

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

**AN ANALYSIS OF THE PERCEIVED EFFECTIVENESS  
OF REMUNERATION COMMITTEES IN DECIDING  
ON EXECUTIVE COMPENSATION IN  
SOUTH AFRICAN LISTED COMPANIES**

**Kenneth David Penkin**

**PNKKEN001**

**C.A. (S.A.), C.P.A. (Isr.)**

**In Partial Fulfilment of the Requirements  
For The Award of the Degree Of**

**Master of Commerce in Financial Management**

**Department of Accounting**

**Faculty of Commerce**

**University of Cape Town**

**Supervisor**

**Associate Professor Michael Wormald**

**Peter J.Cramer**

**2009**

# PLAGIARISM DECLARATION

I know that plagiarism is a serious form of academic dishonesty.

I have read the document about avoiding plagiarism, I am familiar with its contents and I have avoided all forms of plagiarism mentioned there.

Where I have used the words of others, I have indicated this by the use of quotation marks.

I have referenced all quotations and other ideas borrowed from others.

I have not and shall not allow others to plagiarise my work.

**Kenneth David Penkin**

---

## **ACKNOWLEDGMENTS**

Researching a thesis is a novel experience. The guidance of one's supervisor is of importance and fundamental to the result. There are many approaches that a supervisor can adopt. In Professor Wormald, I found someone who exhibited the strength of a wealth of experience shown in a quiet manner that instilled in me confidence to carry out a hard task. Thank you Professor Wormald. In addition I thank Mr Peter J Cramer for his inspiring and firm guidance. Many persons within the Commerce Department, University of Cape Town offered constructive advice willingly whenever asked. Their approach and experience is truly valued.

The acquisition of information from books and research articles is mainly from libraries and the internet. The extent of this information is vast and "never ending." My main source of information has come through the library services of the University of Cape Town to whom I can only pay tribute (and in particular to Susanne Knoll) for their efficient and willing attitude to assist no matter how difficult the problems. Their Knowledge Commons division has rendered to me outstanding assistance in the computer layout and design of this document, with particular thanks to Ms Nuroo Ismail.

Conducting an electronic survey is an aspect of computerisation that is seldom experienced. The facility of the Computer Department of the Commerce Faculty of the University of Cape Town in providing their programme "Select Survey" has been an essential part of the research. The application through the guidance of the Webmaster Craig Lotter without which the programme could not have been applied. I am grateful for his patience and helpfulness.

My research is carried out from my own office far from the University. The efficient operation of my own computer is essential especially as there could be down time. My friend Selwyn Yankelowitz has a vast knowledge of computers and his friendship in assisting me with my computer applications has been invaluable.

The University offer a Writing Department where Mr Oscar Msanyana provided me with stimulating and interesting guidance at various stages of my writings and research.

Friends and business colleagues have shown me support in various ways, so without detailing, I list Eliot Osrin, Showkatalie Mukadam, Robyn McGee, Jacqui Biess (my eldest daughter), Mark Swerling (of London), Jonathan Bloch (of Investec Securities), Jonathan Penkin (of Goldman Sachs, Hong Kong – my son), Frank Rabson, of Johannesburg, Beverley Penkin of Jerusalem and Tammi Forman of Cape Town.

It is always at the end that one acknowledges one's dearest whose continual support has seen me through the undertaking of this Masters. So to the one who exercised so much patience. **THANK YOU DOREEN.**

# DEDICATION

TO MY DAD

**JACK PENKIN**

o.b.m.

(1905 – 1957)

THANKS

*'Great oaks from little acorns grow'*

(14th century proverb. The Oxford Dictionary of Quotations)

\* \* \*

TO MY BROTHER

**RAYMOND PENKIN**

o.b.m.

(1937–1985)

C.A. (S.A.) (Cape Society Final Examination Prize 1959)

B.Com. (UCT) Honours in Taxation)

## **ABSTRACT**

This thesis will examine the administration of executive compensation in listed companies in South Africa in order to understand the background to the topical emotion expressed by the public about the quantum of executive earnings. The Thesis attempts to explain how approaches are made to these vast payments. It commences with the history of the management of executive compensation. Before the 1990s, disclosure of directors' emoluments was limited to one amount. Companies suffered losses due to the Agency Theory where executives dominated boards. With the introduction of remuneration committees and corporate governance, control was moved to a committee of the board of -non-executive directors (a remuneration committee). The purpose of this research was to ascertain whether such a committee is effective. Interviews were held with leading executives and an analyst. An electronic survey was dispatched to the chief executive officers and chief financial officers of a large selection of listed companies.

The results of the research are summarised and conclusions expressed on all such views with the addition of limited input of the author's views. The question requires an examination of the effectiveness of remuneration committees. Some suggestions are also made as to future research and actions which may be conducted.

This thesis shows that remuneration committees are not as effective as they should be and will explain why this is so.

# DEFINITIONS, GLOSSARY AND ACRONYMS

The research will be based on certain fundamental assumptions noted in the following definitions:

## **Appropriate Dates – Companies Act and King Reports**

At the date of submission of this Research, the Companies Act Number 61 of 1973 has been referred to throughout. The Companies Act Number 71 of 2008 has been passed but is only effective from 2010. The King Report 2 was finalised in 2002 and the King Report 3 of 2009 has only recently been issued and has thus not been taken into account, unless a specific recommendation has been considered.

## **Camouflage**

That which compensation designers do to attempt to hide, obscure and to justify the amount and form of excessive pay. (See Rents and Outrage, below)

## **CEO**

Chief Executive Officer – the head of the Executive Branch of the organisation.

## **CFO**

Chief Financial Officer. The head of all the financial operations of the organisation.

## **Chaebol**

A South Korean form of business conglomerate. The Korean word means "business group" or "trust" and is often used the way "Big Business" is used in English.

## **Compensation**

Includes all emoluments including the customary (e.g. monthly) salary, bonus, pension and medical aid contributions, use of vehicles and other assets, and all other perquisites. Share options are a separate item.

## **Corporate Governance**

“Concerned with holding the balance between economic and social goals and between individual and communal goals. The aim is to align as nearly as possible the interests of individuals, corporations and society. Corporate governance is the system by which companies are directed and controlled.” (Cadbury, 1992).

## **Executive**

Includes only those persons at the head of an organisation. Without being too prescriptive this will include the Chief Executive Officer (CEO), the Managing Director (MD) and the Chief Financial Officer (CFO). The Chairman is specifically excluded because corporate governance recommends only an independent non-executive chairman whose remuneration is not that of a full time employee and he does not have a specific function in the day-to-day operations of the firm. Thus, non-executive directors who are also in a similar position to the chairman are similarly excluded.

## **He/She - Gender**

Throughout references are made to the male firstly, as a matter of convenience; then the point has been made that a substantial majority of the executives of listed companies are male. No chauvinistic intention exists.

## **JSE**

The South African Stock Exchange formally known as the JSE Securities Exchange.

## **NASDAQ**

National Association of Securities Dealers Automatic Quotations.

An automatic information network that provides brokers and dealers with price quotations on securities traded over-the-counter. (USA)

## **Non-executive Director (NED) or Outside Director**

A member of the board of directors of a company who does not form part of the executive management team. They are not employees of the company or affiliated with it in any other way. They are differentiated from executive directors who are

members of the board also serving as executive managers of the company (most often as corporate officers). To be an independent Non – executive director there should be no business connection, for example an attorney whose firm conducts substantial legal matters, a supplier; there should be no meaningful connection through a shareholding of the director including his family, clients, family trusts. The difference between an independent non-executive director and a non- executive director is not stressed herein in order not to confuse the major issues about non-executive directors with the issues about executive directors.

## **NYSE**

The New York Stock Exchange.

## **Organisations**

Do not only refer to profit earning companies but governmental agencies such as heads of government, the judiciary and parastatals.

## **Outrage Costs**

The constraints that place some limits on deviations from arms-length contracting which would be between two independent objective parties. (Similarly see Camouflage and Rents).

## **Perks or Perquisites.**

Non - pecuniary benefits.

## **Rents**

That which managers use their power in order to secure extra value beyond what they would obtain under arms–length bargaining, due to their positional advantage. (Also see Camouflage and Outrage Costs)

## **S.E.C**

The U.S. Securities and Exchange Commission, whose mission is to protect investors, maintains fair, orderly and efficient markets, and facilitates capital formation.

**SENS**

The Stock Exchange News Service of the South African JSE Stock Exchange.

**Unitary Board**

A single board of directors rather than separate management and supervisory boards, Ideally, the unitary board would be composed mainly of independent non-executive directors. Such independent non - executive directors would mainly having the function of advise and consent (King 2002:21).

University of Cape Town

# TABLE OF CONTENTS

<b>PLAGIARISM DECLARATION</b> .....	<b>I</b>
<b>ACKNOWLEDGMENTS</b> .....	<b>II</b>
<b>DEDICATION</b> .....	<b>IV</b>
<b>ABSTRACT</b> .....	<b>V</b>
<b>DEFINITIONS, GLOSSARY AND ACRONYMS</b> .....	<b>VI</b>

## CHAPTER 1

<b>INTRODUCTION</b> .....	<b>1</b>
1.1 BACKGROUND.....	1
1.2 THE PUBLIC PERCEPTION .....	2
1.3 RESEARCH WRITINGS AND METHODOLOGY .....	3
1.4 CURRENT EVENTS.....	4
1.5 THE KING COMMISSION AND THE INTRODUCTION OF SOUTH AFRICAN REMUNERATION COMMITTEES ...	5
1.6 STRUCTURE OF THE REMUNERATION COMMITTEE .....	6
1.7 INCENTIVES.....	6
1.8 NEPOTISM AND CRONYISM .....	7
1.9 REMUNERATION CONSULTANTS .....	7
1.10 SHAREHOLDER POWER .....	8
1.11 SUBSTANCE AND SYMBOLISM.....	8
1.12 SOLVING CONFLICTS .....	9
1.13 CONTROLS .....	9
1.14 SYMMETRY OF INFORMATION .....	10
1.15 SOUTH AFRICAN RESEARCH.....	10
1.16 GOVERNMENT CONTROLS .....	11
1.17 THE RESEARCH QUESTIONS AND OBJECTIVES.....	11

## CHAPTER 2

<b>HISTORY OF REMUNERATION FROM AGENCY THEORY</b> .....	<b>13</b>
2.1 INTRODUCTION: WHAT IS AGENCY THEORY? .....	13
2.2 AGENCY THEORY AND REMUNERATION COMMITTEES.....	13

2.3 CONFLICTS .....	14
2.4 SYSTEMS TO RESOLVE CONFLICTS.....	15
2.5 MORAL HAZARD AND INFORMATION ASYMMETRY .....	16
2.6 DIRECTORS AND BOARDS .....	18
2.7 GOVERNMENT INTERVENTION.....	19
2.8 CO-OPERATION .....	19
2.9 INCENTIVES? / PERSUASION?.....	19
2.10 MOTIVATION .....	20
2.11 FROM AGENCY THEORY TO REMUNERATION COMMITTEE .....	20

### **CHAPTER 3**

<b>WHAT ARE REMUNERATION COMMITTEES? .....</b>	<b>21</b>
3.1 INTRODUCTION ON WORKINGS OF THE COMMITTEE .....	21
3.2 THE COMMITTEE OF THE BOARD OF DIRECTORS.....	22
3.3 CHARTER- REGULATIONS .....	23
3.4 NON – EXECUTIVE DIRECTORS (NEDs) .....	24
3.5 THE FUNCTIONS OF THE NED .....	25
3.6 INPUT TO A REMUNERATION COMMITTEE .....	25
3.7 THE CEO AND CFO.....	25
3.8 DUTIES OF THE REMUNERATION COMMITTEE .....	26
3.9 ATTENDANCE AT REMUNERATION COMMITTEE MEETINGS.....	28
3.10 TAKING INDEPENDENT ADVICE .....	29
3.11 POWERS, FUNCTIONS AND ACTIVITIES OF A REMUNERATION COMMITTEE.....	29
3.12 REMUNERATION AND INCENTIVES.....	30
3.13 COMMUNICATIONS REPORTS TO SHAREHOLDERS.....	31
3.14 INDEPENDENCE OF THE NED .....	32

### **CHAPTER 4**

<b>LITERATURE REVIEW .....</b>	<b>33</b>
4.1 INTRODUCTION AND PHILOSOPHY.....	33
4.2 CORPORATE GOVERNANCE .....	34
4.3 QUANTUM OF COMPENSATION.....	35
4.4 REMUNERATION CALCULATIONS AND PERFORMANCE .....	37
4.5 OWNER SHAREHOLDER CEOs.....	38
4.6 SHAREHOLDER POWER.....	39

4.7 CAUSES OF THE TECHNOLOGY BUBBLE .....	40
4.8 OPERATING ON AN AD-HOC BASIS.....	40
4.9 GREATER INFORMATION AND DISCLOSURE .....	41
4.10 REGULATORY REQUIREMENTS .....	42
4.11 INSTITUTIONAL INVESTORS AND MONITORING .....	42
4.12 MERGERS AND ACQUISITIONS .....	43
4.13 THE CEO AS BOARD CHAIRMAN?.....	43
4.14 PAY AND PERFORMANCE .....	44
4.15 CRITICISM OF NEDS .....	45
4.16 INCENTIVISATION POLICY.....	46
4.17 COLLUSION AND BIDDING UP.....	47
4.18 MONITORING ROLE AND FURTHER CRITICISM .....	48
4.19 INSTITUTIONAL INVESTORS: DEDICATED (LONG HORIZONS) AND TRANSITIONAL.....	49
4.20 LONG TERM INCENTIVES (LTI), TOTAL SHAREHOLDER RETURN (TSR) AND SUBSTANCE AND SYMBOLISM.....	50
4.21 SOUTH AFRICAN RESEARCH.....	51
4.22 A SOUTH AFRICAN CRITICAL VIEW OF THE REMUNERATION COMMITTEE AND ITS MEMBERS.....	52
4.23 INDEPENDENCE OF THE NED .....	54
4.24 MOTIVATION .....	56
4.25 AUTHORS QUOTED .....	56
<b>CHAPTER 5</b>	
<b>RESEARCH METHODOLOGY.....</b>	<b>58</b>
5.1 QUANTITATIVE AND QUALITATIVE .....	58
5.2 THE INTERVIEWS.....	58
5.3 THE SURVEY .....	59
5.4 THE RECIPIENTS OF THE SURVEY .....	61
<b>CHAPTER 6</b>	
<b>RESULTS AND ANALYSIS.....</b>	<b>63</b>
6.1 CORPORATE GOVERNANCE.....	63
6.2 SUPPORT FOR THE REMUNERATION COMMITTEE SYSTEM OVER AGENCY THEORY.....	64
6.3 SHAREHOLDERS VS. REMUNERATION COMMITTEES FOR EXECUTIVE COMPENSATION.....	65
6.4 OUTSIDE REMUNERATION CONSULTANTS.....	67
6.5 THE CEO .....	68

6.6 QUALIFICATIONS APPOINTMENT AND INDEPENDENCE OF NEDS.....	69
6.7 CRONYISM, NEPOTISM AND THE “CLUB”.....	70
6.8 COMPENSATION .....	73
6.9 INCENTIVES.....	74
6.10 SHAREHOLDERS – BOARD REPRESENTATION .....	76
6.11 AN INDEPENDENT (NED) NON- EXECUTIVE DIRECTOR AS CHAIRMAN OF THE BOARD.....	77
6.12 THE PRESS.....	77
<b>CHAPTER 7</b>	
<b>CONCLUSION.....</b>	<b>79</b>
<b>REFERENCES .....</b>	<b>82</b>
JOURNALS.....	82
BOOKS.....	86
REPORTS.....	87
ANNUAL REPORTS.....	88
<b>APPENDICES.....</b>	<b>89</b>
APPENDIX 1: FURTHER RESEARCH TO BE UNDERTAKEN.....	89
APPENDIX 2: THE SURVEY QUESTIONNAIRE .....	90
APPENDIX 3: ELECTRONIC SURVEY.....	96
APPENDIX 4: REPORT ON DIRECTORS' REMUNERATION (PEARSON PLC 2006).....	100

# CHAPTER 1

## INTRODUCTION

### 1.1 Background

A lack of controls existed over the CEO and his remuneration before the 1990s. This can be described as compensation failure. With no disclosure, shareholders were not aware of the compensation of executives. The strong CEO operated with a board that he either effectively controlled or there was no controlling shareholder or one holding a sizeable voting shareholding. When a board did not have the support of shareholders, major issues were pushed by the CEO through board meetings. The board had very little knowledge of the detailed operations of the company and was intimidated into accepting what they were told. As far as remuneration and the terms of employment of the CEO go, what was said in his contract, and what actually took place had different interpretations with the CEO being assertive on his own position. This problem relates to Agency Theory. It is dealt with in full in a chapter in this study.

According to Section 297 of the South African Companies Act, number 61 of 1973 there is an obligation to disclose in financial statements "particulars showing the amount (in total) of emoluments received by all Directors." Disclosure of individual directors' emoluments was previously non-existent. Thus, the compensation of the CEO was, accordingly, unknown. There were other decisions that could otherwise have been taken in the interests of the company. Examples would be in the acquisition of businesses where a short-term decision might be better for the CEO's personal share options (which have time limits), rather than making a long-term acquisition that would be more beneficial to the company.

In South Africa, the UK and the USA full disclosure about Executive Compensation is now required. In the USA the SEC, in South Africa it is called for by the King Report through the JSE and in the UK by the Cadbury and Greenbury commissions which were set up. The "Cadbury Committee's purpose, which was to review those aspects

of corporate governance specifically related to financial reporting and accountability” and were introduced by the London Stock Exchange, which requires complete disclosure (Cadbury, 1992.10).

## 1.2 The Public Perception

The complaints about the “grossly excessive” compensation paid to “these greedy” executives are mainly read in the print media. Such perceptions raise emotions that can fairly be described as jealousy. A balanced society is important thus, the press have a duty to guide society. Why should the person at the till of Woolworths earn, say, R 35 000 per annum whereas the chairman’s compensation package may be some R 6 million? Are two human beings so very different? That is not a subject for this treatise but it is important when the remuneration committee considers the vast differences that cause this emotion. This was expressed in a 2006 study, Remuneration of Chief Executive Officers: An overview of JSE listed companies, (National Union of Metal Workers of SA, 2006) Solidarity, a trade union movement which found that

*As at the end of 2005, the average Chief Executive Officer (CEO) of a company listed on the Johannesburg Stock Exchange (JSE) earned between R 3 and R 4 million per year or between 35 and 53 times the total remuneration of the average worker;*

*The average basic salary of a CEO ranges between R 1, 5 m and R 1, 7 m per month (sic);*

*Basic salaries of CEOs increased by an average of 18, 5% between 2004 and 2005; and,*

*No direct relationship could be established between the company profits and the salaries, bonuses and total emoluments of CEOs.*

Even at executive level, at interviews conducted for purposes of this research, it was related to this author, that executives would have a great interest in the annual published reports of their competitors, not only to examine their competitive trading

results, but also in order to compare (emotionally) the emoluments paid to executives with their own earnings.

Trade unions carefully watch results and rates of increases in executive compensation can thus be a factor in negotiations. Kantor (2006:2) verified this to the author. These problems do not simplify the task of the remuneration committee in making compensation decisions.

### **1.3 Research Writings and Methodology**

This thesis will take the reader through an examination of research writings on remuneration committees reporting on interviews held with a variety of persons.. An electronic survey was conducted in which executives of listed companies expressed their views, which views will be analysed and presented to the reader.

The intention is to present the reader with a balanced view on the perceived effectiveness of remuneration committees of listed companies in South Africa and to ascertain whether the research can add knowledge and contribute to the betterment of economic and employment conditions in South Africa.

Whilst the main question asks whether remuneration committees are effective, the 'supplementary questions' asked are:

- Whether the perception of remuneration committees and the reality are the same thing? (Symbolism versus substance)
- How remuneration committees are constituted?
- How well and what are the qualifications of the members?
- What is their structure and what are their functions?
- What research says about how effective they are?
- What our own research methodology proves against what research writings advise on?

The “conversion” from the agency problems (lack of controls) shown in the Agency Theory over to the systems applied to overcome these problems calls for an examination of whether there has been success.

## **1.4 Current Events**

Compensation and the position of NEDs is currently a major global item of contention. As the global economy worsens, scapegoats are not difficult to find in the huge downturns in financial institutions. The first point of call is the “vast, huge, excessive, etc.” payments made to the CEOs duly followed up by the question about who approved such payments. The financial press reported on one of the most prominent and substantial crashes concerning the Royal Bank of Scotland now nearly 70 per cent owned by UK taxpayers after a £20 billion rescue last year. (See Business Report International ,1 11 February 2009:22). Almost every financial journal and newspaper has featured the events prominently. Last year the CEO Fred Goodwin received a £4,19 million salary including a £2,86 million bonus. Formerly regarded as one of the world’s top bankers blamed for the ill-timed take over of ABN Amro, Chairman, Tom McKillop, is now regarded as having failed to keep the CEO in check. He received a £750 000 payment in November 2007 (Is he a NED if he earns such a high salary?). He is quoted as being “profoundly sorry” for the bank’s problems. In HBOS Bank a similar position appears – taken over by Lloyds Bank, 44 per cent owned by taxpayers after bank received a £17 billion bailout, the CEO was paid £ 1,93 including bonus and incentives of £694,000. The chairman waived his rights to a pay-off when he left. These events cause a complete loss of confidence in the system that controls the compensation of those entrusted with the largest and most trusted institutions. In the press report the four bankers are reported as having called on the banking sector to “tweak its maligned pay system”. The problems with these two banks are unfortunately not in isolation.

## 1.5 The King Commission and the Introduction of South African Remuneration Committees

The complaints resulted in setting up the commission under an esteemed Judge Mervyn E King, SC, known as the King Commission on Corporate Governance for South Africa. The first report in 1994 was followed up by the second report of 2002. (The King Committee, 2002:8) described the problem saying

*“Investors were worried about excessive concentration of power in the hands of managers with the era of the professional manager. This protection against greed could encourage the sins of sloth and fear with an erosion of enterprise and an encouragement of subservience. A balance is needed.”*

(Then) President of the World Bank, Jim Wolfensohn, quoted in The King Report (King, 2002:7) said that

*“The proper governance of companies will become as crucial to the world economy as the proper governing of countries”.*

The King Committee, (2002:28) recommended the formation of board committees of which the minimum were to be audit and remuneration committees, with a charter that would include delegated powers and reporting procedures, free to take independent outside professional advice as and when necessary.

The King Committee, (2002:28) wanted non-executive directors to play important roles in board committees including the requirements that one of them be chairman having the obligation to submit an annual report to shareholders. The JSE supported the report and required member companies to comply with these recommendations. Because the JSE approved and is monitoring the regulations no government controls and interference with private businesses have been introduced.

Since the King Report was adopted, every South African listed company is required by the JSE to have a remuneration committee. Only seven years have elapsed since

the introduction of the 2002 King 2 report. Having described the background to and importance of this public problem the purpose of this review becomes clear - to perform research on whether such committees are effective.

## **1.6 Structure of the Remuneration Committee**

Chapter 3 is devoted to showing the structure, membership, duties and functions of the Remuneration Committee. The specialised and important nature of the remuneration of executives is not a matter that can be fully attended to in a usually busy main board agenda.

This Research will examine whether the committee is a pro- active committee or merely one whose function is to advice and consent. If the members of the remuneration committee are not the right persons then the results can be disastrous as they have a great responsibility in their hands.

## **1.7 Incentives**

Chapter 3, where remuneration committees are explained, links incentives to the remuneration functions of the remuneration committee. Employment of an executive today is usually based on basic compensation, to which is added profit sharing. Large sums are often paid as bonuses. These are usually substantially in excess of the earnings of the vast majority of workers and as such the company bears a responsibility to all personnel, to shareholders and society in general. Therefore, they should be calculated and examined most carefully. The responsibility for the supervision of these bonuses rests on the remuneration committee where the capacity for error exists in many ways as the committee members are not directly involved in the basic figures contained therein. The perfect fit is to appoint the right CEO and the right top team. One quote from an interview in this study bears repeating -“The difference between a good company and an excellent company is the top people who make the company work. You must look after them”

It will be of importance to know whether the executive has been motivated by remuneration committees to do the utmost for the shareholder/company – either by the incentive method or by the stewardship system.

How accurate is, the incentive system and what are its failings? Is more shareholder involvement beneficial, workable, or desirable in place of or in addition to remuneration committee governance? Are present regulations adequate and should they be supplemented? These will be viewed herein not only in South African companies but also in other countries like USA and UK.

## **1.8 Nepotism and Cronyism**

In Chapter 6 the results and analysis of the electronic survey expresses the views of respondents. This aspect is viewed with many deep arguments for and against, and the effect on the company, of cronyism and nepotism. Evidence is hardly ever placed before shareholders to show what steps boards take in making new appointments of directors who may thereafter be appointed to the remuneration committee. It is fair to say that the remuneration committee is as good as its members but then the one of the important factors of the success of the company is as good as that remuneration committee.

