairman should have an effective relationship where the chairman can influence and persuade as necessary. Readers should note that in the US (and some other countries) it is common for the CEO to also chair the board (duality). In the UK context, the role of the chairman has changed substantially over the years dating back to the 1992 Cadbury Report. This report focused on corporate governance in the context of financial reporting and publication of relevant figures in the wake of various corporate scandals, written by a committee chaired by Sir Adrian Cadbury. The report put forward a number of recommendations for financial governance, including the division of power between senior leaders, the appointment of non-executive directors and more transparent disclosure of directors’ pay.

The board as well as the committee responsible for remuneration decisions (REMCO) may also draw on the expertise of a range of consultants, including reward consultants, who bring specialised knowledge about current reward and trends. Consultants have no voting rights for day-to-day decisions.

Under UK law,³ listed companies are required to detail the consultancy arrangements that are in place to support their executive pay structures. However, a report by the High Pay Centre (2015)

found that few companies go into detail, for instance, about what other advice reward consultants offer and how much they are paid for any other services. To provide a balanced perspective, it should also be noted that the majority is governed by a comprehensive code of practice via the Remuneration Consultants Group. The High Pay Centre recommends that disclosure of the level and compensation for involvement should be mandated, an issue we return to in the concluding section.

In theory, executive packages should be designed in a way that aligns the performance of the CEO with the organisation’s wider objectives. Executive packages that are overly focused on the short term can encourage undue risk-taking and curtail strategic perspectives (see also Campbell and Pepper 2014), whereas packages that take an overly long-term view may not sufficiently motivate current performance (see Pepper 2015, for a full discussion). For these reasons, packages generally consist of short-term incentives (salary, annual bonus) and long-term incentives (for example stock options and performance shares) as well as other clauses including details on severance agreements. A recent UK report detailing executive compensation arrangements for FTSE 100 companies shows that CEO base salaries on average account for 31% of the total package, the annual bonus for 28%, long-term incentives (LTI) for 33% and pensions for 8% (PwC 2015a). The report also highlights how the median actual bonus payout has remained stable, at 130% of the base salary.

³ Large and Medium Sized Companies and Groups (Accounts and Reports) Amendment Regulations 2013. Schedule 8 Part 3 Para 22.

Has UK policy had any impact on CEO pay?

The most recent changes to public policy introduced by the last UK Coalition Government (2010–15) have had little impact on curbing excessive executive pay to date. The Enterprise and Regulatory Reform Act (ERRA) 2013 requires UK listed companies to publish a ‘single figure’ detailing the total pay awarded for the lead executive’s position. They will eventually have to provide a figure for the previous ten years for benchmarking purposes. In addition, the ERRA also requires listed companies to hold a binding shareholder vote at least every three years, on top of the annual advisory vote on the remuneration report detailing pay over the previous year.

The Government claimed its reforms would provide shareholders with new powers to hold companies to account, while making it easier to understand what directors were earning and how this links to company performance. Launching the reforms in 2012, Business Secretary Vince Cable described the new rules as *‘the most comprehensive and radical reform of the governance of directors’ pay in a decade’*. However, there is little evidence that the status quo has been disturbed in any meaningful way by these reforms.

Analysis by the High Pay Centre of the results of FTSE 100 annual general meetings finds that the average vote against FTSE 100 remuneration reports in 2014 was just 6.5%. Just two FTSE 100 companies, Burberry and Intertek, lost the advisory vote

on the remuneration report in 2014. There has been no majority binding shareholder vote against a FTSE 100 company’s remuneration policy since the binding vote was introduced in 2013. In the US, concern about spiralling chief executive pay has culminated in new regulations being introduced that require companies to disclose the ratio of their chief executive officer compensation in comparison with the median compensation of employees – an idea that is attracting interest in the UK.

Previous CIPD reports on reward

‘Executive pay has continued to grow significantly, despite improvements to governance and transparency.’

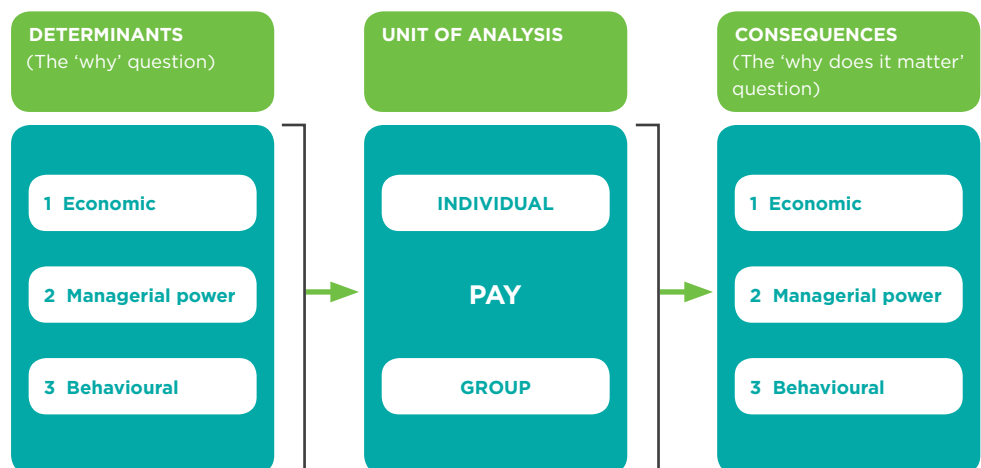
The current research builds on two CIPD reports on reward. Campbell and Pepper (2014) set out the drivers and consequences of executive reward, calling for better evidence to offer improved reward solutions for executives. The authors considered why executive packages have increased so dramatically by reviewing high-quality literature relating to determinants (‘why?’), units of analysis (pay for individuals and groups) and consequences (‘why does it matter?’), as shown in Figure 4.

The first explanation is an economic perspective with focus on **agency theory**, concerned with a financial perspective on what happens when parties in organisations have different goals and attitudes to risk. From a **traditional** rational perspective of economics (such as principal agent

theory or tournament theory), increases in pay simply respond to market trends and economic forces, including factors such as the alignment of shareholder and CEO return, foreign competition, but also a long-term and retention perspective such as providing larger amounts of equity and deferred pay than competing organisations. The evidence reviewed in the report addressing the financial perspective is complex, and findings somewhat contradictory on the link between pay and performance. Much of this is due to how pay has been researched, where ‘snapshot’ data at any point in time has been taken. Long-term analyses tracking data over time are much rarer.