## **1.9 Remuneration Consultants**

Under the section “Taking Independent Advice” in Chapter 3, the expert knowledge on remuneration from consultants who operate in the wider market is explained. The view has been expressed simplistically that such consultants could carry out the work of a remuneration committee on their own quite easily. However, the charter of a remuneration committee is much wider than the quantum of compensation that is the bent of such remuneration consultants. The remuneration committee also knows and must merge remuneration policies with the strategy of the company.

## 1.10 Shareholder Power

Chapter 4 (The Literature Review) and Chapter 6 (Results and Analysis of Research Undertaken) deal extensively with the question whether shareholders should have the say over executive compensation or whether remuneration committees are better equipped. Bebchuk and Fried (2004:16) claim there is much abuse by executives stemming from their position, the solution being increased monitoring roles by directors and larger (institutional) shareholders. They use stronger terms such as “defective board monitoring” recommending “shareholder power”. Remuneration committees are not completely accepted and this review will report on the views expressed both in favour of and against the remuneration committee system as well as support for and opposition to shareholders involvement in work undertaken by a remuneration committee.

A “fat cat” furore erupted in the UK over a 75 per cent pay rise awarded to the CEO of British Gas, which then encapsulated itself to the Greenbury Committee and thereafter to recommendations for the formation of the remuneration committee. This was then followed by Hampel (1998:1.17) who said that they were equally concerned with the positive contribution which good corporate governance can make. The important Combined Code on Corporate Governance was then introduced launching details of requirements that had not previously been formalised.

## 1.11 Substance and Symbolism

Westphal and Zajac (1994) in their article *Substance and Symbolism in CEO Long Term Incentive Plans* find that a large number of companies adopt, but only to a limited extent actually use, long-term incentive plans. This suggests that there is a separation between substance and symbolism in CEO employment contracts in which symbols are more prevalent in companies with a strong CEO and a poor performance record. They attribute the cause to be the problem by a board who wish to exhibit legitimacy in aligning agency costs to the company. It is this avoidance of substance and the application of symbolism merely to impress that has brought about the problems which have been shown earlier herein and which brought about

regulation such as that which was introduced by the JSE and the King Report. The actual consequence is that the long term incentive plans (LTIP) are “seen but not heard” or noted but not applied.

## **1.12 Solving Conflicts**

Chapter 2 explains handling of conflicts. Under the Agency Theory method Henderson (2007) doubts whether the current practices are a solution to the agency problem created by the separation of control in large public companies and refers to the acts of a powerful manager in extracting what he terms “rents”. This is the classic conflict of interest situation. Agency Theory is based on self-interest with no altruistic desires especially in a situation where the agent’s own pockets are the beneficiaries. The manager will have no real incentive to promote the welfare of the firm. A strong term “abuse” features in some writings. The structure outside the firm is also related to the remuneration control problem. Thus, Bolton, Scheinkman and Xiong, (2007) argue that the root cause behind the recent corporate scandals associated with CEO pay is the technology bubble of the latter half of the 1990s. This leads to the conflict between Agency Theory, remuneration committees and shareholder power, - issues that will be dealt with herein.

## **1.13 Controls**

How good are all the systems and how well are all the controls applied? Do the NEDs really make a contribution to the remuneration decisions taken by their committee or do they merely advice and consent with a few pertinent questions added. The remuneration committee reports tabled annually before shareholders show many activities of the committee but how effective are these?

Does the remuneration committee merely state what should have been done, not that which should actually have been done especially in order to cover any pointed questions that may be asked at a general meeting of the company particularly by external stakeholders?

Chapter 3 presents criticism of the NED as well as discussion of their independence. Chapter 6 gives the views of those surveyed on their independence.

### **1.14 Symmetry of Information**

The main board and remuneration committee receive and rely upon information placed before them regarding the operation of the company by the executives. Research, which will be dealt with in Chapter 4 was quoted earlier on Agency Theory, referred to writers who dealt with the difficulties of shareholders and boards verifying the symmetry of such information. The difficulty of verifying information submitted by the executive due to internal control problems, audit problems, performance evaluations, costs and the functions of the non-executive board not embracing active participation will be outlined. Thus, remuneration committees are set up by boards who establish a charter embracing duties that assist in resolving this problem.

These functions are not extensive being almost a monitoring function This research must consider the extent and consider what Westphal and Zajac (1994) called the substance and symbolism of the functions set out. What is vital to the company is whether the NEDs adhere strictly to the rules and procedures and present a “plan” (also called a long term incentive plan) to shareholders which all looks very good or whether these plans are implemented in such a way that the company can go forward in a positive manner to promote itself for the present and the long term future. Chapter 4 (Literature Review) deals with such Long Term Incentive Plans (LTIP) and Total Shareholder Returns (TSR).

### **1.15 South African Research**

Strong South African criticism of the remuneration committee system is more important than reviews of those in the UK and USA. Mongalo (2003) attacks the structure and application of the systems from numerous angles and Crotty and Bonorchis (2006) are also not favourable.

## **1.16 Government Controls**

History showed that should there be weaknesses in the remuneration committee systems the unfortunate alternative could be for the government to institute controls. Reference to Chapter 2 on Agency Theory under Conflicts expounds on this.

## **1.17 The Research Questions and Objectives**

The purpose of this thesis is to examine the perceived effectiveness of remuneration committees in deciding on executive remuneration in South African listed companies. The research is to ascertain how such committees operate, the public perception of remuneration committees and why there are problems and how those problems can be solved.

There is unhappiness about executive compensation not only in the views of investors but of the public. Reassurance is needed that all is not wrong, that there are systems in place to prevent executives from unfairly extracting Rents from companies and that our economy is not suffering because companies are improperly administered and prices become too high as one of the consequences. When a company pays its executives unexplained sums, either too high or too low, with investors being left in the dark a loss of confidence results. This occurs despite there possibly being a more than adequate explanation. The corporate governance of the company is called in to question and the share price will suffer. Overseas and particularly in the UK, remuneration committees report extensively on their activities. The “devil is in the detail” which can virtually never be enough. Viewing the reports of such companies (Appendix 4 furnishes a sample report) will illustrate this and show some of the knowledge that can be added to our South African structure. In essence – Knowledge Begets Confidence - which will flow from this research.

The public wants to know and they need to know and are entitled to know what remuneration committees are about, how they operate, and whether they properly consider executive compensation. A search for information on remuneration committees and how the heavily criticized bonuses are administered is not likely to

be successful. The subject is topical and conversational with investors having decided views. They are thus entitled to know and this research is striving to contribute to that knowledge. In the research, it will be necessary to see whether remuneration committees are effective enough to give effect the purposes for which they were established and whether in South Africa, they can be improved and make a more substantial contribution to the economy and to corporate governance.

Remuneration committees have been introduced to companies and research has been carried out to see whether a committee is or has been effective in the limited number of years since birth. The UK has been advanced in its requirements for the Remuneration Committee although institutions felt that they had not gone far enough (*supra* the literature review). This major problem must also be viewed referring to committees of less than a decade. The research commences with information on the problematic Agency Theory (Chapter 2) and is followed by information on the structure of remuneration committees (Chapter 3). The Literature Review follows in Chapter 4, after which in Chapters 5 and 6 research conducted by the writer is dealt with and finally in Chapter 7 the conclusions with areas for further research are set out. Further research is dealt with in Appendix 1.

## **CHAPTER 2**

### **HISTORY OF REMUNERATION FROM AGENCY THEORY**

#### **2.1 Introduction: What Is Agency Theory?**

The agency relationship is one of the oldest and commonest codified modes of social interaction which Ross,(1973:134) defines as “a relationship that arises between two (or more) parties when one designated as the agent acts for, on behalf of, or as representative for the other being the designated principal in a particular domain of decision problems.” Jensen and Meckling (1976:308) define an agency relationship as “A contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.) “There is a separation of ownership and control that has lead to the notorious ‘agency problem”” (Solomon, 2007:17).

Agency Theory is the principle where the agent performs his function using excessive power to undertake the business of the organisation mainly to his own benefit whereas it should be applied for the benefit of those to whom he is accountable. In Agency Theory when reference is made to agent and principal this means that, the agent is the executive or manager, and usually the CEO and the principal is the shareholder or owner of the organisation. The losses to the organisation caused by the actions of the agent are known as agency costs. The principals incur these losses when their interests and those of the agents diverge.

#### **2.2 Agency Theory and Remuneration Committees**

Agency Theory deals with the systems that were in operation prior to the introduction of the remuneration committee to which it is the antithesis. Various methods to undertake control of agency costs have been researched. The one most often referred to is the agent's contract. The administration of these systems takes place through the establishment of a remuneration committee that is the subject of this

review. The problems that are part of Agency Theory led to the formation of remuneration committees details of which are more fully described in the ensuing chapter.

## **2.3 Conflicts**

The Principal-to-Agent relationship opens the door to conflict. These conflicts affect how the executive administers the company. The departures from shareholder-regarding strategies may involve inefficient behaviour according to Bebchuk and Fried (2004:16) which reduces the size of the pie and causes agency costs. Agents tend to maximise rationally their own utility at the expense of their principals (Sanchez, 2007:5). Jensen and Smith (1984) and Cohen and Uliana(1990:7) found in their research that mainly in the USA the issues are addressed on conflicts of interest between self-interested individuals in organisations. This problem is not, however, restricted to the USA but is worldwide. Executive compensation will be shown herein to be an important factor often considered as a measure of dealing with the problem. A further measure to achieve maximum value for shareholders is for the executive to have the real incentives and enthusiasm to promote the firm. Research into Agency Theory will show in Chapter 4 (Literary Research) that many authors provide suggested solutions to the problems in the relationship between the agent and the firm. Such solutions were applied in detail by implementing mutually beneficial employment contracts.

Bebchuk and Fried (2004:72-74) recognise the agency problem in the managerial power analysis. They explain that when managers/agents use their power to secure extra value beyond what they personally would obtain under arms-length bargaining then economists use the term "Rents". Such arms-length bargaining takes place with a board that has both the inclination to maximize shareholder value and the necessary time and information to perform that task properly. The manager who makes decisions, administers, and implements those decisions is not the ultimate beneficiary of those decisions. This can then result in the manager taking different actions that may not be as beneficial to the ultimate beneficiaries (shareholders/owners) as they should be. Flowing from rents is the perception of

outsiders whose opinions affect the attitudes adopted by boards. Bebchuk and Fried, (2004:61-68) continue that the extent that boards are deterred depends on whether the board sees the rents as unjustified, abusive or egregious. They refer to the negative term used by outsiders as outrage costs. These limits are placed on managers and directors. That which compensation designers do to attempt to hide, obscure and to justify the amount and form of excessive pay is called camouflage. The objective behind camouflaging (as the word itself suggests) is to bring about a perception of the costs of compensation that can limit criticism. The notion of camouflage is consistent with the possibility that an outsider might identify the hidden rents of a compensation arrangement that might otherwise be less visible.

A fuller description of agency costs defines them as the sum of the out-of-pocket costs of structuring, administering and enforcing contracts, both formal and informal, plus the residual loss (Jensen & Meckling, 1976:137). Agency costs include all costs frequently referred to as contracting costs, transaction costs, moral-hazard costs and information costs.

## **2.4 Systems to Resolve Conflicts**

The board or shareholders have the choice whether to use the “carrot or the stick” - the “incentive/persuade or punish” approach – that is a balance between what persuasion should be applied, alternatively that incentives should be offered. The punishment might be the threat of what could happen if the agent did not produce the results expected. Of benefit to both parties in the process of incentivising a manager is that whatever method is to be applied to incentivise the CEO the most successful one will be that in which a board causes him to voluntarily and enthusiastically of his own volition administer the firm. Barnard, (1968) believes it is best that the individual must be induced to co-operate. Incentives are fundamental in formal organisations and in consensus efforts to organise. Conversely, inadequate incentives mean dissolution, failure, or change of purpose. One must then consider why the employee wishes to contribute his efforts to an organisation.

Barnard, (1968) refers to the net satisfaction which results from the positive advantages as opposed to the disadvantages and cites an example of making employment positively attractive or less onerous. Some of the objectives listed as incentives are money or material items such as goods. Negative items are listed as working hours or conditions of work. Depending on the state of mind, the agent can be induced to contribute by a combination of negative and positive incentives.

With the huge problem of information asymmetry, controls need to be imposed by remuneration committees to reduce the agent's self-serving behaviour and in the process reduce agency costs. These controls include, firstly, performance evaluations, then internal controls and lastly audits. "Shareholders cannot control nor watch what the agent is doing" (Jensen & Murphy, 1998:229) Viewing the position of shareholders and a board, shareholders are inactive except when attending a few meetings per annum. They appoint a non - executive board so that monitoring does not start from a positive position. The principals have to put in place situations of trust that incentivise the manager. Thus, the manager's contract is a start of one of the systems that are used to apply as part of the control mechanism. Substantial research deals with the provisions of a vast number of systems of compensating the manager and of aligning his needs with those of shareholders (Lambert and Larcker, 1989:294-5). Of particular importance are the differing views on risk and time horizons between the parties, which would include schemes to tailor investments to be made by the company that will give the CEO reassurance about longer or short-term investments due to his own risk aversion.

## **2.5 Moral Hazard and Information Asymmetry**

Many of the problems of moral hazard are concerned with those raised by agency. In risk sharing a moral hazard may arise under conditions (like delegation of responsibility) where the privately taken actions of agents affect the probability distribution of the outcomes. The source of this moral hazard or incentive problem points to an asymmetry of information among individuals. These come about due to individual actions that cannot be observed and hence contracted upon (Holmstrom, 1979). A lack of trust or a breakdown between the parties can have an adverse

effect with far reaching consequences. The duties of running the firm are delegated by principals (shareholders) to directors who then delegate these duties to agents (managers). Considerable discretion is then available to such executives when they exert day-to-day control as part of their duties. "As agent for the principal the executive is morally responsible to maximise shareholder utility; however, executives accept agent status because they perceive the opportunity to maximise their own utility". (Sanchez 2007:5) Shareholders do not see immediately what is transpiring in a company or see such information differently to what they should see resulting in information asymmetry. Thus, shareholders do not know, nor can they ensure, that the manager acts in their, best interests.

Information asymmetry is an extensive problem relating to the provision of imperfect information. At the outset, the manager holds perfect information. In this position, he has a moral obligation to place the shareholder (and the board) in the same position. The agent then chooses to disclose only the amount of such information as he wishes or in the form that he may wish. The information the parties hold will not be the same and thus not be in symmetry.

To comply with his moral obligation it would be optimal were he to disclose all information and leave it to the principal to decide what portion thereof should be eliminated there from. If he does place full and correct information, and the utility functions of the agent and the principal coincide, then there should not be an agency problem as both parties are in an optimal situation to benefit from such information. The principal can then instruct the agent on the action to be taken. The problems then arise as to how to monitor the action that the agent chooses and to ascertain whether it is correct and if not how to deal with that problem. Full disclosure is the commencement of trust and is the basis towards something of importance in the principal agent relationship, but it is a steep hill to be climbed.

By furnishing information in the format that the agent so chooses, major decisions can be taken by the principal in relying upon such information that decisions are to the detriment of the firm. The agent can benefit personally by whatever flows from there. With such dangers, shareholders need to influence management to act in

accordance with their objectives. “It can be expensive to monitor the activities of the agent and to verify his actions” Eisenhardt (1989:69), who found that “information systems (manipulated by whether or not the principal could monitor the agent's behaviour) were negatively related to performance-contingent (outcome-based) pay”.

Ross (1973:138) also argues that monitoring would involve bringing in outside experts at a senior level that may not be economically feasible. An examination of the actions of a CEO could not be undertaken by managers at a lower (less costly) level than the CEO himself and quality consultants are known to be expensive. Calling in third parties to verify the information provided by the agent immediately commences with the concept that the agent is not believed, thus creating in him an undesirable atmosphere of mistrust and a souring of his relationship with his principals.

## **2.6 Directors and Boards**

The structure of companies gives the final powers to shareholders who appoint a board who then appoint executives to administer the company in accordance with their instructions (see also Chapter 3 on Remuneration committees). The remuneration committee directors are non-executive. Bebchuk and Fried (2004:19) refer to boards that have neither the time nor the information necessary to monitor all managerial actions to ensure that they do actually benefit shareholders; nor are they engaged to conduct managerial actions. Being in such a position, a board will delegate to the CEO the duty to generate shareholder value and in so doing to watch over the principal's money carefully and to maximise shareholder wealth and returns. According to Gstraunthaler Lukacs and Stellar, (2008:47) a member of the board will invest sufficient time to satisfy the investors and thereby ensure his re-election. This imposes a natural limit to the engagements the director can accept. His activities in the firm itself will accordingly be subject to limited time.

A fundamental approach accepts that there should not be a “we/they” relationship but rather a “we/us” working concept in between the board and the agent. The welfare of the company is paramount and any amount of problems would be

disastrous – a strong term but this should be viewed in terms of the capacity for huge problems. Thus, the next matter to review is how to resolve this problem.

## **2.7 Government Intervention**

Because the agency costs can grow to uncountable proportions, which can lead to the failure of a company, there is the alternative of governmental regulation. Writings on the application of such controls have not been found. “The state in its political ideologies cannot close the gap” (Gstraunthaler et al, 2008:39-40). To legislate would almost certainly bring about interference in the internal examination of company records. History shows that this became necessary in Europe after the 1873 and 1929 turbulences. It can be considered whether substantive controls flowing from additional legislative powers granted to a remuneration committee can have extensive effects on markets and share prices. Market crashes are a most undesirable situation. There is still the alternative of more shareholder power.

## **2.8 Co-operation**

Besides the said performance evaluations and audits, flowing from this the essential element of organisation is the willingness and the power of persons to co-operate and contribute their individual effort to the co-operative system. Barnard (1968) says that these constitute the energies of the organisation because of incentives where dominating forces are egotistical motives of self-preservation and self-satisfaction. The approach is turning towards reviewing the individual and his position in the organisation that is always a basic strategic factor to the structure of the organisation. It is thus intended that these incentives would limit the agent’s actions in information symmetry and moral hazard, thus contributing to the overall welfare of the firm and its principals.

## **2.9 Incentives? / Persuasion?**

It is considered to be improbable to the whole existence of a firm should it not employ both the positive and negative methods of incentives and persuasion in

combination. In commercial organisations, the professed emphasis is almost wholly on the side of incentives whereas in the case of other organisations the method is persuasion. Both methods can be used in organisations if account is taken of the different kinds of contributions required. Organisations experience difficulty in supplying incentives or in exercising persuasion.

## **2.10 Motivation**

It is common to all debates that the best company performance results from the intentions of all parties with motivation of the executive being the path to walk. The two sides of the debate hinge upon whether this is done by appealing to his “hip pocket” (McConvill, 2004:18) or to foster those factors that make him genuinely motivated to do best by the corporation. Recognition of the existence of the Agency Theory problem is vital to the existence and continuation of organisations that are always made up of people. It is people who have to be motivated and controlled to ensure the future of organisations. Failing these, unpleasant consequences could ensue. Maslow (1970) suggests that we first need to satisfy our physiological needs and thereafter non-financial requirements. He is quoted by Bender (2004) who states that a main function of the reward is to meet the needs for self-esteem.

## **2.11 From Agency Theory to Remuneration Committee**

Reviewing the problems outlined above in the principal agent relationship and some of the controls, which are attempted by principals to avoid information asymmetry and to overcome moral hazards it, must be realised that none of these are perfect. This is so, especially given the intentions and benefits, which can accrue to the agent. The major factor to note is that Agency Theory has mainly become historical. It did “serve the purpose” of being the forerunner of greater concentration on corporate governance and that is what spawned the Remuneration Committee, details of which will be seen in the following chapter.

## CHAPTER 3

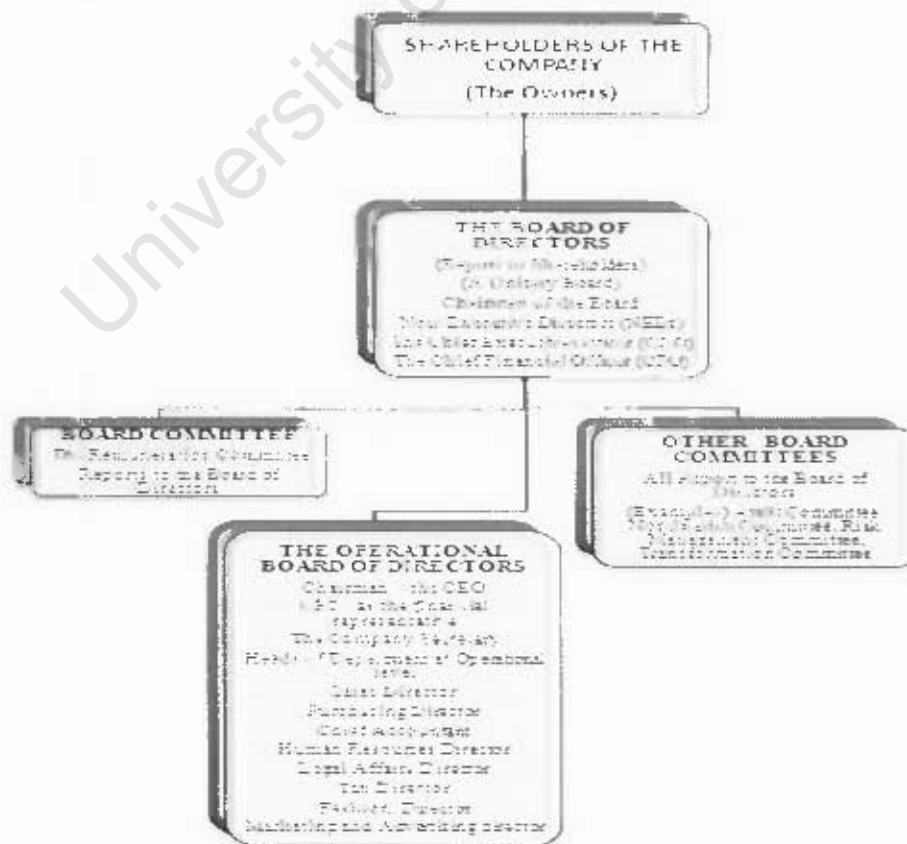
# WHAT ARE REMUNERATION COMMITTEES?

### 3.1 Introduction on Workings of the Committee

In order to have a fuller understanding of remuneration committees this chapter explains the workings of, the regulations applicable to, the composition of and the powers and functions of a remuneration committee, its relationships with shareholders as well as the membership, qualifications and independence of such remuneration committee members. Research and commentary will be restricted to substantially informative matters as regards the structures and regulations of the remuneration committee.

### 3.2 Company Structure

The overall structure of what a typical listed company might resemble follows -



This organogram illustrates the delegation of authority from shareholders who appoint the board of directors who appoint committees and the chief executive who is chairman of the operational board which contains various divisional heads.

### **3.2 The Committee of the Board of Directors**

The main purpose of a remuneration committee is to consider executive remuneration that was administered by the board itself until the early 1990s. In so doing, they must apply the philosophy of compensation and strategy of the company. The Institute of Directors initiated and established the King Committee, who reported that:

*“A suitable mechanism for improving corporate governance, by delegating specific tasks from the main board to a smaller group and harnessing the contribution of non-executive directors brought about the remuneration committee. At a minimum, each board should have an audit and a remuneration committee. Industry and company specific issues will dictate the requirement for other committees”* (King Committee, 2002:28).

Over the last decade, most large public companies have set up such committees. In the UK, Cadbury (1992, 4.42: 30) reported

*“We also recommend that boards should appoint remuneration committees, consisting wholly or mainly of non-executive directors and chaired by a non-executive director, to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary.”*

In South Africa, investors (principals) were becoming unduly concerned with the excessive concentration of power in the hands of the agent/manager. The era of the professional manager, as discussed in the previous chapter, calls for a balance. Controls that are arising indicate the intention to improve the situation by establishing remuneration committees rather than promoting the self-interests that existed under

Agency Theory. Should the remuneration committee not be in place agency losses would occur.

Of all the fundamentals of a company's establishment, the *sine qua non* is staff and importantly, executives. Their terms of employment are important to the application of the philosophy and the strategy of the employer. A remuneration committee is fundamental to such workings. At the heart of its structure, it makes decisions that affect the heads central to the operations of the organization. A remuneration committee should, hopefully, in looking at the issue of executive remuneration, do so in a more detached way says (Mongalo, 2003) and will then make recommendations to the board of directors who would implement them.

The employment of the CEO is a significant matter that carries tremendous responsibility for the board and its remuneration committee. The CEO is the central pivot around whom the day-to-day operations of the company revolve so that the choice of the wrong CEO can lead to disaster.

### **3.3 Charter- Regulations**

When the King Committee, (2002:22) recommended the formation of board committees, they stated that each company should have a charter of its own that would include *inter alia* their duties and delegated powers and reporting procedures. It should be free to take independent outside professional advice as and when necessary. This charter is the board approved mandate upon which a remuneration committee carries out its duties - it is its constitution, its terms of reference. Committees customarily meet three times per annum and on extra occasions should urgent matters arise. Non-executive directors make up the membership playing important roles in all board committees including the requirement that one of them is chairman of the committee. The JSE requires in section 3.84(d) of their current listings requirements that all issuers (institutions listed on the JSE) must, in compliance with the King Code, appoint a remuneration committee. In the absence of any enforcing legislation, government controls and interference with private businesses are thus avoided. See also Gstraunthaler et al (2008:39-40).

### 3.4 Non – Executive Directors (NEDs)

The success of a remuneration committee and of a company depends on whether the right or wrong NEDs hold office. Although they do have to report to the main board of directors, they are not mere puppets. The first NEDs were appointed in the nineteenth century with the intention of attracting investors and to enhance company status by virtue of their status, Spira and Bender (2004) say that NEDs commanded disrespect for being thought of as nominees of the system. NEDs are a counterweight to managerial power which view stresses the monitoring and control aspect of the functions of the NED Tricker (1978, 1.1). The significance of the opinion of Spira and Bender (2004) is highlighted when considering views oft expressed that NEDs are part of cronyism and nepotism that, if ever correct, impinges on their independent judgement.

*“Non-executive directors should be individuals of calibre and credibility, and have the necessary skill and experience to bring judgment to bear independent of management, on issues of strategy, performance, resources, transformation, diversity and employment equity, standards of conduct and evaluation of performance”.* (King Committee, 2002:24)

Hampel (1998), in considering the importance of the skills and experience needed for NEDs and how they should be appointed, queried whether the pool of available people was sufficient and how their independence should be defined. Importance was also stressed about the ability to fulfil the increased control function expected of them. Cadbury (1992:30) stressed their importance as equal board members and the positive contribution expected from them. The Higgs Report described the qualities, personal attributes skills and behaviours required of the NED as “engaged but non executive; challenging but supportive; independent but involved”. It is important for them to ensure consistency with sound risk management. The duties of the NED include availability of time, assuming of risk and knowledge of regulatory oversight requirement (and his remuneration would be affected correspondingly).

### **3.5 The Functions of the NED**

These include focusing on ensuring alignment of the remuneration policy with stakeholders' interests. Performance objectives are set and they must consider performance of the company and the executive when determining remuneration structures. Asymmetry has already been dealt with but the NED must also manage asymmetry interests inherent in variable compensation effectively. A NED should have the additional ability to overview other benefits and financial arrangements in order to ensure that they are justified, market related and disclosed in a transparent manner.

### **3.6 Input to a remuneration committee**

Although the CEO and CFO are not members of a remuneration committee their attendance and input at meetings and other deliberations is vital. Together with the Human Resources Director, they are responsible for fundamental information on which a remuneration committee makes decisions. Their interfacing with that committee is more detailed than their relationship with the board itself as systems and controls are viewed in detail and import. The committee name implies that its main function is to oversee remuneration.

Agency Theory shows the problem that a strong CEO was able to dominate a board that did not have the support of a large (percentage) shareholder. A remuneration committee with a clearly defined charter should thus have the necessary tools with which to control a strong CEO. Proper governance embraces both conformance and performance. Conforming to corporate governance standards results in constraints on management. Boards have to balance this with performance for financial success and the sustainability of the company's business.

### **3.7 The CEO and CFO**

Matters for consideration at meetings would be fully researched by the CEO and CFO beforehand. The other executives of the company whose employment terms

would be decided upon would all be known to the CEO and CFO. These executives account directly to the CEO and CFO, who should accordingly be in a position to satisfy the committee on all aspects of their recommendations.

The CEO heads the operations of a company. The overall administration and controls of all staff are – as with most matters – his final responsibility. At the remuneration committee he accounts and dedicates his attention to staff with the main concentration being on executives. Staff of lesser seniority would be reviewed by the executive operational board – as contrasted to the main board of directors – but it is at the remuneration committee meeting that the CEO would obtain more general guidance and approvals on matters relating to such executives.

### **3.8 Duties of the Remuneration Committee**

The duties of the remuneration committee include tying remuneration closely to performance. In so doing, they set out aspects that need important consideration, asking numerous questions, starting with whether the policy on directors' remuneration is in line with guidance in the Code and with guidelines of relevant institutional investors' organisations. They stress the support by institutional shareholders of the company's remuneration policy. The Code calls on non-executive directors to constructively challenge and help develop proposals on strategy, monitor the reporting of performance, scrutinise the performance of management in meeting agreed goals and objectives, satisfy themselves on the integrity of financial information and also ensure that financial controls and risk management systems are robust and defensible. They must also determine the appropriate level of remuneration of directors and senior executives based on their individual contributions to group performance. They have a prime role in appointing and, where necessary, removing, executive directors and in succession planning. The committee also recommends and monitors the level and structure of remuneration for senior management - at least for the first layer below board level. The board itself should normally determine the non-executive directors' remuneration. A remuneration committee would assist the board in reviewing the annual executive compensation, including overseeing share options and schemes.

Matters on which independent external advisers would be engaged include tracking market trends and salary benchmarking information, both local and international in respect of salary and benefits. Market related remuneration is vital to determining compensation. Thus, maximum knowledge should be made available by them.

The King 2 Report (King Committee, 2002) proceeds to spells out fully the requirements that a remuneration committee or such other appropriate board committee, consisting entirely or mainly of independent non-executive directors, should make recommendations to the board within agreed terms of reference on the company's framework of executive remuneration and should determine specific remuneration packages for each of the executive directors. Their decisions are taken with clearly agreed upon reporting procedures and written scope of authority. This is, ultimately, the responsibility of the board who furnish the final approval of the decisions of a remuneration committee upon reporting procedures and written scope of authority (King Committee 2002:28).

It is therefore up to the NEDs to decide whether they wish to merely implement a policy, to advise and consent or whether they intend to be pro-active. In so doing they will give a lead to the company as to its success, at the same time following the policies which are laid down by the board.

*"It is particularly important that remuneration committees should bring independent thought and scrutiny to the development and review process together with an understanding of the drivers of the business which contribute to shareholder value."* (Association of British Insurers, 2003)

Thus, the problem has been described and the need for action to be taken was being dealt with. The matter now came in to the public purview.

### 3.9 Attendance at Remuneration Committee Meetings

The remuneration committee should consist exclusively of non-executive directors (supra), although in interviews conducted for this study an instance was found of an outside life and pensions adviser being appointed to a committee. The usual number of NED directors is approximately three or four. In the UK FTSE 350, which is a list of the top 350 companies listed on the London Stock Exchange companies listed therein are expected to have a minimum of three members on their committee whereas smaller listed companies are allowed to have just two.

Attendance at the meeting itself consists of far more persons. The main presentations would emanate from and be led by the CEO and the CFO. Other persons in attendance would be the secretariat, legal, human relations and tax advisors. Independent external advisors such as remuneration consultants would also be present. Only the committee members (NEDS) partake in any voting. All other attendees are there to advise the committee members.

The recommendations that have been endorsed by the JSE included the requirement that an independent non-executive director must chair this committee. The JSE requires this “in order to obtain his or her input on the remuneration of the other executives”. Reference is made by the JSE to the chief executive officer’s attendance at the meetings saying this would be by invitation but taking no part in decisions regarding his own remuneration. A substantial part of the information tabled before a remuneration committee would initially be approved by the CEO and CFO. In the light of information asymmetry, the information placed before a remuneration committee also emanates from outside consultants. Thus, whilst agents may have control of the information outside experts should act as a form of control over the accuracy. (See Information Asymmetry, *infra*). NEDs are in a position at a remuneration committee meeting to interface directly with remuneration and human resources and tax consultants. Greater detail elucidating on what should be placed before a committee is seen in the comprehensive remuneration committee report of a UK company to shareholders in the Appendix 4 (Pearson plc, 2006).

### **3.10 Taking Independent Advice**

The King Committee, (2002:28) recommended that a remuneration committee should be free to take independent outside professional advice as and when necessary. This is a fundamental aspect of the committee's deliberation, as its members cannot be expected to have expertise in all aspects of remuneration. Such experts would customarily attend meetings of the committee. They provide specialised services having available voluminous schedules of compensation rates in the market spread across various industries and a wide range of occupations and positions.

### **3.11 Powers, Functions and Activities of a Remuneration Committee**

Being, a sub committee of the board of directors, its charter does not grant it executive powers except possibly in isolated cases of emergency. The committee thus reports to the board of directors. Such reports contain recommendations on policy, strategy and employment of executives. Mainly it would concern itself with the employment of the operational board of directors, including the CEO and CFO.

Some proposals of a remuneration committee also need to be approved by shareholders should the Articles of Association require this. In the USA, UK and RSA varying legal and regulatory obligations have been placed on a board to establish and regulate remuneration committees.

*“Compensation decisions do not rest with shareholders but rather with compensation committees composed of members of boards of directors who are elected by, but are not perfect agents for, shareholders”.* (Jensen & Murphy, 1990:260)

This view is in contradiction to that of (Bebchuk & Fried, 2004:195-200) which calls for more shareholder power. Controls over the misuse of power are supposed to answer the strong criticisms. Laing and Weir, (1998:32) say that

*“There is now greater openness about the way in which executive pay is being determined with the widespread adoption of remuneration committees”.*

### **3.12 Remuneration and Incentives**

Establishing the quantum of remuneration and terms of employment are the main functions of a remuneration committee. The principle involved is to establish the level of pay for delivering on-target performance. A major function of the committee is the incentivising of the CEO and top executives. To do so the system of performance based compensation (bonuses) is applied. This structure links rewards to corporate and individual performance. Such performance pay is often substantial when compared to the basic emoluments and is the subject of much public opinion. To establish the formula, firstly, and thereafter the actual calculation of such bonuses is a major task of the committee. This administers and also promotes profitability for the company. Thus, the remuneration committee should be able to account for the basis upon which their committee approved such pay for performance bonuses. This is central to accountability for public trust in the system say Spira and Bender (2004) and (Cadbury, 1992:58). It has become more acceptable to set out a formula at the beginning of a financial period to apply a target to the executive who then has to strive to attain such a target and consequently receives his bonus based on success of his efforts. Preparing such a target will be based on calculations finally submitted to the committee by the CEO and CFO. This matter is the subject of the asymmetry referred to herein. (Vide Paragraph 1.14).

In the UK, a remuneration committee will be guided by the Principles and Guidelines on Executive Remuneration (2003) issued by The Association of British Insurers. These principles require boards to demonstrate that performance-based remuneration arrangements are clearly aligned to business strategy and objectives, regularly reviewed and in line with current best practice. They point out that simple remuneration structures assist with motivation and enhance the prospects of successful communication with the employees involved and with shareholders. Further, performance conditions should be “relevant, stretching and designed to enhance shareholder value”.

Other aspects of the actual executive compensation will be generally advised on by the independent specialists who make representations to the committee. (Vide Paragraph 3.9).

### **3.13 Communications Reports to Shareholders**

In the USA and on the London Stock Exchange it is compulsory to issue annual remuneration reports to shareholders. This report forms part of the annual report and financial statements. The London Stock Exchange has set out regulations for their expectations. The UK Report is required to comply with the Directors' Remuneration Report Regulations (2002) of the London Stock Exchange and is subject to shareholder approval customarily at the Annual General Meeting. The content of reports by a remuneration committee can best be observed and understood by reference to Appendix 4 containing the 17 page UK report of Pearson plc, an international publishing group listed on the London Stock Exchange. This report was received from Ewald Muller of the Standards Department of the South African Institute of Chartered Accountants. He commented that this was one of the finest he has seen (an opinion that should be endorsed by many, as it is an interesting, comprehensive and readable report). He also confirmed that he knew of no regulations obligating a South African company to submit a remuneration report other than in the King Report (King Committee, 2002:28) and that there are certain disclosures required regarding remuneration. The importance of this report to the shareholder is that it furnishes an overall perspective of how well the company is administered as well as the standard of its corporate governance. Such reports imbue shareholders and investors with knowledge and confidence, which South African remuneration reports lack.

Under the heading "Remuneration Policy in South Africa in clause 2.5.3 of the King Committee Report there is a clear guideline on the policy and objectives of the Remuneration Committee.

*"The chairperson of such committee should attend annual general meetings to answer any questions from shareowners". (King, 2002:25).*

### **3.14 Independence of the NED**

Should NEDs not display independence a perception of bias and wrong decisions would result. The NED holds a position of high trust and accountability. The aspect of nepotism and cronyism as well as systems in use in the USA and UK regulations are dealt with in the literature review.

Chapter 2 sets out Agency Theory Information and Chapter 3 sets out information on the remuneration committee in order to apprise the reader of the committee's workings. These should be a source of reference throughout this research. With these basic facts, this research now proceeds to examine in the next Chapter what the literature tells us about remuneration committees.

University of Cape Town

# CHAPTER 4

## LITERATURE REVIEW

### 4.1 Introduction and Philosophy

Jensen (2000:1) states that his desire is to understand more thoroughly the forces pushing firms to operate efficiently and create value, thereby improving human living standards. Thus, each company will have its own strategy and from this philosophy of its compensation must flow the proper methods by which compensation is paid to all employees including executives. Moreover, from such philosophy and the strategy of the company the result, firstly, should show a positive effect upon employees then on shareholders, on growth of the firm, then on the economy; and lastly be able to meet ever-changing developments.

The strategy and philosophy of the company is the background that a remuneration committee must apply in its deliberations.

The magnitude of payments to CEOs is not only a matter for consideration at stakeholder level but features prominently in wage bargaining sessions with the details of the relative pay featured unsympathetically in the country's media. (Kantor, 2006:2)

In the foreword to the book Reward Management, (Armstrong & Merlis, (2004: viii), Duncan Brown refers to the discipline that has evolved from pay-focused administration to a strategically oriented and impacting total rewards management approach. He says:

*“To be effective a remuneration committee must take into account the strategy of the company and in so doing consider the policy and apply it in its deliberations about compensation. Remuneration decisions cannot be taken in isolation or by making only, for example, industry comparisons. Brown*

*continues that the policy of the company itself must be applied initially to the specific employee being considered."*

In the South African context, the Congress of South African Trade Unions (Cosatu, 2004) proposed that company law needs to take account of stakeholders such as the community in which the company operates, its customers, its employees, its suppliers and the environment in certain situations mandated by the Constitution and related legislation. Research today will show herein that it is fundamental to the amount of compensation that the total remuneration of the executive should not be based on the activities actually carried out but on what has been performed (results achieved).

There is thus a serious and urgent need to view the present systems and ascertain how the problems occurred and whether they were they based on adequate and proper information or on information asymmetry. The sections below explore factors that show the background in addition to factors that a remuneration committee must consistently consider in its deliberations. Considering strategy in their deliberations indicates the importance of a remuneration committee member also being a member of the main board that ensures that he will be involved in and then know, as well as understand, such strategy and policy.

## **4.2 Corporate Governance**

Remuneration committees were set up as part of the implementation of corporate governance policies intended to promote companies.

"Corporate Governance is the system by which companies are directed and controlled". Cadbury, (1992:14) it is concerned with holding the balance between economic and social goals and between individual and communal goals. It has to align as nearly as possible the interests of individuals, corporations and society. Having a remuneration committee is an essential function. According to Cadbury, (1992:30) it is also recommended

*“That boards should appoint remuneration committees, consisting wholly or mainly of non-executive directors and chaired by a non-executive director, to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary”.*

There are vast benefits to companies that conform properly to corporate governance. Coombes & Watson (2000), conducted an investor opinion survey published by McKinsey & Co., Working with Institutional Investors Inc. they found, that more than 84% of the more than 200 global institutional investors surveyed, together representing more than US\$3 trillion in assets, indicated a willingness to pay a premium for the shares of a well-governed company over one considered poorly governed but with a comparable financial record. Three-quarters of these investors indicated that board practices were at least as important as financial performance, when evaluating companies for potential investment; and that the implications for companies are profound. Simply by developing good governance practices, managers can potentially add significant shareowner value. The creation of a good governance climate can make countries, especially in the emerging markets, a magnet for global capital.

These empirical results of an opinion survey in conjunction with a firm of the standing of McKinsey set the mark of how important corporate governance is in capital markets.

### **4.3 Quantum of Compensation**

How high can one pay compensation? What level of remuneration would be just? These are questions with vast consequences. Jensen (2002:1) asks whether current levels of CEO compensation are high enough to attract the best and brightest. Such reward and performance management is used, not just to align with business goals, but also in our more knowledge and service-based economy to involve and engage employees to voluntarily commit to achieving and exceeding those goals. In Talent Management, Zachary Weinberger (2007) believes that a remuneration philosophy should be aligned to a company's overall vision, its mission and its style He states

his view more stringently when he claims that failing this disaster seems the path that will follow. The statement by Jensen and Murphy (1998:270) about paying the executive like a bureaucrat (*supra*) is well known and is quoted often but in the context of the philosophy of compensation, it is seen as vital to the enthusiasm that is injected into the whole company by motivating the CEO. If the CEO is enthused, incentivised and motivated by his compensation he will act and administer the company like an executive and not like an unenthused disinterested bureaucrat. Consequently, a remuneration committee will ensure that the company considers the advice of Jensen (2000) and will then be better able to meet its objectives and profitability.

Even in the broader high-performance human resource management approach Pfeffer (1998) notes that the use of performance contingent pay is recognised as a key component. The shareholder (principal) is striving for the agent to become a "partner" in the businesses. The contingent pay is thus a share in the profits that the company strives to earn and improve

Head-hunters cause a problem to employers because of their extensive activities but they do keep the market volatile.

Whatever method is to be applied to incentivise the CEO the most successful method will be that in which a remuneration committee and the board cause him to voluntarily, willingly and enthusiastically administer the firm. Such policy and strategy is one in which the principal and agent should be operating in tandem. It is often applied by companies today being a method in which the NED can delegate particularly as the NED is not active in the operations of the company. In the process, the participation by the executive in the earnings has resulted in high earnings, to the benefit of him and the principal but this is also the cause of the problems by those who view the payments as too high. Such motivation is dealt with in (McConvill, 2004) where Pay for Performance is considered a flawed methodology and remuneration committees are recommended to consider other non-cash methods of motivation. Refer also to paragraph 4.15 herein.

## 4.4 Remuneration Calculations and Performance

This aspect of research writings shows another side where one sees factors other than direct money considerations come in to deliberations.

Cash compensation of Korean Executives in Chaebols is significantly related to stock market performance of Chaebols. The magnitude of the responsiveness of pay to stock market performance is comparable to Japan (and the US in so far as cash compensation is concerned) (Kato, Kim and Lee, 2007:52).

In their interviews of board committee members, Spira and Bender (2004) bring out clearly this source of tension, earlier identified by (Tricker, 1978) and by (Hilmer, 1993), that exists within the remuneration committee between 'Performance' on the one hand (achieving an effective agency theory type pay mechanism, thereby strategically aligning incentives) conformance' on the other. With 'Conformance' the emphasis is very much on being able to demonstrate in an ex-post sense that pay awards conform with the various governance codes reviewed above, i.e., a monitoring function. In the pursuit of conformance, the remuneration committee is mainly concerned with probity, unrighteousness, moral integrity, honesty and legitimacy (Meyer & Rowan, 1977), (DiMaggio & Powell, 1983). Performance considerations, on the other hand, are more managerial entail the remuneration committee actively designing remuneration arrangements that both connect with the external reality of the executive labour market (in paying the going rate) and address the agency problem by aligning the interests of the executives with the achievement of the key success factors that underpin corporate strategy (Jensen & Meckling, 1976:140). In terms of performance, the remuneration committee plays a key role in the strategic human resource management of the company by crafting remuneration arrangements that attempt to link the interests of the top management team with attainment of the key success factors for corporate strategic success (Stredwick, 2000). Thus, there is obviously a clear tension between the performance role and the conformance role. This finding echoes that of Ogden and Watson (2004, 2006) who, in a series of interviews with remuneration committees of water companies, concluded that these remuneration committees felt highly constrained by political

considerations. Such pressures are seen to result in (DiMaggio & Powell, 1983) isomorphism in organizational practice, whereby the desire to shape remuneration design in a similar manner to other comparable companies dominates detailed considerations of performance effects.

#### **4.5 Owner Shareholder CEOs**

Agency Theory thus implies that unless the holders of control exercise that control then inefficiencies could result which could lead to failure. A comparison is needed between owner CEOs and professional CEOs. This was carried out by (Barak et al 2008). The significance of their positions is that where there is an owner CEO the control vests with him and a remuneration committee's decision can be turned down by his voting power. The results indicate that owner CEOs receive significantly higher pay than the professional CEO does. The authors conclude that owner CEOs extract additional private benefits from the firm. Barak, et al (2008) collected data on CEO pay in 122 closely held firms traded on the Tel-Aviv Stock Exchange during 1995-2001. After estimating CEO pay performance sensitivity and CEO excess pay, they examined how these two pay attributes affect end of period (year 2001).

Their main findings and conclusions are firstly that when the CEO is from the controlling stakeholders, the end of period is negatively correlated with excess pay CEOs, which appears like a form of private benefits. Then when a professional non-owner CEO runs the firm, CEO pay performance sensitivity - incentives to professional CEOs, help promote firm value. This means that the shareholder (owner) is actually the decision maker in place of the independent board. These findings are consistent with the view that owner CEOs exploit the firm and extract private benefits in the form of inflated pay. In the paper by Barak et al (2008), cronyism appears to be a problem in either CEO or closely controlled companies. The situation is in contrast to Agency Theory where the executive controls the board without the existence of a strong controller.

Another aspect of Barak et al's paper (2008) is that of symbolism. Stakeholders see a remuneration committee that cannot operate without the approval of a powerful

controlling chairman. This is similar to a reversion to the agency theory problems. Doubt is thus cast over their decisions.

Barak, Cohen and Lauterbach, (2008) in a similar study found that CEOs who belong to the family or business group that owns most of the firm shares (“owner CEOs”) receive significantly (about 50%) higher pay than professional CEOs who do not belong to the control group (“non-owner CEOs”). Owner CEOs’ pay performance sensitivity is also (insignificantly) lower than that of non-owner CEOs. These findings are most consistent with the view that owner CEOs exploit the firm and extract private benefits in the form of inflated pay. Among owner CEOs, we do not find any significant differences in pay between CEOs in family firms and CEOs in firms controlled by business partners. Here again as in (Barak et al, 2008) a remuneration committee’s decision can be turned down by this voting power.

#### **4.6 Shareholder Power**

Bebchuk and Fried, (2004: Section 4) claim abuse by CEOs stems from their position. The solution is increased monitoring roles by directors and larger shareholders (institutional). They use stronger terms such as “defective board monitoring” recommending “shareholder power”. The book is a critique of board management. The regulations being introduced for compensation committees are set out by them (and quoted in this review on the structure of remuneration committees.) There is very little approval by them of existing systems. On the contrary, when they write on “executive pay excesses” and “defective board monitoring” they recommend “the alternative managerial power model.” The latter subject exposes the extent to which pay has not only become higher than what is optimum for shareholders but how it has been decoupled from performance. They then accuse directors of not following management when they not instinctively seek to maximise shareholder value.

Directors’ desires include re-election to the board, to placate CEOs given their power to benefit directors’ natural tendencies to support awards that benefit their own remuneration, social and psychological factors such as friendship and loyalty to the

CEO and senior executives. The effect of these cases is that a remuneration committee is not effective when its functions are subject to approval of controllers using their power for other intentions.

The basis of their views is that shareholders would be better at controlling compensation than existing systems that they consider to be out of control. Whilst there may be merit in this argument in some companies views have been expressed that there are different methods for shareholders to express their views.

#### **4.7 Causes of the Technology Bubble**

Bolton et al (2007) lay the root cause behind the recent corporate scandals associated with CEO pay to the technology bubble of the latter half of the 1990s. Whilst they do not reject the optimal incentive contracting theory of executive compensation, they believe that the recent evidence on executive pay can be reconciled with classical Agency Theory which begs the question as to what would have happened in those scandals had there been an effective remuneration committee as a watchdog. In a company, the shareholders bear the residual risk in what transpires in the firm. Jensen (2007:2) in his introduction makes it clear that such risk vests in them only saying that, accordingly, for control to vest in any other person who does not bear such risk would be the equivalent of "playing poker with someone else's money". The effect of what (Jensen 2007:2) is recommending is that whilst the agent may be given a cheque book he is not given a "blank cheque" and must account to the principals who should monitor.

These research articles crystallize the questions by reviewing the direction of remuneration committees serving a purpose - whether they are eliminating the problem, or limiting it or whether they are of any effect at all.

#### **4.8 Operating on an ad-hoc basis**

Landsberg (2007:22) holds the view that remuneration committees tend to operate on an ad-hoc basis, adopt a cautious attitude and that executive compensation is

getting too high. This results in the creation of incentives that do not contribute to the overall health and well-being of the corporate enterprise. However, directors should know what their roles are and how to execute the written charter of the remuneration committee as set out by the main board.

#### **4.9 Greater Information and disclosure**

As more information on compensation of executives is made public, a better understanding of the mechanisms that determine executive compensation will develop (Laing & Weir, 1998:33), whose view is a continuation of how the remuneration committee system was developed out of greater information disclosure of compensation rather than under Agency Theory.