An alternative explanation outlined is the **managerial power hypothesis**, where high CEO rewards go hand in hand with high

Figure 4: A model for thinking about senior executive pay



CEO influence on organisational decision-making. While intuitively it may follow that good corporate governance, with independent committees and transparent processes, should counteract unduly high compensation, evidence shows that this is not necessarily the case. Executive pay has continued to grow significantly, as shown in the previous section of this report, despite improvements to governance and transparency.

Lastly, a **behavioural** perspective acknowledges that rewards and compensation mechanisms are the by-product of complex social interactions and power balances, rather than a result of market forces alone. In reality, executive pay is set by boards and groups of people, which all have different dynamics and frames of reference. This perspective also highlights that humans are driven by a comparison with others, rather than the absolute value of rewards. In other words, it matters more that your rewards are higher than others, rather than the actual amount. For instance, ranked position in comparison with others' income predicts people's life satisfaction, whereas absolute income has no effect (Boyce et al 2010). People are also more likely to compare with those who earn more than with those who earn less. So boosting income, or indeed any other reward, will only work if the ranked position also increases.

A second CIPD report – *Show Me the Money!* (Lupton et al 2015) – on the behavioural science of pay and reward considered executive reward as one of four central themes deserving close attention, highlighting that organisational practice is in danger of repeating *'the mistakes of the past'* (p37). The authors contend that reward practice would benefit from consideration of recent advances in

behavioural science – in particular in **behavioural economics** and **neuroscience** – to understand how different types of rewards influence thinking and behaviour.

Individual and group behaviours are subject to a whole range of biases and heuristics (mental shortcuts). For instance, humans have a tendency to be overly **optimistic and confident** about their performance and ability to influence favourable outcomes.

This may be partly due to 'crowding out' effects, where extrinsic factors (for example financial rewards) diminish the influence of the intrinsic motivation for a 'job well done'. In other words, these biases will influence people's perceptions of the size and nature of rewards. Furthermore, people tend to undervalue deferred, future rewards, which may undermine the intended effect of emphasising longer-term, sustainable results. The report concludes that we need to focus on bias in decision-making processes to understand how individuals value rewards and how they make decisions, but also the crucial role of remuneration committees.

The report findings: the behavioural science literature and beyond

‘It is as important to consider not only the size and nature of CEO rewards, but also how these rewards are viewed by other stakeholders.’

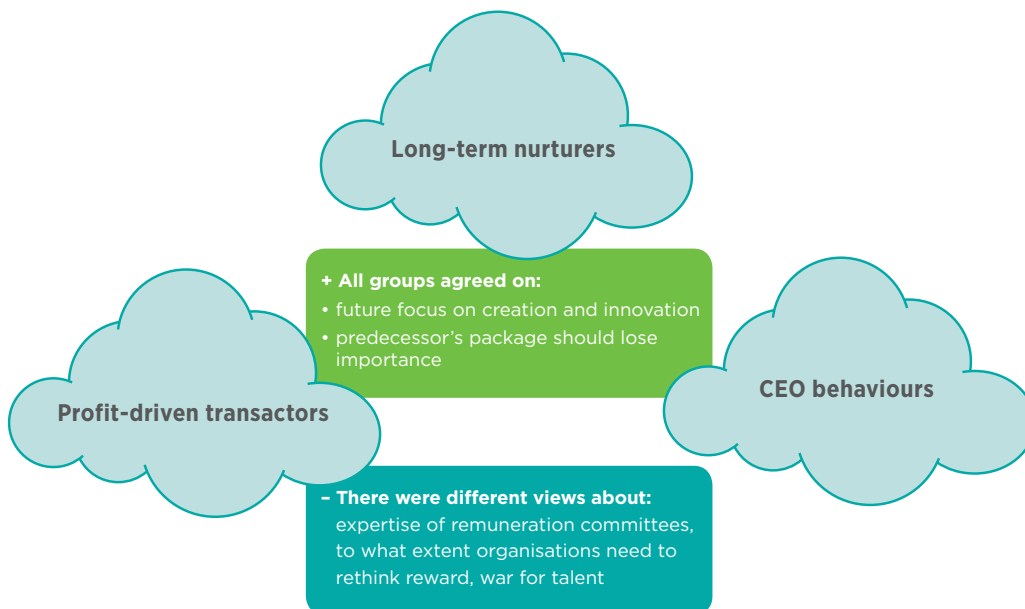
The following sections of our report detail the findings which build on the previous CIPD research to combine a behavioural science perspective with new UK-based research.

Differing stakeholder perspectives on current CEO reward

It is as important to consider not only the size and nature of CEO rewards, but also how these rewards are viewed by other stakeholders – a consideration

that has received curiously little attention in the academic literature. To investigate stakeholder perceptions, we applied the statistical technique of cluster analysis to survey data gathered from a range of practitioners. The results showed three differing perspectives based on respondents’ perceptions of rewards (irrespective of their role or function in organisations), as shown in Figure 5.

Figure 5: Three differing perspectives on CEO rewards



Box 3: Key terms for this section

| Term | Definition |
|---------------------------------------|---|
| IPO (initial public offering) | The first sale of stock by a private company to the public of shares that will be listed on a stock exchange market. |
| Institutional monitoring | The process by which institutional shareholders and their monitoring influence management decision-making. |
| Ranked position | Income (or indeed any other value) as compared with the income of others. |
| Shareholder investment horizon | The length of time for which a shareholder expects to hold an investment. |
| Venture capitalist | An investor who provides capital to start-ups or small companies that do not have access to public funding, but want to expand. |

The largest group of respondents among our sample of 50 are **‘profit-driven transactors’** – they believe it is important that CEOs generate high profit and that a short-term perspective creates wealth for shareholders. Interestingly, though, this group acknowledges that, in the future, a more nurturing and caring approach in CEO leadership is needed, alongside a complete rethink of reward structures, as REMCOs aren’t considered to have the right expertise. The second largest group are the **‘long-term nurturers’**, who think that current CEOs need to nurture and support their organisations, with a clear focus on results in the long term to create stakeholder value. The third group are the **‘CEO behaviourists’**, who believe that behaviour matters more than results to create meaning and purpose for the organisation; they also emphasise that retention factors should drive pay because they see the war for talent as a deciding factor.

Interestingly, all three groups agree that CEOs need to create and innovate more in the future and that the size and value of the predecessor’s package should become less of an influencing factor.

While this analysis is exploratory, it shows that different perspectives on CEO pay exist among key players and need to be made explicit to broaden and deepen understanding of the factors that influence CEO pay. This would be a fruitful avenue for future research, in particular on the extent to which these influence reward decisions and other outcomes.

CEO rewards considered over time

A second key theme to emerge from analysis of both our practitioner workshop and survey data identified time as an important consideration for CEO rewards, both in terms of the organisational perspective (short-versus long-term perspective) and how CEO performance varies across tenure.