Under corporate governance (above 4.2) Coombes and Watson, (2000) showed that substantial investigations indicated empirically how important it is to exhibit that corporate governance is being properly applied in a company, as remuneration is well related to human factor issues of performance of the business. Harrison, (1987) expressed the view that it is very much about how to get the link between the human beings that populate the business and the strategic plan laid down by the board. Comparisons of compensation costs should be made of the company's own costs with that of a properly chosen peer group according to Brain, Jackson, Pymm, and Wright,( 2008). Remuneration committees should set incentives and bonus targets in advance. Even then, the rewards should only be made for outstanding performance with a thorough assessment being made whether the targets have been met prior to making the awards. They stress that the company should not reward failure when directors leave early owing to poor performance. To strive for perfections may be the proper method but examination showed a gap in the UK disclosure rules which Ward (1998) questioned about a serious omission in disclosures. He felt that the aggregate remuneration earned by a CEO for outside directorships should be disclosed as well as the amount of time spent on such directorships, pointing out that remuneration committees should be made aware of such details when reviewing the CEO remuneration. When shareholders vote for the election of such CEO they may believe that he is devoting his full time and attention to the affairs of the company.

This may not actually be so if the CEO is also spending time on outside directorships. Ward (1998) called for UK policy on disclosure to be amended to embrace this disclosure with provisions for prior permission to be granted for outside directorships.

Such research does indicate that remuneration committees are actively pursuing the most efficient, democratic and open approaches to compensation from many angles. The movement is in the opposite direction to agency theory. Operating in this manner does make the committee more effective.

Brain et al (2007) detail some of the authorities under which the UK Combined Code requirements operate for listing on the London Stock Market including the obligation on a company to either comply with the code or explain why they are not so doing, - the so-called 'comply-or-explain' approach.

#### **4.10 Regulatory Requirements**

It is seen from the above requirements in the UK, USA and South Africa that there are great responsibilities and thus expectations placed upon the remuneration committee. Many companies regard the committee as important enough to insist that one of the non-executive directors appointed to the remuneration committee is the chairman of the main board. These necessitate adequate allocation of time and resources plus self-awareness on the part of the committee of the inherent tendency to follow the norms, rules of thumb, and customary practice of others. (Brain et al, 2008).

#### **4.11 Institutional investors and monitoring**

Dedicated, as contrasted to transient, institutional investors can act as a monitoring or restraining factor on executive remuneration. The importance is that the investors must not be transient according to Dong and Ozkan (2008) who believe dedicated investors have a better discipline role to play. They found in their empirical research that the results also indicate that this is extended to institutional ownership having a

positive and significant influence on CEO pay-for-performance sensitivity of option grants. Consequently, whilst a board may watch its largest (institutional) shareholders come and go, the board and the remuneration committee remain in a position where they must steadily continue to take their own decisions with little, if any, guidance from or consultation with the (institutional) owners, who are, in effect, their true principals.

Throughout research it is seen that in the dedication of investors/stakeholders that the company is of primary importance. The internal structure of the company must receive prime consideration, which places great stress on the importance of having a remuneration committee. In South Africa, it has been found that consulting institutional shareholders on the aspect of compensation does not take place other than in exceptional circumstances.

#### **4.12 Mergers and Acquisitions**

Coakley and Iliopoulou, (2006), found that less independent and larger boards award CEOs significantly higher bonuses and salary following Merger and Acquisition ("MA") completion both for the full sample and for the UK and US sub-samples. This is not to be unexpected as a merged firm is larger in terms of profits and turnover thus warranting greater responsibilities. Such a merger or acquisition would be attractive to an agent thus giving him the opportunity for larger compensation. UK CEOs and executives are rewarded more for the effort exerted in accomplishing intra-industry or large mergers than for diversifying or small mergers.

#### **4.13 The CEO as Board Chairman?**

Whether the CEO should be board chairman is considered all the more important to corporate governance as the chairman is the 'communication' between shareholders and the company overall. The chairman of the board is expected to be a non-executive independent director say Coakley and Iliopoulou (2006). Goobey (2005) found that the practice of the CEO also serving as the chairman is more prevalent among US than UK companies. The Institute of Directors (2008) reported

on a survey by KPMG:Corporate - Governance in South Africa: Perceptions and Disclosure, which revealed that 47% of the top 40 companies believe that the chairperson is not independent. King Committee Report, (2002:23), "The chairperson should preferably be an independent non executive director". The draft of King 3 that has just been issued expresses this more directly leaving out the word "preferably".

#### **4.14 Pay and Performance**

Cash pay is unaffected by other measures of their managerial skill or performance. However, there is a caveat to the CEO that when a merger takes place his position will come up for review which can also have a downside or positive effect. In a robust empirical analysis of Dutch listed companies, Duffhues and Kabir (2008) failed to detect a positive pay-performance relationship, thus questioning the conventional wisdom that executive pay based on performance helps to align shareholder interests with those of executives. Included in their examination was a multivariate regression table presenting results for cash compensation. The results of these regressions showed them that executive pay is significantly negatively related to return on assets, returns on sales and stock. It is consistent with the view that powerful managers can influence their own pay despite remuneration committees. The results of the study suggest that other means of resolving agency problems and novel explanations of executive compensation may provide useful insights. Well – known firms like Royal Dutch Shell, Heinekens, Reed-Elsevier, Ahold and Unilever were subject to strong criticisms on total compensation of top executives. In 2003-2004 and 2004-2005, some top companies were given huge increases and generous remuneration irrespective of their meagre performance in those years. In criticising Dutch listed firms for their ingenious use of several anti-takeover defences, resulting in a bad international reputation, they point out that shareholders have no say in executive compensation with the non-executive directors. They then refer to instances in which dominant shareholders are alleged to collude with the management and influence decisions for their own benefits. What is highlighted is that controls do not always operate successfully and that even shareholders do not voice dissent where they should have. This leaves the thought about what effect a remuneration committee might have had.

“Although the CEOs compensation is at very high level, it represents a fractional part of a company’s expenses. Yet the positive impact that a great CEO can have on the company’s success is huge; but the CEO is costing them pennies a share” say (Hsieh & Kleiner, 2003:77) thus putting compensation in another context. Although said in 2003 this is not an outdated view.

Similar findings that executive pay is not linked to performance were made by (Ueng, Wells & Lilly, (2000:4) who confirm that the principal agent model of executive compensation suggests that by tying pay to performance shareholders ensure that corporate managers attempt to maximise shareholder wealth. This is the model of Jensen and Meckling, (1976). Ueng et al, (2000:4) explain that when the interests of the principal and agent are not congruent then agency costs arise. Extensive research writings have endeavoured to find the optimal contract between principal and agent. They investigate the aspect that some boards are less independent with executive compensation being linked to CEO influence over the board but from the two different points of view - that of small and large firms. Their findings show that size is the most significant determinant in firms of asset size less than the \$US 250 million but that CEO influence or pressure is not a determinant.

#### **4.15 Criticism of NEDs**

In principle, the system of independent non-executive directors in a properly advised remuneration committee should be an objective approach to accurately establishing executive compensation says Ozkan, (2007:350-351). She suggests that non-executive directors are not more efficient than executive directors in monitoring executive compensation are. Their function is more an advisory one thus she does not favour the remuneration committee system. Her research proved that a higher proportion of non-executive directors of larger boards pay their CEO higher compensation and finally that CEO compensation is lower when director ownership is higher.

Ozkan, (2007:350-351) continues that this is the main point of agency theory in which the initial prime requisite is a lack of a controlling shareholder to watch over a

strong CEO. Looking at the functions of a remuneration committee it will be seen that a properly constituted remuneration committee will have a sound bank of professional advisors.

Main et al (2007) using evidence collected from interviews conducted in late 2006, questions the adequacy of the agency approach in representing how remuneration committees design executive pay arrangements. Without being critical of other research the empirical extent of the investigations conducted by Brain et al (2008) is noteworthy, with 22 directors who, among them, serve on the remuneration committees of 35 UK companies. "Consideration should be given to criteria which reflect the company's performance relative to a group of comparator companies in some key variables such as total shareholder return (TSR)" This research further found that concerns with legitimacy push remuneration committees towards an institutional isomorphism in processes and practice. The shift in what is expected from remuneration committees has not been fully reflected in committee practice, owing to an overriding desire to seek legitimacy in the eyes of the shareholders and shareholder representative bodies.

#### **4.16 Incentivisation Policy**

An important shift has taken place, Brain et al (2008:233). Remuneration committees are now seen as key agents in the strategic human resource management process of choosing a remuneration package and arranging that it be calibrated in a way that ensures that it incentivises the executive towards those decisions and actions necessary to best deliver the company's chosen strategy (Baron & Kreps, 1999). They were once seen merely as an arms-length administrative device to ensure an acceptable degree of probity in the setting of executive reward, by Core et al, (2003) deals with the basics saying that the higher the CEO power over the board the higher the executive compensation (a reference to Agency Theory). The remuneration committee thus finds itself tasked with a prime responsibility of remedying or ameliorating the principal agent problem of incentive alignment for members of the top management team (Jensen & Meckling, 1976). The effects of incentive compensation on managerial decisions and shareholder value is a vast

subject (not for elaboration here) which is dealt with extensively by (Larcker, 1989:320-321).

Main and Johnston (1993) found that some 30 percent indeed had a remuneration committee and that they were often not composed solely of non-executives. This was contained in a study conducted of 22 large UK companies in 1990 to obtain evidence of a remuneration committee. The companies paid the highest directors' compensation where the companies did have remuneration committees. Although this is but one study and was conducted in 1993 (as noted by Main et al, 2007) it does suggest that having a remuneration committee is not an indication of improved corporate governance. These findings could be interpreted that a remuneration committee is associated with higher levels of pay and made no positive impact on the incentive structure of pay that was also found by Conyon and Peck, (1998). They also reported that higher levels of executive pay were associated with a greater proportion of independent directors on the remuneration committee. Therefore, independence of the remuneration committee may not provide adequate controls over the levels of pay. Daily, Johnson, Ellstrand and Dalton, (1998) found no evidence that a remuneration committee with affiliate directors paid the executives higher than independent committees.

#### **4.17 Collusion and Bidding Up**

A 'cosy collusion' exists between executive directors and non-executive directors who happen to sit on each other's boards or remuneration committees and thus are able to bid up each other's earnings according to Ezzamel and Watson 1998:221). This asymmetric pay adjustment process produced clear evidence of a lack of board independence and is highly contentious.

If this is the case then the concept of a remuneration committee is failing and they are not tough enough says Brett, (2003). In the UK, nearly half of company chairpersons surveyed in the wake of the Hampel, (1998) Report thought that bidding up of pay occurred, but as a consequence of increased disclosure rather than the presence of remuneration committees (Clarke, Conyon, and Peck, 1998). As stated earlier, a remuneration committee is as good as its members. This

problem is so vital that it should be subjected to much scrutiny in our research. In the UK, the London Stock Exchange issued a 76-page brochure on “Corporate Governance - A Practical Guide July 2004” which added much guidance to companies in their corporate governance and particularly on subjects like the qualifications of NEDs and their independence.

#### **4.18 Monitoring Role and Further Criticism**

Fernandes (2008:30) conducted research of Portuguese companies. After recent corporate scandals and central roles that top executives played in them, the Portuguese stock market regulator recommended in 2001 that listed companies must disclose in their annual reports payments to top executives. The Corporate Governance recommendation of 2005 introduced corporate governance recommendations that included the obligation to disclose payment to top executives, obliging payments to board members to be structured to permit their interests to be in line with those of the company. The extensive research by Fernandes, (2008:30) embraced 51 companies listed on Euronext Lisbon from which he hand-collected data on compensation for all directors from 2002- 2004, categorising companies into large, medium and small based on market capitalisation. In his sample, one third of the companies do not have any executive members with the maximum number of non – executives being 80 per cent. The source of their information is Worldscope, Datastream, Euronext, and Lisbon. He finds that executive compensation increases when boards have more non–executive directors, attempting to align the interests of the directors and shareholders. Stock options granted were not included. The results show that the overall level of pay of executive members is in line with pay levels in the U.S. or U.K. The conclusion is not a favourable one for non- Executive Board members stating that they do not have a strong monitoring role (Fernandes, 2008:30). The belief is that they are affected by the high pay they themselves receive for low effort having little incentive to act as honest guardians for shareholders interests. The further conclusion is that wages are higher when companies have more non- executive board members and companies with no non–executive members have better alignment between managers and shareholders interests. This leaves the thought of what effect non–executive members will have on

remuneration committees, which have been promoted as one of the solutions to powerful CEOs, who rule boards Fernandes, (2008:30) accentuate the doubts expressed in many circles on the independence of outside directors. His data suggests the NEDs are not really performing their stipulated roles; and certainly not their watchdog role, there being few incentives for them. They suffer more criticism with (Fernandes, 2008:30) finding “that there are high wages paid and that the relatively low effort required by these non-executive based board directorships can be highly attractive positions.”

Notable in Fernandes, (2008:30) research are firstly, the fact that he is a non-UK or USA researcher, secondly, his article is current – 2007 – and lastly, it contained impressive extensive research. If remuneration committees are not effective then he views the costs of compensation to be too high and corporate governance will also suffer. The only doubt is whether Portugal is so different from the UK or USA that the results may not be comparable but there has not been any cause for this doubt. Finally, his findings are most pointed and direct.

The results of the research by Fernandes,(2008) are against remuneration committees.

#### **4.19 Institutional Investors: dedicated (long horizons) and transitional**

Dedicated institutional investors with long investment horizons can play a positive role according to their trading characteristics Dong and Ozkan, (2008). They were able to provide evidence suggesting that dedicated institutional ownership as elaborated on earlier not only restrains the director pay level, but also strengthens pay–performance relationship in firms where they have significant stakes.

Dong and Ozkan, (2008) examined empirically the determinants of director pay for a sample of listed non-financial firms in the UK. They focused on the effects of institutional ownership in the UK on both director pay and pay–performance relationship. Their analysis initially reveals that institutional investors, as a whole,

make no appreciable difference in the determination of director pay level and pay–performance relationship. After they divide institutions into “dedicated” and “transient” groups, they show that dedicated institutions restrain the level of director pay and strengthen pay–performance link. This is consistent with their expectation that dedicated (long-horizon) institutions are more involved in corporate governance and serve a better monitoring and disciplining role than other short-horizon institutions. Their paper investigated the role of institutional investors in determining director pay in publicly listed non-financial UK companies. The focus has been on the distinction between institutional shareholders regarding their investment horizons. They investigated whether institutional investors, in particular dedicated ones, impact the level of director pay and influence pay–performance relations taken by remuneration committees. This becomes significant when considering whether such investors should be consulted concerning remuneration or even other corporate governance matters.

#### **4.20 Long Term Incentives (LTI), Total Shareholder Return (TSR) and Substance and Symbolism**

This section examines the attitude of a remuneration committee to the long-term future of the company as, contrasted to immediate returns, as well as the importance of the depth of the policy application, when compared to showing a “good story”.

In their interviews, Brain et al (2008:230) found that evidence of a similar desire to conform also emerged when remuneration committee members attempted to explain the relative prevalence of growth in earnings per share and total shareholder return (TSR) (vide paragraph 4.14) as performance metrics in long-term incentive (LTI) awards to the executive. (Bruce Buck & Main, 2005:1500) The requirement to satisfy outside commentators rather than to display any linkage to corporate strategy was usually proffered as a justification. The performance metrics utilised in the companies where the interviewees sit on the remuneration committee reveal a much richer range in short term incentives and (annual bonus) than in long term incentives (share options and performance shares). Westphal and Zajac (1994) also dealt with long-term incentive plans (LTIP) more from the aspect of substance symbolism in

CEO contracts. They examined the political and institutional determinants thereof. Their research extended to 570 of the largest USA companies over two decades. Their findings showed that a substantial number of firms are likely to adopt, but not actually use, or only use to a limited extent, long-term incentive plans that they say suggests a potential separation of substance and symbolism in CEO compensation contracts. What is even more significant is that their analyses suggest that this decoupling of LTIP adoption and use is particularly prevalent with firms with powerful CEOs and firms with poor prior performance. Then they conducted further analyses, which showed that early adopters are more likely to pursue alignment between CEO and shareholders interests substantively, although later adopters then may pursue legitimacy by only symbolically controlling agency costs. How does this leave the shareholder? The principal sees one thing but what is it that he should see and to what extent is his investment to suffer from agency costs unknown to him. To put it succinctly - the principal will believe he is invested in a company with a secure management tied to a long-term incentive plan, which should show good returns, but in fact, this is not the case. This leaves him concerned as to what the future holds for his investment.

#### **4.21 South African Research**

There is a dearth of research articles on the remuneration committee system in South Africa. The book "Executive Pay in South Africa " is a key piece of literature on executive compensation and one of the few dedicated to the subject in South Africa by the authors who write extensively for the daily press in South Africa. Crotty and Bonorchis (2006:118) relate that on a few occasions local board members were called on to justify executive remuneration packages. Generally flimsy replies deny any impression of a vigorous arms length negotiation process or that those directors are concerned about their reputations. Therefore, they say that what is needed is for shareholders to pursue these issues. At general meetings of shareholders they have the opportunity to question the actions of the remuneration committee.

The mere perception of the introduction of a remuneration committee was a welcome move as it brought assurance that steps in the right direction were being taken to

look into whether there are independent checks on executive compensation. However, they raise the question of how strong remuneration committees are in negotiating compensation packages and how effective they are generally (supra).

The test is only likely to be shown where shareholders raise the issue. In South Africa, shareholders will unfortunately generally not have before them an annual remuneration report as extensive as is seen in the example in Appendix 4 (Pearson plc, 2006) in the UK. With such information before them they will be able to make the enquiries which will ascertain whether it is only symbolism that is being put before them or whether there is something of substance which will give them confidence in their company, both present, future short term and long term.

Thus the importance is that companies shape economies, and there needs to be broader accountability structures to ensure sustainability”

#### **4.22 A South African Critical view of the Remuneration Committee and its Members**

The published South African research has been by Tshepo Mongalo whose extensive article on remuneration committees in South Africa refers to their failure. He is now situated at the Law Faculty of the University of Cape Town and confirmed to this writer telephonically in late 2008 that as far as he is aware this is the only published research dedicated to remuneration committees in South Africa. Activism in some large UK companies highlights his view that investors want executive awards tied to their real contribution to value creation. Ten years after the introduction of the Cadbury Report (Cadbury, 1992) executives still did not suffer the consequences of their poor performance and were thus not aligned with shareholders. A further illustration is the golden handshake which Mongalo (2003) quotes as rewarding failure even after and probably because of poor performance, (Supra). He criticises share options that lack the link between pay and performance because they are one sided – the executive can only gain and not lose. Cosatu (2004) have figures to prove the disparity between executive pay and the worker

saying that 'we live in a grotesquely unequal society' and that such disparity will have an adverse impact on employee productivity.

Mongalo (2003) complains about remuneration committees as fundamentally made up of members who may have a good knowledge of the company but no interest therein. This aspect can also be considered in the light of what has been written earlier in this chapter on whether the holdings of institutions are dedicated or transient. In the UK when remuneration committees were established executive compensation grew dramatically. "He knows no evidence that companies with committees pay their executives lesser remuneration" (Mongalo, 2003:761). Some reasons for their ineffectiveness is access to information about other companies that is used as a basis for compensation decisions that should rather be based on merit. Interestingly, he comments that disclosure, which was so badly desired in the past, has actually caused remuneration to increase due to other higher payments by companies being viewed. Whilst expert advisors are promoted as essential to remuneration committees particularly due to the lack of expertise by board members, Mongalo (2003) questions their objectivity. It is risky for them to recommend austere or frugal packages as other consultants would then be preferred by the company in future. Should the consultants wish to ensure their own futures then recommending packages in the cases that mediocre results do not warrant them can only promote them. NEDs sitting on other boards tend to set a higher upper benchmark of pay within companies than is warranted. To him they have lost objectivity. Then comes back- scratching. Mongalo (2003:763) says that this applies particularly where the executive has outside directorships and then continues to recommend that:

*"It is clear that remuneration committees are not well positioned to tackle concerns regarding executive remuneration packages. In the UK they have not been positive in ensuring that at least pay is linked to performance." (Mongalo, 2003:763). It is clear that disclosure as a mechanism to bring pay in line with performance has failed dramatically"*

Mongalo,(2003:766), referring to the GSK vote (51% of GSK shareholders voted down a severance agreement), says it is worthwhile for the UK position to be

seriously considered in South Africa. The payment of \$US 35 million had been recommended in a report from the GSK remuneration committee. This illustrates effective shareholder power at general meetings of a company.

Mongalo (2003) titled his paper "Shareholder Activism in the United Kingdom Highlights the Failure of Remuneration Committees: Lessons for South Africa" and proceeds to show that the significance is that there is a lesson South Africa can learn from the UK. It is of importance that the article is neither South African nor is the date 2003 too long ago as the content empirically evidences this. What we do not have is evidence of empirical South African research. How active are shareholders in South Africa and where are the leading shareholders? Although the press are active critics of companies, there is an opportunity for them to provide a welcome lead to the direction where shareholders should go. Mongalo, (2003) is of the view that remuneration committees are not successful and criticism by the press, although mainly dedicated to the quantum of compensation, is equally critical, as remuneration committees would not, in their view, pay such compensation.

Mongalo (2003) has raised many issues that need to be looked at for a remuneration committee to be more effective.

#### **4.23 Independence of the NED**

Should NEDs not display independence a perception of bias and wrong decisions on compensation and other matters within the bent of the remuneration committee would result. The NED holds a position of high trust and accountability. In the USA, the SEC set out requirements on NED independence. Wood (2004) explained Rule 16b-3, IRC Section 162(m), and the NYSE and NASDAQ listing requirements as creating a number of specific requirements for determining compensation committee independence. These requirements, as detailed as they may be, cannot, however, be relied upon as the exclusive test of independence. Wood (2004) believes that, in assessing a director's independence for state law purposes, a board should take account of personal friendships, prior business relationships, and even ties created by philanthropic activities between executives and board members. As a lawyer, he

explains a background of case law on this aspect of independence. He concludes that such connections might interfere with, or be perceived as interfering with, the board member's objectivity in evaluating executive pay. The USA regulations (quoted by (Wood, 2004)) are of more extensive detail than exists in South Africa. The rules are not only issued by the SEC but also by the Internal Revenue code, the New York Stock Exchange and the NASDAQ. The implementation of these stringent requirements may not be easily implemented but they are not merely symbolic. When called upon to qualify as a NED the applicant should be put to a subjective test that would not be merely symbolic. The implementation of such a test would certainly inspire stakeholders.

Having seen that the NED is fundamental to the activities and effectiveness of the remuneration committee his qualifications are then viewed from two aspects. Firstly, from the requirements of what one would expect of a director with a particular bent towards the remuneration committee and secondly, there are the recommendations (regulations) of bodies like the (Cadbury, 1992) and Greenbury reports (UK) and the SEC in the USA. It has thus been seen quite clearly that the independence of the NED is a *sine qua non*. As with qualifications, this is seen in recommendations (regulations) and in addition in the person himself.

The importance of the independence of directors is stressed in the King Report at 2.4.3 on page 24 which states these as:

*"Independent director – is a non-executive director who:*

*(i) is not a representative of a shareowner who has the ability to control or significantly influence management;*

*(ii) has not been employed by the company or the group of which it currently forms part, in any executive capacity for the preceding three financial years;*

*(iii) is not a member of the immediate family of an individual who is, or has been in any of the past three financial years, employed by the company or the group in an executive capacity;*

*(iv) is not a professional advisor to the company or the group, other than in a director capacity;*

*(v) is not a significant supplier to, or customer of the company or group;*

*(vi) has no significant contractual relationship with the*

*company or group; and  
(vii) is free from any business or other relationship which  
could be seen to materially interfere with the  
individual's capacity to act in an independent  
manner."*

This is a matter for consideration, certainly from the aspect of substance and symbolism and to avoid criticism of cronyism. Research has shown that the independence of the NED is actively desired. It is a vital aspect of corporate governance.

This chapter has shown research on the problems expressed in Agency Theory and views of a remuneration committee. There have been varied opinions on whether the remuneration committee system is working, whether it is applicable or whether shareholders should exercise more power. The importance of the NED has been seen from many points of view. Remuneration is a major task of the committee and many aspects have been seen particularly for the benefit of the company by incentivising the executive. Throughout, the importance and application of corporate governance has been paramount.

#### **4.24 Motivation**

When commenting on the Quantum of Compensation in paragraph 4.3, above reference was made to (McConvill , 2004) whose view is that pay for performance is a flawed methodology. His writings of are of great importance and should be noted by remuneration committees. Unfortunately, this is not a discourse on psychology but his writing are worth noting well. He draws on an extensive range of literature in psychology, management and workplace relations, behavioural law and economics, sociology, philosophy and law.

#### **4.25 Authors Quoted**

This literature review has benefited from the writings of top academics locally and internationally. The King Report (King Committee, 2002) set the tone for corporate

governance in South Africa and Cadbury (1992) reported in the UK. No literature on the topic of remuneration committees and executives could exclude Jensen and the various academics who wrote jointly with him. Sanchez in Spain has vast literature on his website. Numerous UK writers are quoted. The contrary views on remuneration committees are expressed succinctly by (Bebchuk & Fried, 2004) in their book. One might call Crotty and Bonarchis (2006) ubiquitous, reading their articles almost every day in Business Report (Independent Newspapers); and lastly one is rather proud of the direct expressions of the views of UCT's own Mongalo. Because the results of the McKinsey research are so vital to corporate governance, enquiries were made to qualify them. The essence of the response received was "McKinsey is the crème de la crème of strategic and financial consultancies. It has huge and immense credibility."

Such literature is the starting point after which this thesis will proceed to conduct its own research by a survey and interview.

# **CHAPTER 5**

## **RESEARCH METHODOLOGY**

### **5.1 Quantitative and Qualitative**

Research now continues and forms a backdrop to enquiries conducted in a qualitative approach in the form of personal interviews. The quantitative research was conducted in the form of a survey despatched electronically in order to enrich, complement and enhance the qualitative results. In such quantitative research, the results of the survey conducted are analysed.

Of these two main methods, it is necessary to ascertain whether quantitative research will be appropriate and to ascertain whether the information furnished can be applied in comparison with the results of interviews and the literature survey on the administration of executive compensation by a remuneration committee. With this in mind, the questions in the electronic survey have been designed appropriately.

### **5.2 The Interviews**

The qualitative research interviews were undertaken to obtain practical empirical information at high level. A spectrum of views was sought to ascertain what procedures and policies are applied in practice in remuneration committees. The six persons interviewed were the chairman of a listed company, the managing director of a formerly listed company, the recently retired CEO of a listed company, the CEO of a listed company, the chair of remuneration committees of unlisted substantial companies and an analyst. Each of these persons is involved in remuneration committees and they hold positions in companies where such committees are a vital link. The variety of persons interviewed afforded a spread that afforded a balance of views. Although only six persons were interviewed, no matter how balanced, this low number was supplemented by the electronic survey that brought in the views of thirty one persons. After canvassing a variety of views of academics in the Faculty of Commerce this response was considered to be satisfactory. It was concluded that

survey responses should not stand on their own but need to be supplemented by the views obtained in interviews and in the literature review. This is discussed further in 5.4 below.

The writer considers himself highly fortunate in succeeding in obtaining the cooperation of the interviewees. The outcome brought a balance of views. There are numerous companies in which the top executives could most likely have a wealth of experience. To request an interview “out of the blue” would not have much chance of success and then when conducted the respondent would start from a fundamental, understandable basis of not knowing whether to trust the writer. The interviews were highly stimulating. Something, which flowed during the interviews, was an attitude by those running companies that they would observe in the breach many norms but on a legal and moral basis would act in the interests of their companies. This was illustrated by an attitude that where profit targets were not achieved they still paid executives bonuses for plain hard work in exasperating economic climates and the chairmen would then be prepared to take the criticism from investors particularly as they know how hard it is to obtain and retain top executives. They were prepared to make such disclosures to the writer because of the confidentiality undertaking.

### **5.3 The Survey**

The quantitative research follows the qualitative research. The survey was conducted through a questionnaire on various aspects of remuneration committees (Appendix 2). A robust research solicitation of views was conducted in order that a comparison can be made of a research survey against interviews in order to ascertain what knowledge can be added and in order to enrich the information from the interviews.

The basis of choosing the questions flows from the personal interviews conducted as well as the matters dealt with in the Literature Review Chapter. Matters raised in the research and reported on in the literature review are thus canvassed from a wider number of persons in the survey.

Prior to dispatching the questionnaire, a draft was tested against a variety of persons for their reactions and criticisms. Without listing all persons a sample would be a former Cape Town Stock broker who is now a leading investment advisor in London, the Managing Director of the Finance Section of one of the top international investment banks situated in Hong Kong, a business woman in Cape Town, and it goes without saying that this author received valuable guidance from his supervisor. Some of their comments are of interest. One said that he had never served on a remuneration committee; that the answers called for should stress more the “agree/disagree” format; the invitation to the respondent to telephone was considered important. A few important calls were received. There was some criticism of the great stress placed on the “jobs for pals” tone of some of the questions. The response thereto dealt with the importance of the NEDs in the remuneration committee being so fundamental that if there were not completely independent members then the investing public would reconsider the corporate governance aspect of any company's remuneration committee. A few of the persons tested asked for nepotism or cronyism to be explained; consequently, definitions were inserted in to the questionnaire. Inserting a background explanation to the complete questionnaire was considered but as brevity is of the essence in obtaining responses this was not proceeded with. It was decided however to explain briefly the functions of a remuneration committee in a question. This may be seemingly basic, but it is vital. In framing the questions, brevity was of importance as the recipients are top executives and analysts in South Africa who are cognisant of time constraints; if the survey is too long, they will merely ignore it. It is well recognised that there are a vast number of surveys being sent out but the electronic method was on balance considered by far to be the best one.

A general impression received from these discussions is that knowledge on the basic requirements and the workings of a remuneration committee is thin. It is thus considered important that the chapter herein headed “Remuneration Committee” furnishes the reader with a description of the background and workings of the remuneration committee today.

Sending the survey via hard copy correspondence was rejected as being too tedious to the recipient, too costly and not more effective than electronic communication that is considered more acceptable today than hard copy. It is also easier for the recipient to reply electronically. The electronic survey method that was decided upon was that provided by the University of Cape Town known as "Select Survey" which is one not often used by individuals. The facilities on this system allow questions to be asked in a variety of formats with multiple-choice answers, the main one being the 'agree, disagree' method. Thus, the decision was made that the best system is for the questions to be framed mainly to allow for the "agree/disagree" format. This allowed for a more positive and decisive response. The questions were so worded that direct and dedicated answers were required without any long deviations. Care was taken to ensure that opinions were not being expressed or suggested in framing the questions. The email letters were personalised by being addressed to individuals, by name, position and their company and more information where considered necessary, considering that they are persons of influence and experience. The same letter was thus sent individually to many individuals.

#### **5.4 The Recipients of the Survey**

These are persons chosen for their influence and knowledge. The survey was sent to the CEO and CFO of almost all listed companies on the JSE - a total of 243 emails were dispatched.. In other cases, the survey was addressed to the chairman or managing director or similar senior positions for reasons applicable to the individual companies. The analysts or investment officers of institutions were also addressed. It is of importance to ensure that the list of companies is comprehensive. Thus, the names and addresses of such recipients were obtained from Macgregor's "Who Owns Whom" (2008) book which lists 349 companies plus others on the development board of the Alternative Exchange which companies were not included in the survey Whilst the purpose is to include all companies listed on the JSE, those owning properties reflected in the Property Unit Trusts and Loan Stock companies were in some instances excluded where they employ very few, if any, staff, rather using property administration companies. A problem is that new companies are being listed continuously these cannot be found easily and do not have a listed

history. A comprehensive list was therefore used. Considerable efforts were made to obtain email addresses of their companies. Telephonic enquiries were mainly successful although changes did occur and email reports on non-deliveries did not facilitate delivery despite follow up calls. The covering letter was worded as to appeal to the responsibility toward corporate governance. In interviews and general enquiries it was ascertained that every executive is personally, interested in earnings thus the introductory caption to the covering letter read "Executive Remuneration".

Although an email list of all companies listed on the JSE was made available this was not used for the reason that results on an ad hoc basis were not required. The responses are from persons whose views should be respected.

In 5.2 references is made to the receipt of 31 responses to the survey out of 243 requests. Despite that view, the quality of the responses received from some of the most senior executives and the size and stature of their companies make up for quality over the quantity of the views expressed. The responses are thus academically considered both acceptable and defensible. Anderson, Sweeney and Williams (1990:247) confirm this saying that:

*".... The sample size of 30 is the rule of thumb that allows us to assume that the large sample conditions of the central limit theorem have been satisfied.*

This research now proceeds to consider the results of the qualitative and quantitative research and the literature research, organising the various views together in order to facilitate comparison.

## **CHAPTER 6**

### **RESULTS AND ANALYSIS**

Having completed the literature review, conducted the interviews and the survey, it follows to examine the results of these aspects referred to in the research methodology.

#### **6.1 Corporate Governance**

Each person interviewed accepted that corporate governance of the highest standard is the norm, with the King Reports setting the basis in South Africa. No direct reference in the survey was made thereto but it had high standards as the basis. The literature review reflects an attitude that all of the research strives for the highest and the best standards for investors, the executives, the company, and its staff, that corporate governance will produce. A remuneration committee is an essential function of the prerequisites of corporate governance.

In the literature review it was shown that the vast benefits to companies which conform properly to corporate governance were noted by Coombes and Watson (2000), published in the in the McKinsey and Co. report. They found that a huge number of global institutional investors indicated a willingness to pay a premium for the shares of a well-governed company over one considered poorly governed but with a comparable financial record. Three-quarters of these investors indicated that board practices were at least as important as financial performance, when evaluating companies for potential investment simultaneously adding significant shareowner value, which can also make countries, especially in the emerging markets, a magnet for global capital.

Corporate governance is at the core of all aspects of the motivation, results and activities involved in this research. None of those interviewed and surveyed had anything adverse to say about corporate governance nor was there anything adverse in the literature review.

## 6.2 Support for the Remuneration Committee System over Agency Theory

At interviews, there was acceptance almost throughout in favour of the remuneration committee system except from the analyst who favoured to empower shareholders. The survey supported the views of those interviewed by voting 78, 57% against shareholders having more say or 71,42% against applying alternative methods to the remuneration committee system. The system is not left alone in an oligarchic manner but in the survey, there was a 92,74% vote for spelling out their policies to shareholders in the annual report submitted to the Annual General Meeting of Shareholders. One respondent commented: "Shareholders should have the authority to vote on broad remuneration principles via a remuneration report and vote annually – they should vote on principles". Another respondent put it differently

*"It is impractical to let shareholders decide on operational issues like remuneration. The chairman of a remuneration committee is to answer questions on his area of responsibility at a shareholders meeting. They are entitled to voice concerns or refuse to reappoint directors or ask for remuneration details at shareholder meetings".*

However, this may not always be the case in practice. Crotty and Bonarchis (2006:118) relate that when board members were called on to justify packages there were flimsy replies which denied any impression that a vigorous arms length negotiation process had been carried out or that directors are concerned about their reputations. They say that what is needed is for shareholders to pursue these issues at general meetings of shareholders when they have the opportunity to question the actions of the remuneration committee.

A conclusive opinion in the survey summed up the matter when a respondent said:

*"If shareholders do not agree with the remuneration of executives, they should voice their opinion to the board. They should, however, not be in a position to have power to dictate remuneration of executives. The Remuneration*

*Committee system should remain as the method authorising executive remuneration”.*

Other points of view appear in the literature review. South African research was against many aspects of the operations of a remuneration committee. These will be seen in various aspects of the research outlined in this chapter. Overseas research expressed many opinions against the remuneration committee system. (Fernandes, 2008:30) conducted extensive empirical research that concluded that NEDs do not have a strong monitoring role and that executive emoluments are higher when companies have more NEDs. He criticised NEDs as being influenced by their own high pay.

Reviewing the analysis of the views expressed one sees that there is much support for the remuneration committee system in contrast to empowering shareholders but dissatisfaction with the way the committees are conducted. In the UK, USA and South Africa remuneration committees were formally introduced approximately a decade ago. They can thus still be considered young but what should be noted is that they are progressing away from the Agency Theory methods. This is progress although they do have room for further improvement.

### **6.3 Shareholders vs. Remuneration Committees for Executive Compensation**

The debate is whether executive compensation should be decided upon directly by shareholder involvement rather than delegating this power to a remuneration committee. In the literature review, there were powerful writings against a remuneration committee that supported the view that the decisions on remuneration should vest in shareholders. Bolton et al, (2007), however, claimed that the bursting of the technology bubble was attributed to the lack of the proper control by shareholders whereas a properly set up remuneration committee might have assisted in preventing some of the root causes.

No views were expressed calling for reversion to Agency Theory.

78,57% voted against placing more power in the hands of shareholders authorising executive remuneration, with almost the same number (71 42%) not accepting that there are better alternative methods than the remuneration committee. What was considered more practical is to limit institutional shareholders to be more effective in expressing their views to the board on how it decided on executive compensation. In the section provided in the survey for comments, views expressed were “Why have any board then? – no points in having a remuneration committee”, “why weaken the board’s rights, shareholders should vote on broad principles”. One respondent in viewing shareholder involvement as impractical points out that those large blocks of shareholders could then express their interest in board remuneration. Other comments are that decisions in the domain of shareholders destroy wealth and are impractical. The remuneration of executives goes to the core of a company’s longer term performance through its influence on the calibre and depth of leadership - thus they say it is “madness to hand this to a distant and possibly disinterested shareholder body”; “shareholders would not have access to the necessary specialist and informed decisions and would have very little knowledge of appropriate remuneration”. One ‘anti’ view said that shareholder activism is critical on remuneration related issues. By this, one interprets that shareholders would not see a balanced view on the importance of compensation particularly the importance of obtaining and retaining executives and not merely being critical about the remuneration without being constructive by looking at the overall strategy of the company. In the interviews, the objection against shareholder involvement was strong, adding that shareholders also did not have the qualifications to be directors.

Barak et al (2008) as well as Cohen and Lauterbach (2007) showed that shareholder power could negate a remuneration committee decision indicating that the independence of a remuneration committee must not be interfered with by a powerful shareholder.

Bebchuk and Fried, (2004:195-200) were critical of board monitoring and recommended increased shareholder power by larger institutions. They disapproved of existing systems and used strong terms such as “defective board monitoring”,

“abuse by CEOs” and “executive pay excesses” and submitted a “recommended alternative managerial power model”.

Jensen, (2007:2) warns against giving the agent a “blank cheque” saying he must account to the principals who should monitor.

The above views indicate much support for the remuneration committee system from the survey respondents as well as at the interviews. Opposition was shown to remuneration committees in the literature research with corresponding support from them for shareholder involvement.

It is prevalent today for companies to seek approval for payment of the fees payable to NEDs (only) at shareholder meetings.

#### **6.4 Outside Remuneration Consultants**

At interviews, most companies supported the use of remuneration consultants. One company appointed a life and pensions consultant, who is not a director of the company, as a member of the remuneration committee. In the research literature there is a strong adverse view on bias shown by such consultants who would affect their own popularity if they do not present remuneration statistics favourable to the executives. Mongalo (2003) questions their objectivity saying that it is risky for them to personally recommend austere or frugal packages as other consultants would then be preferred by the company in future. Should the consultants wish to secure their own futures then they should realise that in the event of them recommending compensation packages that reflect mediocre emoluments they then take the risk of not being re-appointed

In one interview, the company restricted the use of such consultants to a minimum. Only on an occasional basis were consultants used. Their committee preferred to follow the market itself by keeping abreast of trends in the press and by inserting advertisements themselves as well as generally maintaining communications between companies and executives.

In the survey 89,19 % considered it essential for external and /or internal remuneration consultants to advise the remuneration committee in deciding on compensation. Whatever the correct view is, the committee must be guided by proper research into the quantum of compensation paid in the market place and employments packages and conditions as NEDs cannot themselves be regarded to be specialists in executive packages.

The analysis stresses the importance of consulting experts on the matter of executive compensation that is regarded as not being within the knowledge of the average director. Whilst all were in favour of consulting them, in the literature review there was a strong warning to be sceptical of the motives of the consultants. From this, one is left with the thought that the consultants should be put to direct tests as to their methods; alternatively, two separate firms of consultants could be used independently either on the same issue or on different divisions of a company. The one could be played off against the other.

## **6.5 The CEO**

At each interview, the problem of a sudden unexpected replacement of a CEO was considered to be a major source of concern. One interviewee had been a director of a company that had suffered such a problem. No definitive solution to the problem was offered although many alternatives were considered, the easiest being found in a group of companies consisting of many divisions to have within such divisions executives capable of such promotion. The working life of a CEO is considered a maximum of ten to fifteen years with age being a factor to take in to account, particularly in the fashion industry.

In a unitary board, the CEO is the executive director whilst the majority of the board are NEDs. At interviews, no need was seen to increase the number of executives although some companies do also appoint the CFO and Managing Director to the board. In the survey 62,06% voted to increase the number of executives who are members of the main board but still ensuring that NEDs remained in the majority. The unitary board system is becoming well accepted in South Africa with the majority

of the main board having no involvement at all in the executive function of the company. This matter was not a contentious one. An important aspect emerging from the interviews is the importance of ensuring that there is depth to management that would avoid the major problem of an unexpected loss of a CEO.

*“Given the strategic operational role of the chief executive officer, this function should be separate from that of the chairperson” (King Committee, 2002:23).*

## **6.6 Qualifications Appointment and Independence of NEDs**

In the literature review Clarke et al, (1998) pointed out that a remuneration committee is only as good as its members. A guide as to the qualifications has been issued by the London Stock Exchange as part of their 76-page brochure on corporate governance. The qualifications could not be discussed at interviews, as the interviewees were themselves NEDs.

In the literature review, Mongalo (2003) complains about remuneration committees being fundamentally made up of members who may have a good knowledge of the company but no interest therein. In the interviews, the support was for the unitary board system with no problem being expressed about the selection process. In the survey 100% voted that remuneration committee members should have various specific attributes and not to generally be persons with business experience.

These attributes which respondents to the survey listed commenced with a sound knowledge of remuneration, then followed numerous other attributes such as broad skills, general commercial and business knowledge of the ins and outs of package restructuring, employee benefit funds and of tax, to be economically astute, and have a reputation for being fair with integrity, experience on similar boards (being wary of conflicts at the same time), experience in human resources, a holistic picture of best practice in other organisations, independence, common sense and a sense of reality, having held previous senior managerial positions, industry experience, ability to stand up to executives and shareholders and finally a working knowledge of the business.

67,64% felt that at least two members of the committee should not be directors of the company and should rather be nominated from a pool of outside persons appointed for 3 years in order to maintain their independence from the main board. Following on this 62,85% wanted greater institutional involvement by forming a pool from which members would be available with impeccable qualifications. Whilst 80% are satisfied that remuneration committees are generally made up of independent members, 65,71% felt that the committees too often consist of friends and associates of the board and are thus not entirely independent(vide paragraph 6.7, below). However, 59,38% were against accusing the committee of being part of a “club”. Then 90% called for the nomination committee to play a more active part in forming the membership of the remuneration committee.

The extent of the answers furnished is a strong indication of the importance which senior executives, who are the main respondents of the survey, place upon the qualifications, appointment and independence of members of the remuneration committee and the vital part such committee plays in the welfare and progress of the company.

Thus, one sees that the importance to the company and its owners of the high standards required from the NEDs equates to that required of the main board directors.

## **6.7 Cronyism, Nepotism and the “Club”**

These are problematical questions which themselves invite debate. The answers furnished reflect appropriately. Whilst it is not considered good balance to frame survey questions to suggest an answer this question was initially very carefully looked at. Despite one sharp criticism from a survey respondent that the questions are not appropriate to a Masters thesis - this may well be - there are aspects of the answer that have been difficult to avoid. The choice of the appointment of additional directors must almost always express a board's wish to be responsible towards appointing a person whose qualifications are well known to them – and should refer to the extensive response on the qualifications of NEDs. When inviting non-executive

directors to join the board, the board will be most conservative in their approach as a reversal of their decision can be unpleasant and reflect poorly on them. Accordingly, the choice would veer toward someone known to them. How well known of course is the difference between cronyism and independent judgement.

In the literature review Ezzamel and Watson (1998) suggested that a 'cosy collusion' exists between executive directors and non-executive directors who happen to sit on each other's boards or remuneration committees and thus are able to bid up each other's earnings. If this is the case then the concept of a remuneration committee is failing and they are not tough enough to make independent unbiased decisions.

Mongalo (2003) criticises back scratching particularly where the NEDs have outside directorships in which they can recommend the appointment of each other. He continues to say that this does not allow remuneration committees to tackle concerns regarding executive remuneration packages. Another form of cronyism was seen in the research undertaken by (Barak et al, 2008) where owner CEOs exploit the company and extract private benefits in the form of inflated pay. Research in the UK found in a survey that nearly half of company chairmen thought that bidding up of pay occurred.

Despite these problems, it was thus encouraging to see that the responses to the survey showed that some two thirds voted in support of the accusation that boards did not make appointments based on accusations of cronyism and nepotism. Eighty per cent of the responses confirmed that the independence of persons appointed should be known to respondents. The result of the vote on whether new appointments have to be members of a "Club" was 60% saying this was not so and that appointees were independent of friendship obligations. Some comments are that remuneration cannot be administered by outsiders, that the remuneration committee must stand on its own two feet "and if not it is completely useless". The concerns are valid but not pervasive as shareholders meetings can take up the issue and shareholders do have the ability to nominate and appoint NEDs. Some strong opinions were voiced – an example was that there is a high incidence of cronyism and that there will always be a high incidence of cronyism. Finally, the sharpest

criticism is that companies appoint NEDs who are likely to agree with their views and once appointed they reciprocate favours for the opportunity offered to them. The comments and the votes are rather mixed and leave one without positive direction.

The following are some direct quotes from respondents to the survey:

*"I believe there is a high incidence of cronyism;  
Should not happen but I have no knowledge of whether it actually does;  
In our experience non-executive directors take their responsibilities very seriously and make decisions on external information such as remuneration benchmark reviews;  
Companies in most cases appoint non – executives who are likely to agree with their views. Once appointed these people reciprocate favours for the opportunity offered to them;  
There will always be a degree of cronyism in the appointment of non executive directors to a remuneration committee."*

It would have been considered aggressive to ask the persons interviewed whether the appointments they themselves had made were based on matters other than their best judgement of the suitability of the appointee.

In paragraph 6.5, the importance of the qualifications of the members of a remuneration committee was stressed. Thus, the instance of any cronyism or nepotism becomes a startling and major issue should it exist. Shareholder involvement in the activities of the remuneration committee met with general disapproval, the appointment of the members of such committee is one that should be subject to great interest at shareholder meetings. This need not only takes place when a new appointment is made but when the remuneration committee reports are submitted for approval at the annual general meetings. At that meeting, the opportunity should be availed of by shareholders to evaluate each of the members of the remuneration committee. NEDs should then respond to investor examination.

The recently passed Companies Act, No. 71 of 2008, which will only come into effect in 2010, provides that the sister committee - the audit committee - "...shall be appointed at each annual general meeting and shall comprise of at least 3 independent non-executive directors." A similar provision has not been inserted for a

remuneration committee but this is a matter for future consideration that would stress the importance of a remuneration committee.

## **6.8 Compensation**

The literature review, contained many requirements that the compensation committees should follow the philosophy and strategy of the company. The committee should be aligned to the company's overall vision, its mission and style (Weinberger, 2007). At the interviews, the respondents all felt that compensation in general is market related. Where criticism was levelled against the amount of remuneration, it had been found that, when subject to enquiry as to replacement cost, the latter was found to be higher. The margin of any possible overpayment was very often considered to make very little difference to the overall profits of the company but created excellent inducement to the executive. In literature Hsieh and Kleiner (2003:77) stress that "the positive impact that a great CEO can have is enormous and companies cannot afford to lose it." On the other hand, a robust empirical analysis of Dutch listed companies failed to detect a positive pay performance relationship (Duffhues & Kabir, 2008)

Ward (1998) felt the need for a remuneration committee to control outside appointments by the CEO from the aspect of time taken and his earnings. In addition, his research indicated that remuneration committees actively pursued the most efficient, democratic and open approaches to compensation from many angles that caused him to support the committees as opposed to Agency Theory.

Compensation being the main function of a remuneration committee is the subject of much research on whether various actions by the committee cause compensation to be higher or lower. The quantum of compensation is a vast subject not elaborated on herein, specifically due to this research being mainly on the effectiveness of the remuneration committee. The incentive aspect is considered a major function that this review now proceeds to deal with.

## 6.9 Incentives

In the literature review, Jensen and Murphy, (1998:270) ask whether current levels of CEO compensation are high enough to attract the best and brightest. He is against paying the executive like a bureaucrat because that is how he will then work. All persons interviewed agreed that one of the main financial ways to incentivise the CEO is by participation in the results of operations. 95,24% of those surveyed agreed that it is accepted today that incentive schemes are important to the employment of executives. The only dissenting view was expressed by the analyst who felt that the whole package needed prior approval of shareholders. This was supplemented in one case where executives participated in the results of nodes only which were not related to the bottom line. These nodes applied to specific tasks delegated to these executives. The most prevalent method is where targets are set at the commencement of a cost period, the formula providing for the executive to participate in a share of successfully reaching a target agreed upon in advance. Westphal and Zajac (1994) expressed concern about information asymmetry where substance and symbolism differed and a problem arose with verifying the targets submitted by the executive for purposes of calculating incentive payments. Landsberg (2007:22) warned against remuneration committees acting on an ad hoc basis saying that incentives should be carefully thought out and structured.

In the literature review Pfeffer (1998), stressed that even in the broader high-performance human resource management approach the application of pay contingent upon performance is recognised as a key component of compensation packages. The principal is striving for the agent to become a 'partner in the businesses. The contingent pay is thus equivalent to a share in the profits. To quote one interview

*"The difference between a good company and an excellent company is your top executives who make the company work. You must look after them".*

Whatever method is to be applied to incentivise the CEO the most successful method will be that in which a remuneration committee and the board cause him to

voluntarily, willingly and enthusiastically administer the firm. It was also noted that the CEO compensation endures for a relatively short period of time during which the CEO has to provide for his own subsequent future.