Short-termism

The first proposition is consistent with existing research, which highlights the short-termism of CEOs that can be driven by shareholders. For instance, considering the financial performance of initial public offering (IPO) firms over a three-year period, on average organisations take a more long-term perspective following an

IPO, but the presence of venture capitalists (VCs) counteracts this effect (Cadman and Sunder 2014). The presence of institutional monitoring (the extent to which organisations have high institutional ownership) makes VCs less likely to shorten incentives, otherwise certain shareholders may influence CEOs’ annual horizon incentives following an IPO on a short-term basis, to the detriment of other shareholders. The implication is that it needs to be accountable and transparent, acknowledging, monitoring and, where necessary, counteracting certain shareholder influence. This aspect should be covered by company law, which puts an obligation on a director to act in the interests of all the shareholders, but it appears that the reward aspect may deserve further attention.

A reactive focus

Practitioners participating in our workshop and survey also expressed the view that a short-term focus predominates organisational reward practice, which is likely to reinforce a short-term and therefore more reactive focus among our CEOs and executives. This is, they stressed, in part driven by the process of quarterly reporting

for FTSE-listed organisations, the practice of using bonuses as rewards and a very narrow focus on financial performance measures rather than wider, more representative measures of a CEO's effects and reach, such as customer satisfaction or employee engagement. The behavioural science literature highlights further obstacles in shifting towards a long-term perspective, as individuals have an inherent bias to devalue, or even discount, delayed rewards (see Lupton et al 2015 for a full discussion of this aspect). In other words, individuals would rather receive a smaller instant reward than a larger reward in a year's time. We turn to this point in our conclusion as it also tallies with a subsequent observation (outlined below) regarding the limited range of outcome measures typically used in reward research.

CEO tenure

A second important consideration is CEO tenure, which is on average less than six years for a FTSE 350 CEO and just under five years for CEOs of FTSE 100s (*Guardian* 2014).⁴ An important question is therefore: does CEO impact change over their tenure, and should this be acknowledged in reward practice; and what happens if the effects of CEOs only become apparent when their tenure has ended? Workshop participants agreed that tenure and performance over time deserves attention, as CEOs may be 'winding down' towards the end of their tenure. This gave rise to a discussion about fixed-term contracts for CEOs rather than open-ended tenure, as well as support for clawback clauses (for example when CEOs repay a bonus already received).

Behavioural science research provides further insight into the relationship between CEO tenure and performance and reward. Considering the career histories of all board members of FTSE 350 organisations, Gregory-Smith and Main (2014) found evidence for 'settling up', where pay is adjusted in the light of both past pay and past performance. The authors argue for truly long-term incentives in the form of career shares to encourage a focus on sustainable business performance. It also appears that some aspects of a CEO's track record work to address imbalances, whereas others result in greater imbalances, '*as rich CEOs get richer while poorer ones get poorer*' (Womak et al 2011, p719).

Furthermore, Luo and colleagues' (2014) comprehensive analysis of data for 356 US companies over a ten-year period revealed a linear (direct) relationship between CEO tenure and firm-employee relationship strength, but an inverted U relationship with firm-customer relationships. The authors suggest a 'slippery slope' – when CEO tenure is too long, there are more dramatic drops, particularly in a high uncertainty industry context. It was suggested that CEOs might become out of touch during the later 'seasons' of their tenure, focusing on internal matters but neglecting changes in the external market. This implies that organisations need a nuanced view of CEO performance across their tenure, as CEOs who are in post longer may be more effective at managing the organisation internally, but must take care not to neglect firm-customer relationships. On this basis, Luo and colleagues suggest that CEO rewards and incentive plans should

encompass customer relationship metrics and external market signals.

How does current reward practice influence CEO behaviour, and vice versa?

There are two important considerations in relation to whether CEO rewards encourage the right kinds of behaviours. The first relates to current reward practice and whether it encourages the right kind of behaviours. The latter explores the characteristics of CEOs themselves and how these influence reward. The latter is important given the evidence for the effects of CEO personality characteristics on performance, the subsequent implications for selection, talent management and succession planning and, perhaps most importantly, for reward practice given current controversies.

Research shows that individuals high in narcissism are not only more likely to emerge as leaders, but among CEOs with longer tenure, more narcissistic CEOs receive bigger compensation packages (salary, bonus and stock options), have higher shareholdings, with a larger discrepancy between their total compensation and other members of the executive team (O'Reilly et al 2014).

How might CEOs go about obtaining such potentially self-serving levels of compensation? Evidence from more than 2,000 organisations (using measures about their influence and board weakness) suggests that 'rigging' may be at play (Morse et al 2014). Powerful CEOs are more adept at highlighting better-

⁴ <http://www.theguardian.com/sustainable-business/2014/oct/02/ceos-challenge-creating-lasting-legacy-sustainability-short-term>

Box 4: Key terms for this section

| Term | Definition |
|---------------------------------------|---|
| CEO celebrity | Socially constructed concept and intangible asset, usually linked to particular examples of executive leadership, as documented by various media, said to be linked to potentially profit-generating value of individual status. |
| CEO reputation | Concept that is based on CEO skill to build long-term strategic value for an organisation and enhance the external image. |
| Contingent reward leadership | This term comes from a behaviourist perspective and describes a leadership which reinforces follower behaviour through extrinsic rewards when objectives or goals have been met. |
| Core self-evaluations | A quartet of relatively enduring personality characteristics which are belief in one's capability, emotional stability, locus of control and self-esteem. |
| 'Dark side' personality traits | Negatively perceived sets of behaviours, including narcissism and other self-promoting tendencies. |
| Emotional intelligence (EQ) | Awareness of one's own and others' emotions. Depending on the specific model of EQ, this is seen as either a skill, an enduring trait or a competency. |
| Narcissism | A personality characteristic which outlines someone who has an inflated sense of their own importance, a need to be admired by others, paired with a lack of concern for others. |
| Organisational culture | Long-lasting, ingrained, often unspoken and unwritten characteristics of an organisation. |
| Shared leadership | A leadership model which considers leadership as shared between individuals, usually members of a team, and links different leadership styles to a number of outcomes. |
| Transactional leadership | Leadership style based on 'give and take' – uses contingent rewards for behaviours and focuses on day-to-day operations and management rather than long-term strategy. |
| Industry volatility | Measured through a range of indices, including variations in stock performance. |
| Transformational leadership | Transforming leaders catalyse significant change for people and organisations, by changing perceptions, aspiration and values. It redesigns perceptions and values through the leader's ability to articulate a vision and goals and lead by example. |

performing outcome measures, hence driving up their personal compensation levels. This effect accounts for 10% of the link between compensation and performance, and increases with CEO human capital and industry volatility (measured through a specific index, taking into account stock performance), but, in turn, can decrease firm value and operating performance. In other words, rigging is good for the CEO, but bad for the organisation. Furthermore, organisations appear to be quite poor at estimating the extent of their CEO's influence on organisational performance. Unfortunately, evidence using a sophisticated financial analysis demonstrates that random chance effects are regularly and overly attributed to CEO influence (Fitza 2014).