It was however, agreed that the payment of bonuses based thereon are not “cast in stone”. At one interview, the current economic downturn was considered in this light. The remuneration committee had to consider not paying bonuses when the executives completed a gruelling year in difficult economic circumstances. The head-hunters arrived with attractive signing on bonuses. A redeeming feature in these circumstances is the employment contract to which the executive was bound by a restraint of trade payment. So the remuneration committee was left with the problem of how to incentivise major efforts other than in “terms of the rules” especially when the results achieved are due to external economic factors. They broke the rules and paid bonuses in these circumstances.

The remuneration committee is guided by a CEO who shows his appreciation and leadership of the executives. All accept adherence to corporate governance. Important research writing is the comment by (Jensen and Murphy, 1998:270) that executives must be incentivised failing, which they will perform like bureaucrats to the detriment of the company.

In the survey 63,04% disagreed with the concept of shareholders approving the salary of the executive whilst 61,36% disagreed with the concept of shareholder approval of executive bonuses.

The views expressed were sharply in favour of the financial aspect taking steps to incentivise executives by participation in results achieved. Remuneration committees must however be cautious in merely accepting figures placed before them, whether such details relate to forecasts as to the future or of historical amounts. The mechanism of participatory incentivisation is regarded in the interviews as being of great importance to the success of the organisation. The public perception of high total emoluments of executives stems not so much from their basic salaries but from these bonus incentives.

## 6.10 Shareholders – Board Representation

Because shareholders are more involved and have an investment to consider, the question was included which asked whether institutions – generally referred to because they hold the largest shareholdings – should take up positions on the board. 65,51% supported this view yet, at interviews, the views were that they did not usually have the expertise or the commitment to the company, whether they have long or short-term horizons. The institutions themselves were reluctant to accept board positions and preferred having regular informal financial reviews with their analysts and executives of the company. One of the institution's main considerations is that if they have board representation and then bought and sold the shares they might be accused of insider trading. This exhibits an interesting aspect of the logic behind their investing in listed companies. It does not evidence an intention to be a long-term holder.

In the literature review we read that dedicated, as contrasted to transient, institutional investors can act as a monitoring or restraining factor on executive remuneration. The importance is that the investors must not be transient according to (Dong & Ozkan, 2008:351) who believe dedicated investors have a better discipline role to play. Dong and Ozkan, (2008:350) found that this is extended to institutional ownership having a positive and significant influence on CEO pay-for-performance sensitivity of option grants. Consequently, whilst a board may watch its largest (institutional) shareholders buy and sell their shares, the board and the remuneration committee remain in a position where they must steadily continue to take their own decisions with little if any guidance from or consultation with the (institutional) owners.

Other than the analyst interviewed; there is little support for shareholder involvement in the form of direct board representation – not even through the remuneration committee. In theory, the board should represent the major shareholders who are the true beneficiaries of the organisation's results. They should be "there to look after their money". This is not the situation due, firstly, to institutions not employing experts trained with the skills to sit on boards and secondly, because they keep to

themselves the right to be able to trade in the company's shares. This latter logic would render them subject to the penalties of insider trading as well as not being dedicated long-term holders - thus defeating the purpose of board representation.

### **6.11 An independent (NED) non- executive director as chairman of the board**

This question is close to the cronyism. In corporate governance, it is accepted and considered by the King Report, (King Committee, 2002:23) that "the chairperson should preferably be an independent non-executive director". Thus, one quarter of the votes in the survey against an independent NED chairman is significant but in the end not surprising due to the approach of many executives who are large shareholders who wish to have stronger control.

In the UK, there was a sharp adverse reaction when household name company Marks and Spencer appointed its CEO to be the board chairman. The chairman of the board is expected to be a NED having no management ties (Coakley & Iliopoulou 2006). Studies found that less independent and larger boards award CEOs significantly higher bonuses and salary.

*"Companies should be headed by an effective board that can both lead and control the company. The board should comprise a balance of executive and non-executive directors, preferably with a majority of non-executive directors, of whom sufficient should be independent of management so that shareowner interests (including minority interests) can be protected".*(King Committee, 2002:22). Today more companies are moving towards appointing an Independent NED as chairman.

### **6.12 The Press**

*"The media also have a part to play in drawing attention to governance issues of public or shareholder concern. It is vital to seize the opportunity presented".* (Cadbury, 1992:18)

Criticism of the press because they look for sensationalism was felt strongly by (96, 67%) of respondents to the survey. The suggestion was that the press should turn their attention to investigate fully how compensation is calculated (96,67%) as well as how such calculations are comprised (91, 66%). The consequences were not as strongly felt when 66,67% of respondents said that this could affect the quality of investors and investment. None of the respondents proffered commentary on whether there are any positive aspects of the functions served by the press.

No research was found on the effect of the press on remuneration committees nor were they discussed at interviews. The attitude of the press should be reviewed in an objective long-term context. Until disclosure became obligatory, investors were ill informed. Once King and other overseas bodies brought in disclosure requirements it was the press who then highlighted the extent of executive payments as disclosed in annual and other reports. These writings could be applied to more constructive comments on other aspects of listed companies' compensation policies. Announcements by companies of results are part of press briefings at which journalists have the opportunity to make balanced enquiries on the operations of remuneration committees. Thus they could then report in even greater depth on the emoluments that they consider being so vast.

A gap exists for the press to be informative on the workings of a remuneration committee as well as the infrastructure of executive employment. Such information would add strength to the information customarily provided by them and simultaneously promote investor confidence.

The views of those interviewed, the results of the electronic survey and research literature have now been compared. Conclusions must now be drawn from the research conducted.

## CHAPTER 7

### CONCLUSION

To establish remuneration committees has been a corrective process. The King Commission in South Africa and the Cadbury Commission in the UK successfully introduced remuneration committees. The initial problem was the escalating losses suffered under Agency Theory. Investments in companies suffered Rents and Outrage costs, the consequential mistrust, losses of confidence and weak corporate governance. Remuneration committees were thus, introduced as the solution to the Agency Theory problem. In that they have succeeded.

The importance, whether they are effective is seen in the strategic effect that remuneration committees have on the results and operations of listed companies. A divergence of views expressed no confidence in the remuneration committee system, supported in the literature review by many authors although persons interviewed did not express any adverse views against the system, nor did the electronic survey elicit strong views against the system. There was some support for shareholders to be more empowered, albeit without direct involvement. The strong call has been for shareholders to be more outspoken in their contacts with boards whether at shareholder meetings or by indirect approaches. With such a hiatus of opinions, are they effective? Firstly, the committees are young, having only been established in the 1990s. Then, there is not much research of a current and topical nature to establish in some detail whether their operations have actually been successful. This is one of the matters for future research.

Whether remuneration committees are effective enough has been shown to be debatable, but they are “the best we have”. Nevertheless, they can be improved upon. Whilst many faults have been shown in this research, remuneration committees, although effective, have need for much improvement.

Symbolism may give the impression to outsiders that all is well whereas substance may well be lacking. Doubts exist whether the committees are substantially carrying out their functions; for example by the employment of the correct remuneration

consultants or whether the right persons are appointed to the committees or whether NEDs are merely friends of the board appointed “crony like.”

There is now full disclosure of the emoluments of the executives and their incentive bonuses are properly shown. Nevertheless, it has not been established whether the committees apply their minds fully to the calculations placed before them on how participation in profit sharing schemes is calculated. Information furnished on such procedures would instil confidence in investors

King and Cadbury supported the use of outside advisers. The committees are thus not left to select emoluments based on their own non-professional experience. Nevertheless, investors should be advised of this in the annual remuneration report together with information showing that the committee has chosen such consultants wisely. Doubt has been expressed whether the consultants apply themselves fully in the interests of the company in a professional manner. The committee should also be a direct party to the engagement of remuneration consultants and not leave it to executives to engage them. Enquiries should also be instituted directly by the NEDs as to compensation in comparable businesses.

King and Cadbury called for the unitary board system comprised of the appropriate number of NEDs that is now extensively applied by listed companies. The question is left open as to who appoints the NEDs. Logic would expect those who own the companies to be represented on the board. Such owners (the institutions) are avoiding this and leaving it to professional management. They should be more involved and take such interest as would be expected of one who values full protection of his assets. Institutions are mainly investing on behalf of client investors who would expect them to be more involved in the underlying companies in which their savings are invested. The holder of a life policy with (say) Old Mutual, Sanlam or Liberty will want to know that his savings are invested in Companies where the insurance company takes proper and full board representation where they hold large percentages of the capital and not leave it to others.

Many points of view have been expressed for and against the effectiveness of the remuneration committee system for listed companies in South Africa. However, the structure of the committee omits what is truly left outstanding, that is whether a committee made up of transient members can finally be effective. Greater openness in the appointments of NEDs would be one step in improving this perception with more involvement from larger shareholders on boards that would instil greater confidence. Strong views were expressed on whether the NEDs were appointed consequent upon cronyism or nepotism - serious matters which affect their independence and which cast doubt on whether they were chosen on merit. There is a need for the regulations defining independence to be more rigorously applied.

The problem is whether their appointments are merely an assignment to them with no permanence. The introduction to this study related the problems in the Royal Bank of Scotland and Lloyds Bank. It has still to be seen whether remuneration committees are strong enough to prevent recurrences. One doubts whether transient NEDs with short-term engagements have the commitment to become sufficiently involved.

Remuneration committees serve an important function in promoting corporate governance. Their existence adds to investor confidence that corporate governance is in place. The McKinsey quarterly showed us of what tremendous importance corporate governance is to the capital structure of a company and empirically illustrated the quantitative effect on company values when corporate governance is, or is not, properly in place. More visibility is needed in appointments of NEDs.

The conclusion drawn from the research conducted in its various forms is that remuneration committees are effective with the qualification that much progress still needs to be made. Thus, there is scope for improvement and further research will promote this.

Suggestions for further research are contained in Appendix 1.

## REFERENCES

### JOURNALS

- Barak, R., Cohen, S. and Lauterbach, B. 2008. The Effect of CEO Pay on Firm Valuation in Closely Held Firms. Abstract of Working Paper.[Online]. Available from the UCT Libraries Website: Social Sciences Research Network at <http://www.lib.uct.ac.za> [2009, July, 16].
- Bender, R., 2004, Why do Companies Use Performance Related Pay for Their Executives? *Corporate Governance: An International Review*. 12(5):521-525.
- Bolton, P., Scheinkman, J.A., Xiong, W., 2007. Pay for Short-Term Performance: Executive Compensation in Speculative Markets *SSRN-ECGI - Finance Working Paper No. 79/2005*.
- Brain, B.G.M., Jackson, C., Pymm, J. and Wright, V.. 2007. The Remuneration Committee and Strategic Human Resource Management, University of Edinburgh. SSRN. *Corporate Governance an International Review*. 16(3):225-238.
- Brett, 2003, Participation and Accountability in Development Management, *The Journal of Development Studies*, Vol.40, N.2.
- Bruce, A., Buck, T., Main, B.G. M. 2005, Top Executive Remuneration: A View from Europe. *Journal of Management Studies*. 42:7:1493-1506.
- Business Report International, An article in the Cape Times daily newspaper of 11 February 2009, 1:22.
- Clarke, R. N., Conyon, M. J. and Peck, S. I. 1998. Corporate Governance and Directors' Remuneration: Views from the Top. *Business Strategy Review*, 9(4):21-30.
- Coakley, J. and Iliopoulou, S. 2006. Bidder CEO and Other Executive Compensation in UK M As. *European Financial Management*, 12(4):609-631.
- Cohen, T. and Uliana, E. 1990. An evaluation of Corporate Ownership Structures on Employee, Management and Shareholder Compensation for JSE Companies. *De Ratione*. (Winter): 7-14.
- Cohen, S. and Lauterbach, B. 2007. Differences in Pay between Owner and Non-Owner CEOs: Evidence from Israel. *Journal of Multi-Financial Management*. 18:4-15.

Companies Act Number 61 of 1973 and latterly Number 71 of 2008.

Canyon, M. J. and Peck, S. I. 1998. Board Control, Remuneration Committees and Top Management Compensation. *Academy of Management Journal*. 41:146-157.

Coombes, P. and Watson, M., 2000. Three Surveys on Corporate Governance. *McKinsey Quarterly*, (December 2000), 74.

Core, J.E., Guay, W.R, David, F and Larcker, D.F. 2008. The Power of the Pen and Executive Compensation. *Journal of Financial Economics* 88(1):1-25.

Core, J.E. and Larcker, D.F. 2003. Performance Consequences of Mandatory Increases in Executive Stock Ownership. *The Journal of Financial Economics*.64 (3):317-340.

Cosatu (2004): Guidelines for Corporate Law Reform. Presented to Corporate Law Reform Task Team, Trade and Industry Chamber, Nedlac.

Daily, C. M., Johnson, J. L., Ellstrand, A. E., and Dalton, D. R. 1998. Compensation Committee Composition as a Determinant of CEO Compensation. *Academy of Management Journal*. 41(2): 209-220. 20-47.

De Fusco, R.A., Johnson, R.R. and Zorn, T.S. 1990. The Effect of Executive Stock Option Plans on Stockholders and Bondholders. *Article provided by American Finance Association in its journal The Journal of Finance*.45 (2):617–627.

DiMaggio, P. J. and Powell, W.W., 1983. The Iron Cage Revisited Institutional Isomorphism and Collective Rationality in Organizational Fields. *American Sociological Review* 48:147-160.

Dong, M. and Ozkan, A. 2008. Institutional Investors and Director Pay: an Empirical Study of UK Companies. *Journal of Multinational Financial Management*. 18(1):1-351.

Duffhues, P. and Kabir, R. 2008. Is the Pay-Performance Relationship Always Positive? Evidence from the Netherlands. *Journal of Multinational Financial Management*. 18(1):45-60.

Eisenhardt, K., 1989. Agency Theory: An Assessment and Review. *The Academy of Management Review*. 14(1):57-74.

Ezzamel, M. and Watson, R. 1998. Market Comparison Earnings and the Bidding up of Executive Cash Compensation. Evidence from the Unit. *The Academy of Management Journal*. 41(2):221-231.

- Ezzamel, M and Watson, R, 2002. Pay Comparability Across and Within UK Boards: An Empirical Analysis of the Cash Pay Awards to CEOs and Other Board Members. *Journal of Management Studies*, 39: 207-232. Available at SSRN.
- Fernandes, N., 2008. EC Board Compensation and Firm Performance: The Role of Independent Board Members. *The Journal of Multinational Financial Management*, 18:30–44.
- Goobey, A.R., 2005. Developments in Remuneration Policy *Journal of Applied Corporate Finance*. 17(4):36–40.
- Gstraunthaler, T., Lukacs, J. and Steller, M. 2008. The Board of Directors and its Role in the Corporate Governance System – Considerations about the Control Model—A Research Note. *The International Journal of Economic Sciences and Applied Research*, 1(1):37-54.
- Harrison, J. R. 1987. The Strategic Use of Board Committees. *California Management Review*, 30:109–125.
- Hilmer, F.G., 1993, An Exploration of Board Remuneration Committee Challenges. *Asia Pacific Journal of Human Resources*, Vol. 47, No. 2, 201-218
- Holmstrom, B. 1979. Moral Hazard and Observability. *Bell Journal of Economics*. 10(1):74–91.
- Hsieh, C.H. and Kleiner, B.H. 2003. New Developments in Executive Compensation *Management Research News*. 6(7):72–78.
- Kantor, B., 2006. Bosses Play Business Lotto for All. *Business Report*.2.
- Kato, T., Kim, W. and Lee, J.H. 2007. Executive Compensation, Firm Performance, and Chaebols in Korea: Evidence from New Panel Data. *The Pacific- Basin Finance Journal*. 15:36–55.
- Larker, D. 1983. The Association between Performance Plan Adoption and Corporate Capital Investment. In. *Journal of Accounting and Economics* 5:3–30.
- Laing, D. and Weir, C. 1998. Corporate Performance and the Influence of Human Capital Characteristics on Executive Compensation UK. *Personal Review*.28 (1/2):28-40.

- Landsberg, R.D., 2007. Understanding the Role of a Corporate Compensation Committee *Journal of Financial Service Professionals* 22.
- Main, B. G. M. Johnston, J. 1993. Remuneration Committees and Corporate Governance. *Accounting and Business Research*. 23 (91A):351-362.
- Maslow, A.H. 1970. A Theory of Human Motivation. *Management and Motivation* 27–41 and *Psychological Review*, 50, 370-396.
- Meyer, J. W., and Rowan, B., 1977. *Institutionalized Organizations: Formal Structure as Myth and Ceremony*. *American Journal of Sociology*, 83(2), 340.
- Mongalo, T. 2003. Shareholder Activism in the United Kingdom Highlights the Failure of Remuneration Committees: Lessons for South Africa. *The South African Law Journal*. 120: 756-766.
- Ogden, S Watson, R, 2004. Remuneration Committees and CEO Pay in the UK Privatized Water Industry. *Socio-Economic Review*, Vol. 2, pp. 33-63, 2004.
- Ozkan, N., 2007. CEO Compensation and Firm Performance: An Empirical Investigation of UK Panel Data. *School of Economics, Finance and Management. University of Bristol, UK*, 1-36.
- Ozkan, N., 2007. Do Corporate Governance Mechanisms Influence CEO Compensation? An Empirical Investigation in to UK Companies. *The Journal of Multinational Financial Management*. 17(5):349-364.
- Pfeffer, J.: 1998, 'Size and Composition of Corporate Boards of Directors: The Organization and its Environment', *Administrative Science Quarterly* 17: 218–229.
- Ross, S.A. 1973. The Economic Theory of Agency. The Principal's Problem. *American Economic Review, Papers and Proceedings*, 63 (2):134–9.
- Sanchez, A.V. 2007. Agency Theory versus Stewardship Theory. *Universitas Onubensis, University of Spain, Huelva, Spain*.1.
- Spira, L. F. and Bender, R., 2004. Compare and Contrast: Perspectives on Board Committees. *Corporate Governance: An International Review*. 12(4):489-499.
- Stredwick, J. (2000). Aligning rewards to organisational goals – A Multinational's Experience, *European Business Review*, 12, 9-19.
- Tricker, R. 1978. - A study of the non-executive director and of the audit committee; *The Independent Director, London*, 1978, 1.1.
- Ueng, D.J., Wells, D.W. and Lilly, J.D. 2000. CEO Influence and Executive compensation: Large Firms vs. Small Firms. *Managerial Finance*.26 (8):3-10.

- Ward, M., 1998 Disclosure Remuneration: a Gap in the Rules. *Corporate Governance: An international Review*. 6(1):48–51.
- Westphal, J.D. and Zajac, E.J. 1994. Substance and Symbolism in CEO Long Term Incentive Plans. *Administrative Science Quarterly*. 39(3): 367-390.
- Wood, R. E., 2004. How Independent Is Your Compensation Committee? *Benefits Law Journal*. 17(4):82-92.

## BOOKS

- Armstrong. and Merlis, H. 2004. *Reward Management*, Anthony Rowe, Chippenham.
- Anderson, D.R., Sweeney, D.J. and Williams, T.A. 1990. *Sampling and Sampling Distributions in Statistics for Business and Economics*. West Publishing Company, St. Paul MN. 247.
- Barnard, C.I. 1968. The Economy of Incentives. In *the Functions of the Executive, Part 3, Chapter 11*. Cambridge, Massachusetts: Harvard University Press. 139-160.
- Baron, J.M. and Kreps, 1999. D.M. *Strategic Human Resources: Frameworks for General Managers*. Matrix Publishing Services, New York.
- Bebchuk, L. and Fried, J. 2004. *Pay Without Performance, The Unfulfilled Promise of Executive Compensation*. Cambridge, Massachusetts: Harvard University Press.
- Berle, A. A. and Mearns, G. C. 1932. *The Modern Corporation and Private Property*. New York: Harcourt, Brace and World, Inc.
- Crotty, A. and Bonorchis, R. 2006. *Executive Pay in South Africa, Who Gets What and Why*. Cape Town: Juta Co Ltd.
- Hart, O. 1995. *Firms, Contracts and Financial Structure*. Oxford: Oxford University Press.
- Guidelines to listing on the JSE (2003) as amended from time to time. Issued by the JSE Securities Exchange, Johannesburg.
- Jensen, M.C. and Smith, C.W. (Jr) 1984 “*The Theory of Corporate finance: A historical overview*” In the *Modern Theory of Corporate Finance* Mc Graw-Hill, New York, 2 – 20.
- Jensen, M.C. and Meckling, W.H. 2000, *Theory of the firm: Managerial behaviour, agency costs and ownership structure*. In *A Theory of the Firm: governance, residual claims, and organizational forms*. Massachusetts: Harvard University Press.

- Jensen, M.C. and Murphy, K.J. 1998. Performance Pay and Top- Management Incentives. In *Foundations of Organisational Strategy*, Jensen, M.C Ed. Massachusetts: Harvard University Press. 229-269.
- Jensen, M.C. and Murphy, K.J. 1998. CEO Incentives: It's Not How Much You Pay, But How. In *Foundations of Organisational Strategy*, Jensen, M.C Ed. Massachusetts: Harvard University Press. 270-298.
- Jensen, M.C. and Ruback, R.S. 1983, "The Market for Corporate Control" in the Journal of Financial Economics, 11: 5–50.
- Lambert, R.A. and Larcker, D.F. 1989. Executive Compensation, Corporate Decision-Making and Shareholder Wealth; A Review of the Evidence. In *Corporate Restructuring and Executive Compensation*. Stern, Stewart and Chew. USA: Ballinger Publishing Company. 17:287-309.
- Larcker, D.F. 1989. Managerial Incentives in Mergers and Their Effect on Shareholder Wealth. In *Corporate Restructuring and Executive Compensation*. Stern, Stewart and Chew. Cambridge, Massachusetts: Ballinger Publishing Company. 18:312-321.
- McConvill, J., 2004. Executive Compensation in Contemporary Corporate Governance: Why Pay for Performance is a Flawed Methodology in the Harvard University Press -19.
- McGregor, R 2008. McGregor's Who Owns Whom 1993: Southern Africa 13th edition.
- Solomon, J., 2007. Corporate Governance and Accountability, in *Stakeholder Theory* John Wiley and Sons Ltd., Chichester, UK. On pages 23-29.
- Stern, J. M., Stewart III, G.B., and Chew, Jr., D. H. 1989. *Corporate Restructuring and Executive Compensation*. Cambridge, Massachusetts: Ballinger Publishing Company.
- Weinberger, Z., 2007. The Philosophy behind Compensation Benefits. In *Talent Magazine*, 1.

## REPORTS

- Cadbury, A. 1992. The Code of Best Practice on Corporate Governance. The Corporate Governance Overview (Cadbury Report). *World Bank Report of the Committee on the Financial Aspects of Corporate Governance*. London: Gee and Co. Ltd.
- Filatotchev, I., Jackson, Gospel and Allcock, D., 2007. *Key Drivers of 'Good' Corporate Governance the Appropriateness of UK Policy Responses*". Final Report to The Department of Trade Industry King's College London.

Hampel, R. 1998, *The Hampel Committee on Corporate Governance*. Final Report to The European Corporate Governance Institute.

Higgs Report, 2007 by Igor Filatotchev, Gregory Jackson, Howard Gospel and Deborah Allcock "Key Drivers of 'Good' Corporate Governance and the Appropriateness of UK Policy Responses" p25

King, Committee, 2002. King Report on Corporate Governance for South Africa, *King Committee*, Parklands, South Africa.

Solidarity, 2006. "Remuneration of Chief Executive Officers, An overview of JSE listed companies", by National Union of Metal Workers of SA.

The Association of British Insurers, 2003. *Principles Guidelines on Executive Remuneration*

The Institute of Directors, 2008. Sustainability critical in Good Corporate Governance of the Future, Bulletin. Institute of Directors Website. Accessed, 13 November 2009.

The London Stock Exchange, 2002. Corporate Governance. A Practical Guide.

## **ANNUAL REPORTS**

Pearson plc. 2006. Report on Directors' Remuneration. *In Pearson Annual Report 2005*. [Online] Available:  
<http://www.pearson.com/investor/ar2005/governance/remuneration.html> [2009, August 18].

# APPENDICES

## Appendix 1: Further Research to be Undertaken

It would be beneficial to conduct research into the following aspects of remuneration committees:

What is the reason that shareholders do not attend company meetings and what can be done either to encourage them or to facilitate their attendance? Some suggestions have been for video screening between main centres or holding additional informative meetings at various centres (This was successfully carried out by the ApexHi Ltd (now Redefine Group).

Should remuneration committees be appointed by shareholders and not by boards? Should appointments of committee members comprise an equal number of outside members as NEDs to remuneration committees? Such outside persons would not be directors with the result that openness would be applied in their appointments, particularly by shareholders at meetings.

Is it beneficial for institutions to become more involved in directorships and to hold longer-term horizons in the companies in which they invest, being substantial investors in most companies on the JSE? This matter has wider implications and does not only apply to listed companies.