The implications for reward practice are that metrics for determining rewards need to be transparent and comprehensive enough to allow a clear understanding of the CEO's actual contribution. More fundamentally, though, organisations need to have clear criteria in place for benchmarking CEO effectiveness in selection and ongoing performance management. With regards to succession planning, Higgs and Rejchrt (2014) take a dim view based on their sample of 350 CEOs, suggesting that when CEOs are recruited internally, as they often are, they tend to be replaced with others who also match their profile. Given that performance is not only likely to vary according to CEO tenure, but the requirements for effective leadership may also have changed over a CEO's tenure, these findings stress the need to ensure robust CEO selection and succession planning processes that question implicit assumptions about effectiveness. Indeed, a recent CIPD report (Linos and

Reinhard 2015) highlighted that recruiting organisations need to move away from '*vague notions of fit*' (p4) to embrace an evidence-based perspective to selection using clear criteria, including aspirational organisational culture as well as current, to maximise effectiveness and counteract biases and stereotyping.

Financial indicators of performance

By and large, current CEO remuneration practice relies on financial indicators of performance. These may need to broaden further to encompass other metrics (PwC 2015a) that recognise and reinforce behaviours beyond profit-generation. Adding to this point is an interesting US paper that considered the CEOs of 75 major league baseball organisations and how their performance linked to performance indicators over a 100-year period (Resick et al 2015). Transformational CEO leadership (see Box 4) was positively related to independent ratings of influence, team winning percentage and fan attendance, whereas contingent reward leadership was negatively related to manager turnover and ratings of influence (whether or not the CEO has been identified as influential in an encyclopaedia of baseball). These findings reinforce the importance of using a range of performance indicators, beyond purely financial metrics, to determine CEO performance and corresponding rewards.

Another robust study, using a series of six experiments, considered to what extent the ratio of CEO wage to employees' wage make a difference to the bottom line (Mohan et al 2015). The findings show that lower pay ratios significantly enhance consumers' perceptions of products, of the organisation's warmth and competence ratings. Prices would

have to be discounted by 50% to counteract the effects of high pay ratios. Clearly, this kind of experimental evidence is hard to come by in organisational reality, but this is the kind of evidence we need to ensure that CEO and other reward strategies are based on a sound footing.

Another important characteristic is the extent to which CEOs promote shared or distributed leadership. The benefits of this approach in terms of team effectiveness are confirmed by a meta-analysis of 42 studies (Wang et al 2014), where more shared leadership shows a strong link to better team performance. It might also impact reward practice because it would suggest that there should be less focus on the performance of key individuals, in particular the CEO, and more emphasis on collective performance.

In the traditional model, where power is concentrated in a small number of key roles, the relative value of all the different functions in the executive team is difficult to evaluate on an individual basis. It is often driven by perceived contribution, which in turn is frequently a product of features of both the organisation and the role-holder(s). This differentiation in perceived contribution feeds through to reward practice and supports the significant gaps in total reward that are common today, particularly between the CEO and other members of the top team (PwC 2015a).

If a shared ownership model is adopted, it might lead to less disparity in pay levels, but there is a rationale for continuing some level of differentiation. In most listed businesses the main board comprises the CEO, the senior executive director(s) (most often the CFO) and non-executive

directors. The remaining executive directors usually help make up the executive management team that sits below the board. The nature of corporate governance suggests that those executive directors who sit on the main board carry the most responsibility and, in turn, it is arguable that those directors should earn the highest reward. As ultimately the CEO is accountable for the performance of the whole business, this supports the case for the role attracting the highest reward. The impact of the shared leadership model is therefore less likely to be about the removal of differentials and more about the impact on the size of the differentials.

Desired CEO attributes

Other differences between the current reality and desired future in terms of CEO attributes and reward were identified in our survey. More than 50 senior

professionals indicated how they currently perceive CEOs (rated on a four-point scale, from not important at all to very important; five equalled not applicable; indicated as **C for current** in Figure 6) and what they desire from CEOs in the future (rated on the same scale; indicated as **D for desired** in Figure 6). The largest differences between current and future attributes were for CEOs to:

- be more inspiring, energising and engaging, as opposed to directing and controlling
- shift their focus from deploying resources for short-term returns to the longer term
- move away from a focus merely on results (what is achieved) towards a broader focus on behaviours (how success is achieved) and place more emphasis on nurturing and supporting employees rather than organising and managing.

‘The nature of corporate governance suggests that those executive directors who sit on the main board carry the most responsibility and, in turn, it is arguable that those directors should earn the highest reward.’

Figure 6: The difference in importance between ‘current’ and ‘desired’ attributes for CEOs

| | 1 | 2 | 3 | 4 | | Shift |
|-------------------------------------|---------------------|---------------------|---------------------|---|---|-------|
| What’s in it for me? | | | C → D | | What’s in it for us? | 0.44 |
| Organise and manage | | C → D | | | Nurture and support | 0.77 |
| Shareholder value | | C → D | | | Stakeholder value | 0.60 |
| Focus on profit | | C → D | | | Focus on meaning and purpose | 0.44 |
| Inspire, energise, engage | | D ← C | | | Drive, direct, control | 1.23 |
| Focus on results (what) | | C → D | | | Focus on behaviour (how) | 0.87 |
| Analysis of numbers and information | | C → D | | | Intuition and feeling | 0.17 |
| Develop resources for the long term | D ← C | | | | Deploy resources for short-term returns | 1.04 |
| Personal strength and confidence | | C → D | | | Humility and seeking understanding | 0.50 |
| Focus on create and innovate | | | D ← C | | Focus on efficiency and performance | 0.58 |

Note: Figures in red show a shift from right to left; figures in black show a shift from left to right.

‘High salaries, and short-term bonus payments, are likely to reinforce celebrity status, rather than encourage true building of reputation.’

In addition, workshop participants engaged in an activity about CEO characteristics based on frame of reference training (see appendix for detail on this activity), whereby they were asked to propose individually, and then achieve consensus on, the five most important characteristics needed by CEOs in the future. These were identified as:

- 1 facilitators of successful high-potential teams
- 2 their ability to deliver a clear strategic vision
- 3 high levels of integrity
- 4 high emotional intelligence
- 5 focus on long-term sustainability of the business.

A topic of hot debate during the workshop was the perception that today’s CEOs feel pressure to **‘have and provide all the answers’**. Participants considered this to relate to a perceived tendency for others to **‘hero-worship’** CEOs – overly attributing successes to their individual performance. Indeed, Treadway et al (2009) cautioned that to be truly effective, CEOs should take care to differentiate between **‘reputation’**, which is based on long-term perceptions, and **‘celebrity’**, which is fleeting and socially defined, and focus their energies accordingly. Externally, they should use their social skills to create an image of competence and a compelling vision, and internally to engage and motivate employees, as well as achieving personal success. The authors argue that none of these elements work in isolation but come together to increase leader, unit and organisational effectiveness. It follows therefore that reward should be aligned with all three units of analysis. High salaries, and short-term bonus payments, are likely to reinforce celebrity status, rather than encourage true building of reputation.

Potential barriers to changing CEO reward practice

An important aspect of the analysis feeding into this report is the identification of potential barriers to changes in CEO reward practice so that these can be recognised and tackled as necessary.

Power of precedence

The first barrier is that CEO reward practice is guided by **what's been done before**, with a deep faith in incentives; as our analysis of CEO remuneration shows, this results in a year-on-year increase and little change to the constituent elements of rewards. Unfortunately, research suggests that boards with best practice arrangements – chaired and dominated by non-executive directors – are no better at enforcing CEO pay that is based on performance than executive-dominated boards (Capezio et al 2011). The authors point to the need for a 'contingency-based understanding' of board composition, giving more attention to the complex interplay between group and organisational factors, to help us better understand the processes involved in decision-making and behaviour. This aligns with the reasoning put forward by other researchers that more attention needs to be given to group dynamics in reward decisions and how these impact executive rewards (for example Lupton et al 2015).

Effects of standardisation

Other studies also warn against year-on-year standardisation. An analysis of more than 500 US organisations identified that the effects of different CEO compensation types vary across the CEO lifespan, with declining benefits

for shareholders from performance-based compensation (shares and options) but an opposite effect for non-performance-based compensation (Hou and Priem 2014). This ties in with the point made earlier that CEO reward practice needs to take account of performance over tenure and to consider potential influences of the wider economy. Although the latter assessment is clearly not easy, research involving a robust analysis of over 3,000 organisations and more than 6,000 different CEOs using a range of measures, including the value of total compensation and CEO cash compensation, indicated that incentive-based compensation strategies were not effective in the aftermath of the financial crisis (Yang et al 2014). While each of the measures had a positive relationship with firm performance before the crisis, after the crisis the data shows a negative relationship between total compensation and firm performance, and a negative relationship between both cash-based and stock-based CEO compensations.

REMCO structure and dynamics

A second barrier raised by workshop participants and survey respondents, reinforced by the literature on 'say on pay', is the structure and dynamics of REMCOs, with insufficient consideration of the social factors influencing reward decisions. For instance, an analysis of FTSE 350 data from 2003–12 showed that voting dissent (the level of agreement in the remuneration committee) plays only a moderating role in higher quartiles of rewards (Gregory-Smith et al 2013).

'An important aspect of the analysis feeding into this report is the identification of potential barriers to changes in CEO reward practice so that these can be recognised and tackled as necessary.'

Furthermore, Main (2011) and colleagues (Gregory-Smith and Main 2014) have long acknowledged the need to have both economic and psychological perspectives on CEO remuneration (O'Reilly and Main 2010). They highlight the concept of reciprocity, whereby individuals are motivated by **'give and take'**, leading overall compensation levels to rise. People are also more likely to reciprocate where transaction costs are high, the *'group continues to interact over time, the period between interactions is relatively short, and the group itself is small and homogeneous (Borcherding and Filson, 2002), all characteristics of many Boards of Directors'* (p11). Remuneration committees will also typically set executive compensation in the absence of knowing exactly what rival organisations are doing, which Main (2011) refers to as the 'prisoner's dilemma', and are therefore likely to pay above market rate. Of course, if every organisation does likewise, this has the simple effect of driving up pay further, without any advantages in terms of competing for talent (Main 2011, Pepper 2015).

The value of a 'coaching culture'

Workshop participants also highlighted the lack of a **'coaching culture'** as a third point, arguing that executives should be offered coaching and development in coaching skills, then in turn coach or mentor others. This should help to create a culture of continuous learning and reflection, where constructive challenge is encouraged, even of those in the most senior positions. Such learning may help to prevent potentially subversive practices. Workshop participants challenged whether tightened regulation on pay ratio reporting would actually improve organisational practice or merely lead to firms finding 'loopholes' such as outsourcing labour, which may affect actual figures reported.

Executive board diversity

The fourth key theme raised in the workshop is the diversity of executive boards and the influence of this on organisational culture and decision-making. Academic literature on the subject is diverse and often contradictory. For example, some research finds no evidence for a link between diversity and organisational performance (Chapple and Humphrey 2014), whereas others suggest that a higher percentage of female representation is linked to better organisational performance (Dawson, Kersley and Natella 2014).

It is not the intention of this report to paraphrase this body of work, but rather highlight some examples of the relevance to CEO rewards, which focused mainly on gender. Of course, many factors might be at play here, as neither of the aforementioned studies controlled for the actual effectiveness of individual board members.

However, there is convincing evidence demonstrating that organisations are more likely to appoint women to the board when the organisations are not performing well, a phenomenon termed the 'glass cliff' (Ryan and Haslam 2005). This is also evident in politics, where women are more likely to be selected as parliamentary candidates for marginal seats (Ryan et al 2010), and this trend therefore needs to be taken into consideration when determining rewards.

In addition, a study relating managerial bonuses to organisational performance in a matched sample of 192 female and male UK executive directors revealed that bonuses awarded to men were larger on average, but more sensitive to fluctuations in performance, than for female executives. If

organisations are biased towards greater indifference to female performance (so are more likely to recognise good performance from males), this has implications for how female contributions are recognised and rewarded. A question that remains, however, is whether greater gender diversity on boards will help to reduce these biases, or whether men and women are equally susceptible.

Other solutions to address these issues and encourage more diversity and stakeholder involvement in boards can be found outside of the UK. Boards in other countries are arguably more balanced than the UK; for instance, in Germany, the *mitbestimmungsgesetz* mandates worker representation; other EU countries such as Norway have long brought in gender quotas. Two-chamber boards are another potential solution, where one chamber is elected by shareholders (the current process) and the other chamber is selected randomly from existing stakeholders (Zeitoun et al 2014). It is tenable, but not yet tested, that such two-chamber set-ups may result altogether in more diverse boards and, as a consequence, fairer and more stakeholder-focused executive reward practice.