Greater independent scrutiny of whether corporate governance by companies is implemented in substance or form. Possibly an inspectorate like that of the JSE could establish whether the corporate governance of individual companies has actually been successful Reference to the research reported on by Mongalo will indicate an extension of such avenues which could be explored.

## Appendix 2: The Survey Questionnaire

1. It is essential for members of the remuneration committee, especially because it is a board sub-committee who must oversee the remuneration of top executives, to have a sound working knowledge of remuneration.<sup>14</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

2. Prior Shareholder approval should be required BEFORE the board may pay of any of the following emoluments:<sup>15</sup>

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Shareholders must approve the Executive Director's Salary.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Shareholders must approve the Executive Director's Performance bonus.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Shareholders must approve the Non Executive Director's Salary.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The Remuneration Committee may make an urgent appointment on approximately the same terms in the event of a CEO vacancy.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

3. Placing more power in the hands of shareholders directly is better than the Remuneration Committee system of authorising executive remuneration:<sup>16</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

4. The space box here is for you to have the opportunity to insert any comments you wish to make on the above questions.<sup>17</sup>

5. There are alternative methods of deciding on Executive Remuneration other than the Remuneration Committee or shareholders voting to approve Remuneration.<sup>18</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

6. Institutional shareholders should be more effective in expressing their views to the Board of Directors on executive remuneration.<sup>19</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

7. Because they have no say on Executive compensation, institutions should express their disapproval by then voting against different items submitted to shareholders meetings like disapproval of annual reports or appointments of directors.<sup>10</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

8. The policies of the Remuneration Committee should be spelled out in detail in their report to shareholders submitted to the AGM.<sup>11</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

9. If independent non-executive directors do not have a working knowledge of remuneration, in your opinion what else might qualify them to serve on the committee? Kindly also insert here any observations on questions above which you may wish to make.<sup>12</sup>



10. Given that we are in a closed economy is it possible to have a high level of independence of our non-executive directors who serve on the remuneration committee? Please insert your opinion below.<sup>13</sup>



11. At least two members of the Remuneration committee should not be directors of the company and should therefore be nominated from a pool of outside available persons appointed for a minimum of three years in order to retain their independence of the main board.<sup>14</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

12. It is essential for external and/or internal remuneration consultants to advise the Remuneration committee.<sup>15</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

13. Remuneration surveys from outside expert firms are essential for the committee to decide on compensation.<sup>16</sup>

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

14. Do you feel that the independence of members of the remuneration committee is most important? Please give your views below.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
The constitution of Remuneration Committees is too often made up of friends and associates of the Board and to this extent is not entirely independent.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Are you satisfied that Remuneration Committees are generally made up of independent members?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

15. The nomination committee should play a more active part in forming the membership of the Remuneration committee.

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

16. Remuneration committees are not entirely effective because their non-executive directors are part of the "club" of the board.

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

17. Would you like to express your opinion on the previous questions about the appointment of non-executive directors especially because of comments about cronyism (defined as an old or intimate companion) or nepotism (defined as undue patronage to one's own relations)?

18. Institutions should group together and form a pool of proposed non-executive directors who have impeccable qualifications, available to be nominated on their behalf to boards. (This would exclude staff of the institutions' pool of outside directors)

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

19. The chairman of the board should always be an independent non-executive director.\*

Yes  No

20. Whilst maintaining a majority of independent non-executive directors the full time executives should be represented on the main board by more than just the CEO, CFO and the MD.\*

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

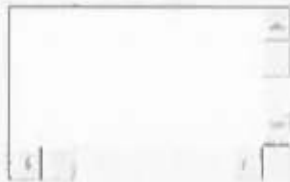
21. Institutions with LONG TERM HORIZONS have an obligation to nominate their representative to the board. (Should the institution not have adequately equipped staff they should then train them to hold such positions.)\*

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

22. Whether institutions have LONG or SHORT TERM HORIZONS they should (because they are the larger shareholders) as a group be represented on the board.\*

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

23. This box is provided for you to proffer any comments you wish to make on any of the last few items. All comments are most welcome.



24. Availability of non executive directors to serve on Remuneration Committees.\*

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Do you think that there is a shortage of non-executive directors available for appointment to boards?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Do companies make adequate effort to appoint truly non-executive directors to their boards?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

25. Non-executive directors do not receive any tax concessions entitling them to claim expenditure as a deduction from their income. This matter should be given further consideration by the Minister of Finance.

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

26. It is accepted today that incentive schemes are important to the employment of executives.

Strongly Agree  Agree  Neutral  Disagree  Strongly Disagree

27. The following choices are available on SHARE OPTIONS:

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Share options are merely a form of remuneration and should not be granted in that form?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Awarding SHARE OPTIONS to Executive Directors brings them more in to line with sharing and thus adds value to shareholders	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Share Options require prior shareholder approval or recommendation of the Remuneration Committee.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The total of Share Options should not exceed 5% of Share capital.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The total of Share Options should not exceed 7.5% of Share capital.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The total of Share Options should not exceed 10% of Share capital.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The maximum Share options which any one director may hold should not exceed 1% of share Capital.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The strike price of Share Options should always reasonably equate the current ruling price of the share.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

28. Are the Press performing a useful function in guiding the investing public? Your views on the following questions would be much appreciated. They relate to compensation. C:\LY:

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
The press are generally looking for sensationalism.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The press should comment more on how compensation is calculated.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The press should investigate more how performance compensation is calculated.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
If the press reported more objectively on compensation the public would become better investors.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

29. If you would like to receive the results of what other opinion makers like you have said then kindly insert your email address below. Should you so desire (and completely voluntarily) you may also add some description of yourself. Thanks.\*

### Appendix 3: Electronic survey

#### THE RESPONSES TO THE SURVEY QUESTIONS ARE ANALYSED HERE.

Most answers are in the groups AGREE or STRONGLY AGREE on the one hand and DISAGREE or STRONGLY DISAGREE on the other hand with provision for neutral. In order to crystallise the respondents views it is desired to categorise them into percentages for and against. The formula for so doing is to allocate two points for a "strongly" and one point for a "not strongly" vote. The reason for the gaps in the sequence of the numbers below is that the questions requesting comments are reflected in the detailed responses received.

No.	QUESTION IN SURVEY	Percentage FOR	Percentage AGAINST
1	It is essential for members of the remuneration committee (especially being a board sub committee who must oversee remuneration of the top executives) to have a sound working knowledge of remuneration.	100.00%	
2	Prior Shareholder approval should be required BEFORE the board may pay of any of the following emoluments:		
2.1	Shareholders must approve the Executive Director's Salary.	36.96%	63.04%
2.2	Shareholders must approve the Executive Director's Performance bonus	38.64%	61.36%
2.3	Shareholders must approve the Non Executive Director's Salary.	78.57%	21.43%
2.4	The Remuneration Committee may make an urgent appointment on approximately the same terms in the event of a CEO vacancy.	70.21%	29.79%
4	Placing more power in the hands of shareholders is better than the Remuneration Committee system of authorising executive remuneration	21.43%	78.57%

5	There are alternative methods of deciding on Executive Remuneration other than the Remuneration Committee or shareholders voting to approve Remuneration	28.51%	71.42%
6	Institutional shareholders should be more effective in expressing their views to the Board of Directors on executive remuneration	79.41%	20.59%
7	Because they have no say on Executive compensation, institutions should express their disapproval by then voting against different items submitted to shareholders meetings like disapproval of annual reports or appointments of directors.	39.02%	60.98%
8	The policies of the Remuneration Committee should be spelled out in detail in their report to shareholders submitted to the AGM.	92.74%	4.26%
11	At least two members of the Remuneration committee should not be directors of the company and should therefore be nominated from a pool of outside available persons appointed for a minimum of three years in order to retain their independence of the main board.	67.64%	32.36%
12.1	It is essential for external and/or internal remuneration consultants to advise the Remuneration committee	89.19%	10.81%
12.1	Remuneration surveys from outside expert firms are essential for the committee to decide on compensation		
14.1	The constitution of Remuneration Committees is too often made up of friends and associates of the Board and to this extent is not entirely independent.	65.71%	34.28%

14.2	Are you satisfied that Remuneration Committees are generally made up of independent members	80.00%	20.00%
15	The nomination committee should play a more active part in forming the membership of the Remuneration committee	90.00%	10.00%
16	Remuneration committees are not entirely effective because their non - executive directors are part of the "club" of the board	40.62%	59.38%
18	Institutions should group together and form a pool of proposed non - executive directors who have impeccable qualifications, available to be nominated on their behalf to boards. (This would exclude staff of the institutions)	62.85%	37.15%
19	The chairman of the board should always be independent non - executive directors.	74.28%	25.72%
20	Whilst maintaining a majority of independent non - executive directors the full time executives should be represented on the main board by more than just the CEO, CFO and the MD	62.06%	37.94%
21.2	Whether institutions have LONG or SHORT TERM HORIZONS they should (because they are the larger shareholders) as a group be represented on the board.	65.51%	34.49%
24	Availability of non executive directors to serve on Remuneration Committees		
24.1	Do you think that there is a shortage of non - executive directors available for appointment to boards?	89.28%	10.72%
24.2	Do companies make adequate effort to appoint truly non - executive directors to their boards	64.28%	35.72%

25	Non - executive directors do not receive any tax concessions entitling them to claim expenditure as a deduction from their income. This matter should be given further consideration by the Minister of Finance.	68.00%	32.00%
26	It is accepted today that incentive schemes are important to the employment of executives	95.24%	4.76%
28	Are the Press performing a useful function in guiding the investing public? Your views on the following questions would be much appreciated. They relate to compensation ONLY		
28.1	The press are generally looking for sensationalism	100.00%	
28.2	The press should comment more on how compensation is calculated.	96.67%	3.33%
28.3	The press should investigate more how performance compensation is calculated.	91.66%	8.33%
28.4	If the press reported more objectively on compensation the public would become better investors	66.67%	33.33%

**Appendix 4: Report on Directors' Remuneration (Pearson plc 2006)**

University of Cape Town

## REPORT ON DIRECTORS' REMUNERATION

The board presents its report on directors' remuneration to shareholders. This report complies with the Directors' Remuneration Report Regulations 2002.

This report also demonstrates how the principles of the Combined Code relating to directors' remuneration are applied.

A resolution will be put to shareholders at the annual general meeting on 21 April 2006 inviting them to consider and approve this report.

### The personnel committee

During 2005, Reuben Mark chaired the personnel committee; Terry Burns and Rana Talwar were the other members. All three members of the committee were independent non-executive directors. Reuben Mark is standing down as a director of the company at the annual general meeting. The board is considering who will serve as chairman of the committee thereafter.

Dennis Stevenson, chairman until 1 October 2005, Marjorie Scardino, chief executive, David Bell, director for people, and Robert Head, compensation and benefits director, provided material assistance to the committee during the year. They attended meetings of the committee, although no director was present when his or her own position was being considered.

To ensure that it receives independent advice, the committee has appointed Towers Perrin to supply survey data and to advise on market trends, long-term incentives and other general remuneration matters. Towers Perrin also advised the company on health and welfare benefits in the US, but has no other involvement with the company.

The committee's terms of reference are set out on the company's website.

### Compliance

The committee believes that the company has complied with the provisions regarding remuneration matters contained within the Combined Code.

### Items subject to audit

The items subject to audit in this report comprise the sections on directors' remuneration, directors' pensions and movements in directors' interests in restricted shares and share options set out in tables 1, 2, 4 and 5 together with the accompanying notes set out below each table.

### Remuneration policy

This report sets out the company's policy on directors' remuneration. This policy will continue to apply to each director for 2006 and, so far as practicable, for subsequent years. The committee considers that a successful remuneration policy needs to be sufficiently flexible to take account of future changes in the company's business environment and in remuneration practice. Future reports, which will continue to be subject to shareholder approval, will describe any changes in policy for years after 2006. Shareholders should consider all statements in this report about remuneration policy for years after 2006 in this context.

Pearson seeks to generate a performance culture by operating incentive programmes that support its business goals and reward their achievement.

It is the company's policy that total remuneration (base compensation plus short- and long-term incentives) should reward both short- and long-term results, delivering competitive rewards for target performance, but outstanding rewards for exceptional company performance.

The company's policy is that base compensation should provide the appropriate rate of remuneration for the job, taking into account relevant recruitment markets and business sectors and geographic regions. Benefit programmes should ensure that Pearson retains a competitive recruiting advantage.

Share ownership is encouraged throughout the company. Equity-based reward programmes align the interests of directors, and employees in general, with those of shareholders by linking rewards directly to Pearson's financial performance.

The committee selects performance conditions for the company's various performance-related annual or long-term incentive plans that are linked to the company's strategic objectives and aligned with the interests of shareholders.

All outstanding long-term incentive awards for each of the executive directors are set out in tables 4 and 5 on pages 32 to 37 of this report.

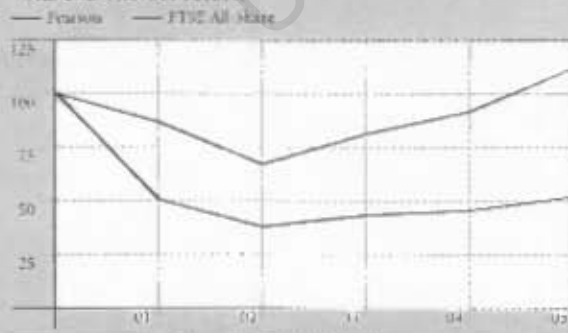
The committee determines whether or not targets have been met under the company's various performance-related annual or long-term incentive plans based on the relevant information and input from advisers.

For 2005, the Group's financial results have been reported under IFRS. In order to reflect the performance of the business on a consistent basis, earnings per share and any other accounting measures for prior years used for the purposes of the company's short- or long-term incentive plans have been rebased on IFRS.

**Performance**

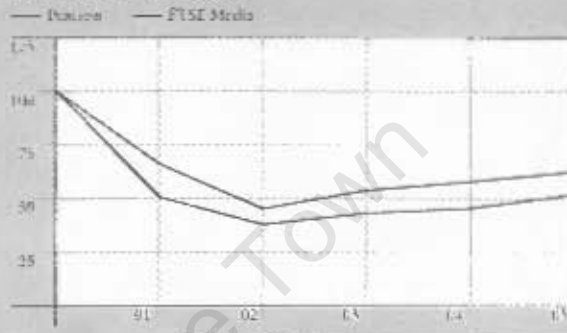
Below we set out Pearson's total shareholder return on three bases. First, we set out Pearson's total shareholder return performance relative to the FTSE All-Share index on an annual basis over the five-year period 2000 to 2005. We have chosen this index, and used it consistently in each report on directors' remuneration since 2002, on the basis that it is a recognisable reference point and an appropriate comparator for the majority of our investors.

Total shareholder return



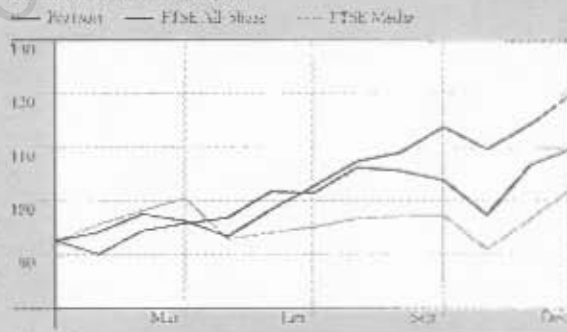
Secondly, we show Pearson's total shareholder return relative to the FTSE Media index on an annual basis over the same five-year period.

Total shareholder return



And thirdly, we show Pearson's total shareholder return relative to the FTSE All-Share and Media indices on a monthly basis over 2005, the period to which this report relates.

Total shareholder return



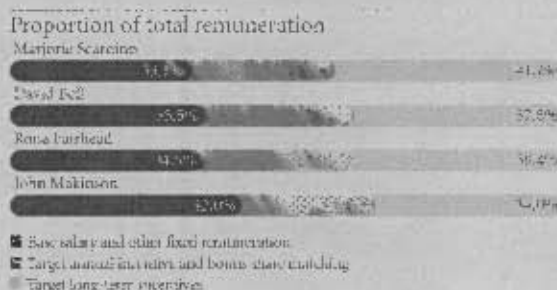
Pearson is a constituent of all the indices shown above.

**Main elements of remuneration**

Total remuneration is made up of fixed and performance-linked elements, with each element supporting different objectives.

Base salary and other fixed remuneration (such as benefits and pension) reflect competitive market level, role and individual contribution. Annual incentives motivate achievement of annual strategic goals. Long-term incentives drive long term earnings and share price growth, improvement in returns and value creation and align with shareholders' interests through ownership and retention of shares.

Consistent with its policy, the committee places considerable emphasis on the performance-linked elements i.e. annual incentive, bonus share matching and long-term incentives. Based on the details set out in this report, our policy is that the relative importance of fixed and performance-related remuneration for each of the directors should be as follows:



The committee will continue to review the mix of fixed and performance-linked remuneration on an annual basis, consistent with its overall philosophy.

Our policy is that the remuneration of the executive directors should be competitive with those of directors and executives in similar positions in comparable companies. We use a range of UK companies in different sectors including the media sector. Some are of a similar size to Pearson, while others are larger, but the method which the committee's independent advisers use to make comparisons on remuneration takes this into account. In addition, all have very substantial overseas operations. We also use selected media companies in North America.

We use these companies because they represent the wider executive talent pool from which we might expect to recruit externally and the pay market to which we might be vulnerable if our remuneration was not competitive.

#### Base salary

Our policy is to review salaries annually, considering levels of pay and pay increases throughout the company.

The committee has reviewed executive directors' base salaries for 2006 consistent with this policy. Full details will be set out in the report on directors' remuneration for 2006.

#### Other emoluments

It is the company's policy that its benefit programmes should be competitive in the context of the local labour market, but as an international company we require executives to operate worldwide and recognise that recruitment also operates worldwide.

#### Annual incentive

The committee establishes the annual incentive plans for the executive directors and the chief executives of the company's principal operating companies, including performance measures and targets. The committee also establishes the target and maximum levels of individual incentive opportunity based on an assessment by the committee's independent advisers of market practice for comparable companies and jobs.

The performance measures relate to the company's main drivers of business performance at both the corporate and operating company level. Performance is measured separately for each item. For each performance measure, the committee establishes thresholds, targets and maxima for different levels of payout. With the exception of the CEO, 10% of the total annual incentive opportunity for the executive directors and other members of the Pearson Management Committee is based on performance against personal objectives.

For 2006, the financial performance measures for Pearson plc are sales, growth in underlying adjusted earnings per share for continuing operations at constant exchange rates, average working capital as a ratio to sales and operating cash flow. For subsequent years, the measures will be set at the time.

There have been no changes to the executive directors' individual incentive opportunities. For the CEO, the target annual incentive opportunity is 100% of base salary and the maximum is 150%. For the other executive directors and other members of the Pearson Management Committee, the target is up to a maximum of 75% of salary and the maximum is twice target.

The committee may award individual discretionary payments.

Details of actual payouts for 2005 are set out in table 1 and the notes on page 29 of this report.

The committee will continue to review the annual incentive plans each year and to revise the performance measures, targets and individual incentive opportunities in light of current conditions.

Annual incentive payments do not form part of pensionable earnings.

#### Bonus share matching

The company encourages executive directors and other senior executives to acquire and hold Pearson shares.

The annual bonus share matching plan permits executive directors and senior executives around the company to invest up to 50% of any after-tax annual bonus in Pearson shares. For awards to be made in 2006 and thereafter, if these shares are held and the company's adjusted earnings per share increase in real terms by at least 3% per annum compound over a five-year period, the company will match them on a gross basis of one share for every one held. Half the matching shares will vest if the company's adjusted earnings per share increase in real terms by at least 3% per annum compound over the first three years.

Real growth is measured against the UK Government's Index of Retail Prices (All Items). We choose to test our earnings per share growth against UK inflation over three and five years to measure the company's financial progress over the period to which the entitlement to matching shares relates.

Since its introduction, there have been four full five-year cycles of this plan. For the 1998 award, the first one-for-two match vested, but not the full one-for-one. For both the 1999 and 2000 award, both matches lapsed. For the 2001 award, the full one-for-one match vested as set out in the notes to table 4 on page 33 of this report.

#### Long-term incentives

We are asking shareholders by separate resolution to approve the renewal of the long term incentive plan first introduced in 2001.

The committee has reviewed the operation of this plan in the light of the company's strategic goals and concluded that it is operating satisfactorily and achieving its objectives. We are therefore seeking approval of its renewal on broadly its original terms.

Subject to shareholders' approval, executive directors, senior executives and other managers will be eligible to participate in the plan which can deliver restricted stock and/or stock options. The aim as before is to give the committee a range of tools with which to link corporate performance to management's long-term reward in a flexible way.

Restricted stock granted to executive directors will vest only when stretching corporate performance targets over a specified period have been met. Awards will vest on a sliding scale based on performance over the period. There will be no retesting. The committee will determine the performance measures and targets governing an award of restricted stock prior to grant.

The conditions that will apply for the 2006 award and subsequently for the executive directors will be focused on delivering and improving returns to shareholders. The performance measures will be relative total shareholder return, return on invested capital and earnings per share growth.

The committee chose total shareholder return relative to the constituents of the FTSE World Media index because, in line with many of our shareholders, it felt that part of executive directors' rewards should be related to performance relative to the company's peers.

We chose return on invested capital, which is defined as operating profit net of 15% cash tax divided by net operating assets plus gross goodwill (pre-amortisation), because, over the past few years, the transformation of Pearson has significantly increased the capital invested in the business (mostly in the form of goodwill associated with acquisitions) and required substantial cash investment to integrate those acquisitions.

Earnings per share growth was chosen because strong bottom-line growth is imperative if we are to improve our total shareholder return and our return on invested capital.

Pearson wishes to encourage executives and managers to build up a long-term holding of shares so as to demonstrate their commitment to the company. To achieve this, for awards of restricted stock that are subject to performance conditions over a three-year period, 75% of the award will vest at the end of the three-year period. The remaining 25% of the award will only vest if the participant retains the after-tax number of shares that vest at year three for a further two years.

Restricted stock may be granted without performance conditions to satisfy recruitment and retention objectives. Restricted stock awards that are not subject to performance conditions will not be granted to any of the current executive directors.

It is not the committee's intention to grant stock options in 2006. Should the committee decide to grant them in future, options granted to executive directors would come with a minimum three-year vesting period and would vest on a sliding scale based on stretching performance over the three-year period with no retesting.

The committee's independent advisers calculate the expected value of both restricted stock and stock options i.e. their net present value after taking into account all the conditions and, in particular, the probability that any performance conditions will be met.

Taking into account these values and assessments by the committee's independent advisers of market practice for comparable companies, the committee establishes guidelines each year for the maximum expected value of individual awards. Since 2001, we have adopted this market-based approach which established maximum award levels of 300% of salary expected value for the CEO and 200% of salary expected value for the other executive directors. In practice, since 2002, actual awards have always been below these maximum levels. The expected value of awards for the executive directors in 2006 as a percentage of base salary will be in line with the value of awards granted in 2004 and 2005. As the 2006 award will not be made until later in the year, full details will be set out in the report on directors' remuneration for 2006.

In establishing these guidelines for the maximum expected value of individual awards, the committee also has regard to the face value of the awards and their potential value should the performance targets be met.

In any rolling 10-year period, no more than 10% of Pearson equity will be issued, or be capable of being issued, under all Pearson's share plans, and no more than 5% of Pearson equity will be issued, or be capable of being issued, under executive or discretionary plans.

Details of the actual awards, performance periods, measures and targets for the 2005 restricted stock awards are set out in table 4 and the notes on pages 32 to 34 of this report.

At 31 December 2005, stock awards granted in the last 10 years under this and all other employee share plans, to be satisfied by new-issue equity, amounted to 3.6% of the company's issued share capital and under this and other executive or discretionary plans amounted to 2.5%.

#### All-employee share plans

Executive directors are eligible to participate in the company's all-employee share plans on the same terms as other employees. These plans comprise share acquisition savings programmes in the UK and the US.

These plans operate within specific tax legislation (including a requirement to finance acquisition of shares using the proceeds of a monthly savings contract) and the acquisition of shares under these plans is not subject to the satisfaction of a performance target.

#### Shareholding policy

As previously noted, in line with the policy of encouraging widespread employee ownership, the company encourages executive directors to build up a substantial shareholding in the company.

Given the share retention features of the annual bonus share matching and long-term incentive plans and the volatility of the stock market, we do not think it is appropriate to specify a particular relationship of shareholding to salary. However, we describe separately here both the number of shares that the executive directors hold and the value expressed as a percentage of base salary.

The current value of holdings of the continuing executive directors based on the middle market value of Pearson shares of 705.5p on 24 February 2006 against the base salary set out in this report is as follows:

	Number of shares	Value (% of base salary)
Marjorie Scardino	184,889	184%
David Bell	103,158	184%
Rona Fairhead	43,209	73%
John Makinson	149,466	222%

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Service agreements

As set out in the annual report for 2004, Peter Jovanovich stood down as a director of the company for health reasons on 31 January 2005, but remained entitled to contractual short- and long-term disability and other benefits. These arrangements are set out in an agreement dated 28 January 2005.

Dennis Stevenson retired as chairman and director on 1 October 2005. Glen Moreno was appointed chairman and director on 1 October 2005.