What needs to change?

Our survey results dovetail with the themes identified above, in terms of participants' ratings of what needs to change most. The top five aspects on which there was most consensus and most dissent (rated on a five-point scale from totally agree to totally disagree) are set out in Table 1, in ranked order.

The results show strong support for the 'ranking hypothesis' (that the comparative value of the reward matters more than the absolute size), but also that packages need to be aligned to the complexity of

Table 1: Level of consensus for how rewards need to change

| The five points on which there is most consensus | The five points on which there is most disagreement |
|--|---|
| <ul style="list-style-type: none"> The level and structure of CEO reward is driven by market practice. | <ul style="list-style-type: none"> There should be regulation and legislation of CEO reward packages. |
| <ul style="list-style-type: none"> The level of CEO reward should be led by the complexity of their roles (such as the level of international diversification). | <ul style="list-style-type: none"> Incentive-based CEO packages are ineffective in times of economic crisis. |
| <ul style="list-style-type: none"> Regular review of CEO reward using market data has the effect of ratcheting up pay levels. | <ul style="list-style-type: none"> Reward consultants have no vested interest in maintaining current CEO reward frameworks. |
| <ul style="list-style-type: none"> CEOs have significant influence over what they are rewarded for (for example growth in TSR, EPS). | <ul style="list-style-type: none"> Members of remuneration committees have sufficient expertise to make informed reward decisions. |
| <ul style="list-style-type: none"> CEOs want their packages to match or be higher than those of close competitors. | <ul style="list-style-type: none"> CEOs are primarily motivated by money and material reward. |

CEO roles and the upward influence of benchmarking comparisons. People questioned the role of regulation, rated reward consultants to have vested interests and also questioned the expertise present on remuneration committees.

Participants also commented that boards seem apprehensive about change and that REMCOs have a limited range of vision, as well as there being a need to balance short-term incentives – which are required, for instance, to attract good candidates – with effective long-term incentives – which align with business objectives. Clearly, more research is needed to explore

how representative these views are, but nevertheless the topic areas identified align with the academic literature, highlighting the importance of social and group factors in decision-making, as well as the respective merits and demerits of long- versus short-term incentives.

Finally, our survey data contrasts how CEO packages are determined now and how participants believe they should be determined in the future (as seen in Figure 7; we asked professionals to rate on a 4 point scale how important they thought each of these aspects should be now and in the future). The largest gaps emerged between

the behaviours required from CEOs now and in the future, with an increased focus on the types of behaviours and ethics that we need reward packages to foster in the future, with far less emphasis on using predecessors’ reward packages as a guide.

These findings align with the recent PwC CEO survey (2015b) highlighting how CEOs increasingly need to keep abreast of *‘dizzying changes, making the right decisions in the absence of clear data while being “truly visionary”* – but all of this with very clear emphasis on human qualities. This ties in with the previous section on the qualities of CEOs.

Figure 7: Professional views of the current and future of CEO reward packages



Summary and conclusion

The key findings from this report show the following.

Data on executive rewards

- The gap between CEO pay and other people's pay continues to increase, even during times of economic recession; CEO reward is rarely sufficiently adjusted to reflect a decline in company performance.
- CEO reward is not necessarily linked to performance, but is also influenced by organisation sector and size, as well as unknown factors.
- Shareholders and social influences, for instance board dynamics, push up rewards.
- Financial metrics are still the dominant metric for determining variable rewards; other measures have less of an influence and need more attention in the research literature.

The behavioural basis for CEO selection and reward

- We need a psychological and economic perspective to really understand executive rewards.
- There is a less strong basis for the motivational aspects of rewards than might be assumed, as human thinking is liable to bias and heuristics. We tend to devalue delayed rewards and are likely to make upward comparisons.
- It has been questioned whether those who advise on and set CEO compensation are free from vested interests, or appropriately trained, for instance to avoid common decision-making biases.

- The motivational effects of rewards need to be considered against the long-term strategy of the business.

CEO effectiveness

- CEO performance varies over time, with implications for selection, succession planning and reward.
- The literature cautions that CEOs who have more self-serving tendencies also negotiate higher rewards.
- There is a need for greater shared leadership and hence less emphasis on the figurehead at the top.

Barriers to change

- CEO rewards are influenced by what's gone on before, meaning that they are unlikely to decline.
- The social dynamics of boards and the decision-making context for REMCOs (prisoner's dilemma) deserve closer attention.
- The lack of diversity in top management teams needs to be tackled as this has implications for leadership and therefore reward practice.

Do the current ways that CEOs are rewarded support the performance, behaviours, skills and attitudes needed for sustainable performance? Essentially, the answer is 'no'! CEO reward practice needs to change, and the sooner the better. Calls for increased transparency and accountability across different sectors abound; changes need to happen at both policy and organisational level. For too long, organisations have relied on the assumption that giving CEOs more money will motivate

better performance. It is clear that this assumption is misplaced and that organisations need to look to a more differentiated approach to understanding and rewarding appropriate behaviours.

Pepper and Gore (2015) call this 'behavioural agency theory', outlining how prevalent models and practices ignore executives' motivations and preferences, but instead blindly follow what others do, or follow regulatory advice without questioning what is appropriate. The authors argue cogently that it is not practically feasible to design reward packages that incorporate **all** possible individual objectives and predict the full range of other factors that are likely to influence performance (for example changes in the wider economy). Crowding-out effects mean that extrinsic rewards will work only with proportionally ever greater increases, and deferred pay is an expensive solution.

The peer-reviewed literature and practice-based evidence show that CEOs are likely to be rewarded in line with past rewards rather than actual performance indicators. Where performance is measured, this is usually confined to organisational and financial metrics, rarely taking a wider stakeholder perspective such as customers or employees. Rewards are typically short term and few, if any, organisations have taken the concept of 'career shares' – stopping CEOs from cashing in early – to heart. That said, others caution against the potentially demotivating aspects of delayed rewards (for example

Pepper 2015). However, there should be less consideration of what has gone before in terms of reward practice and much better alignment with shareholder and wider interests.

Fundamentally, it is important to give greater consideration to who is selected to lead organisations and the dynamics of entire top teams, including the link between the board and reward committees. In other words, CEO rewards have to be considered in the context of wider organisational practice, including how they are hired and selected in the first place, how performance is gauged and how effectiveness of different processes involved is monitored and made transparent, with more emphasis on sustainable business performance.

In his recent book on executive compensation, Pepper raises many of the issues this report also brings to the forefront, including the perceived value of compensation, the role of CEO personality and motivation, and the dilemmas that organisations face. He articulates clearly that change is needed and that the present race to offer the biggest rewards to capture talent has resulted in an unhealthy competition based on many, potentially false, assumptions. As compensation committees for listed organisations continue to participate in ‘reward wars’, an illusion of best practice abounds, where few if any organisations buck the trend. Change needs to happen, and behavioural science is a good place to start for drawing up principles to underpin future change. The behavioural

science lens acknowledges the complex interplay between the factors influencing organisational decision-making, but also individual characteristics, including motivation and personality.

Pepper sets out six design principles (see Table 2) which caution against performance-related (long-term) incentives, overly complicated reward systems and badly designed executive jobs, as well as deficient selection, which encourage individuals to focus on extrinsic, but not intrinsic, factors. The findings outlined in this report reinforce Pepper’s views and call for a much greater mandate for change and transparency.

Table 2: New design principles for executive pay

| | | |
|---|---|--|
| <p>Performance-related pay can be expensive Executives will expect to be compensated with higher awards because their risk discount factors are up to 50% higher than predicted by financial theory.</p> | → | <p>Use wisely Performance-related pay is not a universal solution to the pay design question.</p> |
| <p>Deferral comes at a cost Subjective time-value discount factors are much higher than objective financial discount factors.</p> | → | <p>Use annual bonuses to signal desired behaviour Short-term incentives are much more efficient than long-term incentives.</p> |
| <p>Equity plans are inefficient The economic and accounting cost to the company typically exceeds the perceived value to the recipient.</p> | → | <p>Use sparingly Where possible, pay in cash or in other financial instruments whose value is readily appreciated.</p> |
| <p>Complexity destroys value Executives are not motivated by things they do not understand, including complex relative financial performance conditions.</p> | → | <p>Simplify performance conditions Simple but challenging performance metrics are more effective than complex relative financial performance conditions.</p> |
| <p>Fairness matters Executives assess the value of incentives and reward relative to awards made to members of their referent peer groups.</p> | → | <p>Focus on maximising total team motivation Ensure that pay differentials in the top management team are commensurate with relative contributions and hence perceived to be equitable.</p> |
| <p>Money is not everything Intrinsic and extrinsic motivation are independent constructs. Extrinsic rewards may crowd-out intrinsic motivation.</p> | → | <p>Select for character Pay attention to the qualities of the person and to the design of their jobs, not just executive remuneration arrangements.</p> |

Source: Pepper, A.A. (2015) *The economic psychology of incentives: new design principles for executive pay*. Palgrave Macmillan. Reproduced with kind permission of the author.

Recommendations for change

CEO performance is a complex issue, and so, by definition, are the corresponding rewards. The analysis presented here shows that current executive reward practice is based on misplaced assumptions about the motivating force of money. CEO reward practice also, therefore, fails to address some of the root causes of why current rewards might not have the desired effects. Organisations need to become more diverse, more embracing of shared and accountable leadership, more transparent in their reporting and more concerned with stakeholder rather than simply shareholder value. A key barrier is the lack of knowledge or guidance around how CEO rewards should be allocated in order to promote desired leadership behaviours, ethics and values, in the absence of which organisations redo what they have done before rather than strive to continuously improve. It is hoped that this report will stimulate discussion and activity around appropriate practice, even where practitioners don't agree with, or can't see how to implement, each of the recommendations.

Good practices should be highlighted and disseminated, so that organisations hungry for change can learn from effective case studies. Perhaps most importantly, all stakeholders need to take heed from the evidence offered by behavioural science. Reward practice remains curiously lacking in evidence – it's time to start now to build a solid foundation. One aspect which, before this report, no other

research has tackled (at least not in the published literature) is that stakeholders may have different perspectives on reward. Reward practice cannot change without understanding stakeholders' perceptions as both potential enablers and barriers.

More detailed work is needed on how these changes could be implemented practically, but below we draw some broad recommendations from this research regarding CEO reward practice.

Changes to public policy

The evidence suggests that changes to public policy are needed to underpin organisational change, including greater mandates for broader, more transparent reporting and consequences for organisations that do not comply. The level of consent with remuneration reports (High Pay Centre 2015, PwC 2015a) has demonstrated that complex factors are at play amongst reward decision-makers given the public debate over the magnitude of CEO pay. As outlined in this report, new regulations are being introduced in the US that require companies to disclose the ratio of their chief executive officer in comparison with the median compensation of employees. The weight of evidence shows that similar legislation should be introduced in the UK to enable the ratio between chief executive pay and the median pay of employees in publicly listed companies to be tracked over time and to encourage greater scrutiny of the individual value that chief executives contribute.

Looking at the evidence, there is a strong case for employee representatives to be appointed to remuneration committees, as advocated by the High Pay Centre, to bring fresh perspective to discussions about executive pay levels and bring a further focus on ensuring rewards are proportionate and linked to clear and measurable performance measures beyond simply the short term. As we outlined above, such representation is common in other European countries at board level. In addition, organisations must also be encouraged to report more clearly on how reward decisions are being made, and whether reward consultants have any other links with the organisation.

Finally, public policy should encourage the publication of more balanced scorecards beyond financial metrics and profit. The CIPD believes that government should introduce voluntary human capital reporting targets for FTSE 100 organisations, for example, on the total value of workforce employed (including contingent labour), investment in training and development, employee turnover costs and employee engagement data. Consistent reporting on these measures, backed up by a clear narrative, can show over time the extent to which chief executive performance is contributing to wider organisational outcomes, including how their leadership is impacting on workforce investment and well-being.

Changes to practice

Organisational practice needs to embrace the changes outlined above, but also go beyond

these mandates by improving CEO selection and performance management. Curiously little evidence is available on how CEOs are selected currently or the indicators used for selection. The selection criteria of the entire top management team should map onto explicit and relevant principles and desired organisational outcomes. A recent CIPD report on selection (Linow and Reinhard 2015) addresses some of the issues cogently and calls for more reliance on objective data and evaluation. In tandem, organisations need to address how executive-level jobs and rewards are designed to ensure that teams work effectively, in a context of shared leadership. This should curb the ‘myth of the heroic CEO’ and lead to greater accountability across the board – which should in turn equate to smaller pay gaps. CEOs should be rewarded for delegating, promoting shared leadership and for how they build the reputation of the organisation, rather than their celebrity status *per se*. There also needs to be much greater attention paid to improving the diversity of top

leadership teams to broaden the range of stakeholder opinions in executive decision-making and to avoid group-think. Dual-chamber boards may be an alternative option to traditional board constitution, where one half of the board is drawn from a much wider range of stakeholders and takes on a monitoring function. Alongside this, organisations need to train those who are in charge of reward and selection decisions to ensure a clear frame of reference and minimise bias.

Finally, executives should be offered coaching and development in coaching skills, then in turn coach or mentor others. This should help to create a culture of continuous learning and reflection, where constructive challenge is encouraged, even of those in the most senior positions, and ownership of results is shared.

The implications for reward

This report has unearthed much food for thought. The overall implication from the findings is that change to CEO reward practice is needed now. The increasing gap

in wealth-creation set out in our earlier section is not supported by the behavioural literature. Short- and long-term incentives need to change, where bonus payments should be paid ‘as it says on the tin’ – to reward extraordinary performance – rather than be paid out as a given at a level which is more than 50% of median executive salaries (PwC 2015a). It follows from our analysis of the behavioural science perspective that extrinsic rewards (for example money) are not everything. Intrinsic aspects of leadership roles need to be highlighted and rewarded to counteract ‘crowding out’. The data presented here shows that CEO pay is more influenced by FTSE rankings and size than financial performance. It follows that the link between reward and performance needs to be more transparent and include wider metrics. If these changes are successful, surely executive pay should fluctuate more than it currently does. One way of achieving this would be to have a smaller salary and a bonus structure which is linked to a range of measures appropriate to the organisation’s sector and operations.

Table 3: The now and the future for CEO rewards

| Type of reward | Now | Future |
|-----------------------|---|---|
| Base pay/salary | Substantial, particularly for high-ranked FTSE firms; linked to the size of the organisation. | Kept in proportion to the median salary of employees in general and set at a level that is socially acceptable. |
| Short-term incentive | Prominent role in CEO rewards. | Reduce size and link to transparent and simple metrics that recognise the broad church of stakeholders. |
| Long-term incentives | Prominent role in CEO rewards. | Reduce size and link to transparent and simple metrics that recognise the broad church of stakeholders. |
| Non-financial rewards | Little data available. | Encourage intrinsic motivation through rewards which encourages such factors. |

Final remarks

CEO reward practice has reached a crisis point. It needs to become evidence-based, focused on more holistic metrics, be simple yet effective and build on sound enforceable policy to encourage sustainable business performance

and a culture where learning and innovation happen naturally. Taken together, it is hoped that these initiatives will curb excessive CEO reward, while maximising individual and organisational performance instead.

Table 4: Recommendations for change

| Recommendation | Aspect | Policy | Organisational practice |
|--|--|--------|-------------------------|
| 1 Enforce measurement of comprehensive performance metrics to ensure a total reward perspective. | Mandate organisations to publish diverse internal and external performance data, including from employees and customers over CEO tenure. This should include the pay ratio between senior organisational leaders and also other employees. | ✓ | ✓ |
| 2 Reconsider the size and constitution of rewards. | Executive pay packages need to be proportional to the contribution to performance, simple to understand and implement and recognise that immediate rewards are more motivating than delayed rewards. Base salaries should be generous but not inflated, and incentives play a smaller role. | ✓ | ✓ |
| 3 Make pay ratios transparent. | Pay ratios between senior organisational leaders and other employees should be published and subjected to 'transparency checks', publicising factors which may influence the size of the ratio, such as the percentage of labour outsourced to other countries. This is likely to be challenging in practice, but has to be met head on. | ✓ | ✓ |
| 4 Increased focus on REMCOs: mandate publication of complete REMCO data, and train and develop members. | Ensure that organisations publish complete data on who is part of the REMCO, and in particular whether remuneration consultants have other vested interests (for example are consulted by the organisation on other matters, too). | ✓ | ✓ |
| 5 Consider dual-chamber boards. | Consider two-chamber boards – where one chamber is elected by shareholders (the current process) and the other chamber selected randomly from existing stakeholders – and allocate clear responsibilities. | ✓ | ✓ |
| 6 Mandate and monitor board diversity. | Organisations need to ensure diverse boards, remuneration committees and organisational leaders. | ✓ | ✓ |
| 7 Continuously improve CEO selection and performance management practice. | Use valid selection measures, including bespoke psychological profiling, to ensure that leaders are narcissistic but bring a balanced leadership style. Profile the leaders you want – think beyond the present to where the organisation needs to go. | | ✓ |
| 8 Redesign top team jobs. | Leadership behaviours can weaken over time and too much emphasis is being placed on CEOs. Ensure a job design where both intrinsic and extrinsic aspects feature highly, as in an ethical approach, and leadership and accountability is shared. This should result in more equal distribution of rewards in top teams. | | ✓ |
| 9 Profile perspectives on rewards. | Make perceptions on rewards within your organisation and beyond explicit – a good place to start is a gap analysis between the now and the future. Such data will assist to identify priorities that will provide evidence to underpin CEO reward decisions. | | ✓ |
| 10 Build coaching cultures. | Coach executives, develop their coaching skills and have them coach or mentor others to ensure that learning, innovation and mutual respect permeate practice and encourage more transformational and distributed leadership. | | ✓ |

Suggestions for further reading

CAMPBELL, R. and PEPPER, A.A. (2014) *Executive reward: a review of the drivers and consequences*. London: Chartered Institute of Personnel and Development. Available at: http://www.cipd.co.uk/binaries/executive-reward_2014-drivers-consequences.pdf [Accessed 28 September 2015]. Sets out the fundamental links between what drives executive rewards and what the results are; explains the fundamental economic and behavioural theories succinctly.

DORFF, M. (2014) *Indispensable and other myths: why the CEO pay experiment failed and how to fix it*. Oakland, CA: University of California Press. In a detailed, wide-reaching and thought-provoking historical analysis, Dorff outlines why standard theories about executive pay such as the managerial power argument are wrong.

HIGH PAY CENTRE. (2015) *No routine riches*. London: High Pay Centre. Available at: http://highpaycentre.org/files/No_Routine_Riches_FINAL.pdf [Accessed 28 September 2015]. The High Pay Centre is an independent think tank. This report outlines how performance-related pay is currently measured and modelled, provides criticisms of such models and practical concerns. It concludes with recommendations.

LUPTON, B., ROWE, A. and WHITTLE, R. (2015) *Show me the money!* London: Chartered Institute of Personnel and Development. Available at: http://www.cipd.co.uk/binaries/show-me-the-money_2015-behavioural-science-of-reward.pdf [Accessed 28 September 2015]. Wide-reaching and extensive report which outlines many of the biases and limitations inherent in human behaviour and decision-making processes.

PEPPER, A.A. (2015) *The economic psychology of incentives: new design principles for executive pay*. Basingstoke: Palgrave Macmillan. This is a very recent book which proposes a revised model for executive pay to address the links between performance of senior executives to management teams and corporate performance. It concludes with new design principles for pay.

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