In accordance with long established policy, all continuing executive directors have rolling service agreements under which, other than by termination in accordance with the terms of these agreements, employment continues until retirement.

These service agreements provide that the company may terminate these agreements by giving 12 months' notice, and they specify the compensation payable by way of liquidated damages in circumstances where the company terminates the agreements without notice or cause. We feel that these notice periods and provisions for liquidated damages are adequate compensation for loss of office and in line with the market.

We summarise the service agreements that applied during 2005 (or in the case of Peter Jovanovich and Dennis Stevenson that applied to 31 January 2005 and 1 October 2005 respectively) and that continue to apply for 2006 as follows:

Name	Date of agreement	Notice periods	Compensation on termination by the company without notice or cause
Dennis Stevenson	13 May 1997 (for service to 1 October 2005)	Six months from the director; 12 months from the company	100% of salary at the date of termination
Glen Moreno	29 July 2005 (for service from 1 October 2005)	12 months from the director; 12 months from the company	100% of annual fees at the date of termination
Marjorie Scardino	27 February 2004	Six months from the director; 12 months from the company	100% of annual salary at the date of termination, the annual cost of pension and all other benefits and 50% of potential annual incentive
David Bell	13 March 1996	Six months from the director; 12 months from the company	100% of annual salary at the date of termination, the annual cost of pension and all other benefits and 50% of potential annual incentive
Rona Fairhead	24 January 2003	Six months from the director; 12 months from the company	100% of annual salary at the date of termination, the annual cost of pension and all other benefits and 50% of potential annual incentive
Peter Jovanovich	9 October 2000 (for service to 31 January 2005)	Employment may be terminated by either party at any time, subject to three months' notice from the director in the case of voluntary resignation	200% of annual salary and target annual incentive
John Makinson	24 January 2003	Six months from the director; 12 months from the company	100% of annual salary at the date of termination, the annual cost of pension and all other benefits and 50% of potential annual incentive

**Retirement benefits**

We describe the retirement benefits for each of the executive directors. Details of directors' pension arrangements are set out in table 2 on page 30 of this report.

Executive directors participate in the approved pension arrangements set up for Pearson employees. Marjorie Scardino, John Makinson, Rona Fairhead and Peter Iovanovich will also receive benefits under unapproved arrangements because of the cap on the amount of benefits that can be provided from the approved arrangements in the US and the UK.

The pension arrangements for all the executive directors include life insurance cover while in employment, and entitlement to a pension in the event of ill-health or disability. A pension for their spouse and/or dependants is also available on death.

In the US, the approved defined benefit arrangement is the Pearson Inc. Pension Plan. This plan provides a lump sum convertible to a pension on retirement. The lump sum accrued at 6% of capped compensation until 31 December 2001 when further benefit accruals ceased. Normal retirement is age 65 although early retirement is possible subject to a reduction for early payment. No increases are guaranteed for pensions in payment. There is a spouse's pension on death in service and the option to provide a death in retirement pension by reducing the member's pension.

The approved defined contribution arrangement in the US is a 401(k) plan. At retirement, the account balances will be used to provide benefits. In the event of death before retirement, the account balances will be used to provide benefits for dependants.

In the UK, the approved plan is the Pearson Group Pension Plan and executive directors participate in the Final Pay section. Normal retirement age is 62 but, subject to company consent, retirement is possible after age 50. The accrued pension is reduced on retirement prior to age 60. Pensions in payment are guaranteed to increase each year at 3% or the increase in the Index of Retail Prices, if lower. Pensions for a member's spouse, dependent children and/or nominated financial dependant are payable in the event of death.

In response to the UK Government's plans for pensions simplification and so-called 'A-Day' effective from April 2006, UK executive directors and other

members of the Pearson Group Pension Plan who are, or become, affected by the lifetime allowance will be offered a cash supplement as an alternative to further accrual of pension benefits on a basis that is broadly cost neutral to the company. Further details will be set out in the report on directors' remuneration for 2006.

**Marjorie Scardino**

Marjorie Scardino participates in the Pearson Inc. Pension Plan and the approved 401(k) plan. Additional pension benefits will be provided through an unfunded unapproved defined contribution plan and a funded defined contribution plan approved by HM Revenue and Customs as a corresponding plan to replace part of the unfunded plan. The account balance of the unfunded unapproved defined contribution plan is determined by reference to the value of a notional cash account that increases annually by a specified notional interest rate. This plan provides the opportunity to convert a proportion of this notional cash account into a notional share account reflecting the value of a number of Pearson ordinary shares. The number of shares in the notional share account is determined by reference to the market value of Pearson shares at the date of conversion.

**David Bell**

David Bell is a member of the Pearson Group Pension Plan. He is eligible for a pension of two-thirds of his final base salary at age 62 due to his long service but early retirement with a reduced pension before that date is possible, subject to company consent.

**Rona Fairhead**

Rona Fairhead is a member of the Pearson Group Pension Plan. Her pension accrual rate is 1/30th of pensionable salary per annum, restricted to the earnings cap introduced by the Finance Act 1989. The company also contributes to a Funded Unapproved Retirement Benefits Scheme (FURBS) on her behalf. In the event of death before retirement, the proceeds of the FURBS account will be used to provide benefits for her dependants.

**Peter Iovanovich**

Peter Iovanovich is a member of the Pearson Inc. Pension Plan and the approved 401(k) plan. He also participates in an unfunded, unapproved Supplemental Executive Retirement Plan (SERP) that provides an annual accrual of 2% of final average earnings, less benefits accrued in the Pearson Inc. Pension Plan and

US Social Security. He ceased to build up further benefits in the SERP at 31 December 2002. Additional defined contribution benefits are provided through a funded, unapproved 401(k) excess plan and an unfunded, unapproved arrangement. In the event of death while in receipt of disability benefits, the account balances in the defined contribution arrangements will be used to provide benefits for dependants. The SERP arrangement provides a spouse's pension on death while in receipt of disability benefits and the option of a death in retirement pension by reducing the member's pension.

*John Makinson*

John Makinson is a member of the Pearson Group Pension Plan under which his pensionable salary is restricted to the earnings cap. The company ceased contributions on 31 December 2001 to his FURBS arrangement. During 2002 it set up an Unfunded Unapproved Retirement Benefits Scheme (URBS) for him. The URBS tops up the pensions payable from the Pearson Group Pension Plan and the closed FURBS to target a pension of two-thirds of a revalued base salary on retirement at age 62. The revalued base salary is defined as £450,000 effective at 1 June 2002, increased at 1 January each year by reference to the increase in the Index of Retail Prices. In the event of his death a pension from the Pearson Group Pension Plan, the FURBS and the URBS will be paid to his spouse or nominated financial dependant. Early retirement is possible from age 50, with company consent.

The pension is reduced to reflect the shorter service, and before age 60, further reduced for early payment.

*Executive directors' non-executive directorships*

Our policy is that executive directors may, by agreement with the board, serve as non-executives of other companies and retain any fees payable for their services.

*Chairman's remuneration*

Our policy is that the chairman's pay should be set at a level that is competitive with those of chairmen in similar positions in comparable companies. He is not entitled to any annual or long-term incentive, retirement or other benefits.

The committee's view is that, taking into account the remuneration of chairmen in comparable positions, the appropriate total pay level is £425,000 per year.

*Non-executive directors*

Fees for non-executive directors are determined by the full board having regard to market practice and within the restrictions contained in the company's articles of association. Non-executive directors receive no other pay or benefits (other than reimbursement for expenses incurred in connection with their directorship of the company) and do not participate in the company's equity-based incentive plans.

For 2005, the chairman and the executive directors of the board reviewed the level and structure of non-executive directors' fees, which had not been changed since January 2000. After reviewing external benchmarks, they agreed an increase in the basic fee to £45,000, an increase in the fee for the committee chairmen to £10,000, the introduction of separate fees of £5,000 for committee membership and of £10,000 for the senior independent director and the replacement of the fee for non-UK based directors with a fee of £2,500 for overseas meetings.

	Fees payable from 1 January 2005
Basic non-executive director fee	£45,000
Chairmanship of audit and personnel committees	£10,000
Membership of audit and personnel committees	£5,000
Senior independent director's fee	£10,000
Overseas meetings (per meeting)	£2,500

One-third of the basic fee, or the entire fee in the case of Rana Talwar, is paid in Pearson shares that the non-executive directors have committed to retain for the period of their directorships.

In the case of Patrick Cescau, his fee was paid over to his employer.

Non-executive directors serve Pearson under letters of appointment and do not have service contracts. There is no entitlement to compensation on the termination of their directorships.

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Table 1: Remuneration of the directors  
Excluding contributions to pension funds and related benefits set out in table 2, directors' remuneration was as follows:

All figures in £000s	2005 Salaries/Fees	2005 Annual Incentive	2005 Other <sup>2</sup>	2005 Total	2004 Total
<b>Chairman</b>					
Dennis Stevenson (retired 1 October 2005)	281	–	–	281	325
Glen Moreno (appointed 1 October 2005)	106	–	–	106	–
<b>Executive directors</b>					
Marjorie Scardino	710	1,038	62	1,810	1,538
David Bell	393	560	17	972	874
Rona Fairhead	420	608	16	1,044	907
Peter Ivanovitch (stepped down 31 January 2005)	41	–	373	414	1,052
John Makinson	475	564	211	1,250	791
<b>Non-executive directors</b>					
Terry Burns	71	–	–	71	35
Patrick Cescau	35	–	–	35	35
Susan Fuhrman	35	–	–	35	18
Reuben Mark	70	–	–	70	47
Vernon Sankey	60	–	–	60	40
Rana Talwar	55	–	–	55	35
<b>Total</b>	<b>2,794</b>	<b>2,770</b>	<b>679</b>	<b>6,243</b>	<b>5,697</b>
<b>Total 2004</b>	<b>2,878</b>	<b>1,507</b>	<b>312</b>	<b>–</b>	<b>5,697</b>

Note 1 For Marjorie Scardino, David Bell and Rona Fairhead, annual incentives were based on the financial performance of Pearson plc. In the case of John Makinson, 70% of his annual incentive was based on the performance of Penguin Group and 30% on the financial performance of Pearson plc. In the case of David Bell, Rona Fairhead and John Makinson, 10% of their annual incentives was based on performance against personal objectives.

For Pearson plc, the performance measures were earnings per share growth, operating cash flow, sales and average working capital as a ratio to sales. Actual underlying growth in adjusted earnings per share at constant exchange rates consistent with the reported adjusted earnings per share (pre-intangibles) of 14.1p, operating cash flow of £370m and average working capital as a ratio to sales were each better than the level of performance required for maximum payout. Actual sales at £4,096m were above target but below maximum.

For Penguin Group, the performance measures were operating profit, operating cash flow and average working capital as a ratio to sales. For operating cash flow and working capital, as a ratio to sales, actual performance was better than that required for maximum payout and for operating profit was above target but below maximum.

Note 2 Other emoluments include company car and health care benefits. In the case of Marjorie Scardino, these include £39,245 in respect of housing costs and a cash US payroll supplement of £8,572. John Makinson is entitled to a location and market premium in relation to the management of the business of the Penguin Group in the US. He received £186,279 in cash for 2005. Marjorie Scardino, Rona Fairhead, David Bell and John Makinson have the use of a chauffeur. In accordance with the agreement dated 28 January 2003 referred to on page 26 of this report, Peter Ivanovitch received short- and long-term disability payments in cash for the period 1 February 2003 to 31 December 2005.

Note 3 No amounts as compensation for loss of office and no expense allowances chargeable to UK income tax were paid during the year.

Note 4 The following executive directors served non-executive directorships elsewhere and received fees as follows: Marjorie Scardino (Nokia Corporation – £110,000; MacArthur Foundation (from 1 December 2005) – \$3,667); David Bell (VITEC Group plc – \$28,542); Rona Fairhead (HSDG Holdings plc – £70,000); John Makinson (George Weston Limited – C\$89,000).

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Table 2: Directors' pensions

Directors' pensions	Age at 31 Dec 05	Increase in accrued pension over the period 2004-2005	Accrued pension at 31 Dec 05 £000	Transfer value at 31 Dec 04 £000	Transfer value at 31 Dec 05 £000	Increase in transfer value £000	Increase in accrued pension during the period 2004-2005	Transfer value of the increase in accrued pension at 31 Dec 05* £000	Other pension costs to the company over the period 2004-2005	Other pension related benefit costs £000
Marjorie Scardino	58	0.4	4.2	29.5	34.6	5.1	0.3	2.5	514.3	26.5
David Bell	59	21.3	254.6	3,311.9	4,085.0	773.4	14.9	219.7	-	-
Rona Fairhead	44	3.8	14.5	69.1	100.9	26.7	3.4	18.9	109.2	-
Peter Ivanovich	56	6.8	64.2	404.5	297.5	93.0	5.3	41.1	246.9	0.8
John Makinson	51	19.6	169.5	1,438.3	1,762.1	318.7	15.6	157.1	-	4.2

\* Less directors' contributions.

\*\* Net of inflation.

Note 1 The accrued pension at 31 December 2005 is that which would become payable from normal retirement age if the member left service at 31 December 2005. For Marjorie Scardino it relates only to the pension from the US Plan. For David Bell and Rona Fairhead it relates to the pension payable from the UK Plan. For Peter Ivanovich it relates to the pension from the US Plan and the US SERP. For John Makinson it relates to the pension from the UK Plan, the URRBS and the URRBS in aggregate.

Note 2 The UK transfer values at 31 December 2005 are calculated using the assumptions for cash equivalents payable from the UK Plan and are based on the accrued pension at that date. For the US SERP, transfer values are calculated using a discount rate equivalent to current US government long-term bond yields. The US Plan is a lump sum plan and the accrued balance is shown.

Note 3 For UK benefits, this column comprises contributions to EURBS. For US benefits, it includes company contributions to funded defined contribution plans and national contributions to unfunded defined contribution plans.

Note 4 This column comprises life cover and long-term disability insurance not covered by the retirement plans.

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Table 3: Interests of directors

	Ordinary shares at 1 Dec 05	Ordinary shares at 31 Dec 05
Dennis Stevenson	167,043	174,517
Glen Moreno	–	100,000
Marjorie Scardino	127,761	184,889
David Bell	77,305	103,158
Terry Burns	4,589	5,439
Patrick Cescau	–	–
Rona Fairhead	12,710	43,209
Susan Fuhrman	551	3,318
Peter Iovanovich	86,461	86,461
John Makinson	115,898	149,466
Reuben Mark	14,798	16,546
Vernon Stankev	3,943	5,285
Rana Talwar	8,152	13,103

Note 1 Ordinary shares includes both ordinary shares listed on the London Stock Exchange and American Depositary Receipts (ADRs) listed on the New York Stock Exchange. The figures include both shares and ADRs acquired by individuals investing part of their own after-tax annual bonus in Pearson shares under the annual bonus share matching plan.

Note 2 In the case of Peter Iovanovich and Dennis Stevenson, the closing balance represents the number of shares held on 31 January 2005 and 1 October 2005 respectively.

Note 3 Executive directors of the company, as possible beneficiaries, are also deemed to be interested in the Pearson Employee Share Ownership Trust, the trustees of which held 5,249,407 Pearson ordinary shares of 25p each at 31 December 2005 and 5,748,615 at 26 February 2006.

Note 4 At 31 December 2005, John Makinson held 1,000 shares in Interactive Data Corporation.

Note 5 From 2001, Marjorie Scardino is also deemed to be interested in a further number of shares under her unfunded pension arrangement described on page 27 of this report, which provides the opportunity to convert a proportion of her notional cash account into a notional share account reflecting the value of a number of Pearson shares.

Note 6 The register of directors' interests (which is open to inspection during normal office hours) contains full details of directors' shareholdings and options to subscribe for shares. The market price on 31 December 2005 was 687.5p per share and the range during the year was 608.0p to 694.5p.

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Table 1: Movements in directors' interests in restricted shares  
 Restricted shares designated as: a annual bonus share matching plan; b long-term incentive plan; and \* where shares at 31 December 2005 have vested and are held pending release.

Date of award	Unvested	Vested	Released	Forfeited	At 31/12/05	Market value at date of award	Earliest vesting date	Date of release	Market value at date of release
<b>Dennis Stevenson</b>									
b 5/5/04	30,000				30,000	673.5p	5/5/07		
Total	30,000				30,000				
<b>Marjorie Scardino</b>									
a* 11/5/01	14,181				14,181	1438.5p	11/5/06		
b* 9/5/01	39,057		29,293		9,764	1421.0p	9/5/04	1/3/05	641.5p
b 16/12/02	362,640		60,340		302,300	638.5p	28/6/05	26/7/05	676.0p
b 26/9/03	144,240				144,240	582.0p	26/9/06		
b 21/12/04	416,130				416,130	613.0p	21/12/07		
b 23/09/05	-	450,000			450,000	655.0p	23/9/08		
Total	975,648	450,000	89,633		1,336,015				
<b>David Bell</b>									
a* 11/5/01	6,371				6,371	1438.5p	11/5/06		
a* 17/4/03	3,052				3,052	541.0p	17/4/06		
a 17/4/03	3,053				3,053	541.0p	17/4/08		
a 16/4/04	4,503				4,503	652.0p	16/4/07		
b* 9/5/01	15,369		11,527		3,842	1421.0p	9/5/04	1/3/05	641.5p
b 16/12/02	159,678		26,613		133,065	638.5p	28/6/05	26/7/05	676.0p
b 26/9/03	98,880				98,880	582.0p	26/9/06		
b 21/12/04	165,063				165,063	613.0p	21/12/07		
b 23/09/05	-	170,000			170,000	655.0p	23/9/08		
Total	455,969	170,000	38,140		587,829				
<b>Rona Fairhead</b>									
a* 19/4/02	466				466	892.0p	19/4/05		
a 19/4/02	467				467	892.0p	19/4/07		
a* 17/4/03	7,551				7,551	541.0p	17/4/06		
a 17/4/03	7,552				7,552	541.0p	17/4/08		
a 16/4/04	5,146				5,146	652.0p	16/4/07		
a 15/4/05		19,746			19,746	631.0p	15/4/08		
b 8/4/02	5,000		5,000		-	843.0p	8/10/04	1/3/05	641.5p
b 16/12/02	159,678		26,613		133,065	638.5p	28/6/05	26/7/05	676.0p
b 26/9/03	98,880				98,880	582.0p	26/9/06		
b 21/12/04	165,063				165,063	613.0p	21/12/07		
b 23/09/05	-	200,000			200,000	655.0p	23/9/08		
Total	449,803	219,746	31,613		637,936				

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Table 4: Movements in directors' interests in restricted shares continued  
Restricted shares designated as: a annual bonus share matching plan; b long-term incentive plan; and \* where shares at 31 December 2005 have vested and are held pending release.

Date of award	1/1/07	awarded	Released	Leased	31 Dec. 05	Market value at date of award	Earliest vesting date	Date of release	Market value at date of release
<b>Peter Jovanovich</b>									
b*	9/5/01	29,300		21,975	7,325	1421.0p	9/5/04	1/3/05	641.5p
b	16/12/02	198,396		33,066	165,330	638.5p	28/6/05	28/6/05	649.5p
b	26/9/03	98,880			98,880	582.0p	26/9/06		
b	21/12/04	165,063			165,063	613.0p	21/12/07		
<b>Total</b>		<b>491,639</b>	<b>-</b>	<b>55,041</b>	<b>-</b>	<b>436,598</b>			
<b>John Makinson</b>									
a*	11/5/01	9,553			9,553	1438.5p	11/5/06		
a*	17/4/03	6,105			6,105	541.0p	17/4/06		
a	17/4/03	6,105			6,105	541.0p	17/4/08		
b*	9/5/01	18,598		13,908	4,690	1421.0p	9/5/04	1/3/05	641.5p
b	16/12/02	206,880		34,480	172,400	638.5p	28/6/05	26/7/05	676.0p
b	26/9/03	98,880			98,880	582.0p	26/9/06		
b	21/12/04	165,063			165,063	613.0p	21/12/07		
b	23/09/05	-	180,000		180,000	655.0p	23/9/08		
<b>Total</b>		<b>511,184</b>	<b>180,000</b>	<b>48,428</b>	<b>-</b>	<b>642,756</b>			
<b>Total</b>		<b>2,914,243</b>	<b>1,019,746</b>	<b>267,855</b>	<b>-</b>	<b>3,671,134</b>			

Note 1 The number of shares shown represents the maximum number of shares that may vest, subject to any performance conditions being met.

Note 2 No variations to the terms and conditions of plan interests were made during the year.

Note 3 Each plan is described below in relation to its status during the year, i.e. whether awards have been released or vested, have vested and are held, are outstanding or were granted.

➤ Awards released The long-term incentive plan shares awarded to Rona Fairhead on 8 April 2002 in accordance with the terms agreed with her when she joined the company vested in 2004 on the third anniversary of her date of her appointment and were released on 1 March 2005. No consideration was payable for these shares. Details of this award are set out in table 4 and itemised as b on page 32 of this report.

The first tranche of long-term incentive plan shares granted on 16 December 2002 vested and were released on 28 June 2005 with the exception of the awards for Marjorie Scardino, David Bell, Rona Fairhead and John Makinson which were released on 26 July 2005. The shares were released in accordance with the original terms of the award disclosed in detail in the report on directors' remuneration for 2002. No consideration was payable by participants for these shares. Marjorie Scardino, David Bell, Rona Fairhead, Peter Jovanovich and John Makinson held awards under this plan. Details of these awards are set out in table 4 and itemised as b on pages 32 and 33 of this report.

➤ Awards vested and held The restricted stock awards made on 9 May 2001 vested with a payout of 70.5% of the shares originally awarded and three-quarters of the vested shares were released on 1 March 2005. The original terms of the award and the company's performance against the relevant targets were disclosed in detail in the report on directors'

remuneration for 2004. No consideration was payable for these shares. The remaining one-quarter of the vested shares may be called within six months of 9 May 2005 being the fifth anniversary of the original grant date, but only if the participant has not disposed of any shares in the first three-quarters, other than those that may be released in order to satisfy personal tax liabilities. Marjorie Scardino, David Bell, Peter Jovanovich and John Makinson hold shares under this plan. Details of these awards are set out in table 4 and itemised as b\* on pages 33 and 34 of this report.

The target for the increase in adjusted earnings per share from 2002 to 2005 for the annual bonus share matching plan awards made on 11 May 2001 was 27.7% (i.e. inflation of 12.5% plus 13% (3% per annum for five years)). The increase in adjusted earnings per share over the period has been 28.2% which means that the target, which was consistent with policy when the award was made, has been met. The awards will vest and be released on 11 May 2006. Marjorie Scardino, David Bell and John Makinson held awards under this plan. Details of these awards are set out in table 4 and itemised as a\* on pages 32 and 33 of this report.

The target for the increase in adjusted earnings per share from 2002 to 2005 for the annual bonus share matching award made on 17 April 2003 was 17.7%, i.e. inflation of 3.7% plus 9% (3% per annum for three years). The increase in adjusted earnings per share over the period has been 34.8% which means that the target, which was consistent with policy when the award was made, has been met. Participants are entitled to receive half of their matching shares. These shares, together with the remaining half of the matching shares which are subject to the performance target being met over the period 2002 to 2007, will be released on 17 April 2008. If participants elect to call for the first half of the matching shares on 17 April 2006, their entitlement to the second half of the matching shares (i.e. David Bell, Rona Fairhead and John Makinson) will be released under this plan. Details are set out in table 4 and itemised as a\* on pages 32 and 33 of this report.

REPORT ON DIRECTORS' REMUNERATION CONTINUED

- Awards outstanding Outstanding awards under the annual bonus share matching plan and the long-term incentive plan for Dennis Stevenson, Marjorie Scardino, David Bell, Rona Fairhead, Peter Kovacsich and John Makinson are set out in table 4 and itemised as a and b respectively on pages 32 and 33 of this report.

The performance and other conditions that apply to these awards and that have yet to be met were set out in the reports on directors' remuneration for the years in which they were granted.

- Awards granted The annual bonus share matching plan shares awarded on 15 April 2005 will vest in full on 15 April 2010 if the increase in the company's adjusted earnings per share exceeds inflation by at least 3 percentage points per annum over the period 2004 to 2009. Half this number of shares will vest on 15 April 2008 if the increase in the company's adjusted earnings per share exceeds inflation by at least 3 percentage points per annum over the period 2004 to 2007. The market price of the shares on the date of the award was 531p. The latest vesting date of this award is 15 April 2010. Rona Fairhead holds shares under this plan. Details of this award are set out in table 4 and itemised as a on page 32 of this report.

The shares awarded on 23 September 2005 were based on three performance measures: relative total shareholder return, return on invested capital, and a combination of earnings per share and sales growth. The award is split equally across all three measures.

For relative total shareholder return, the comparator group is all the constituents of the FTSE World Media index. Total shareholder return will be measured over the three-year period 2005 to 2008 based on the period immediately following the 2004 results announcement to the period immediately following the 2007 results announcement. Subject to the

committee satisfying itself that the recorded total shareholder return is a genuine reflection of the underlying financial performance of the business, the award will vest in full if Pearson's total shareholder return relative to this group of companies is ranked at the upper quartile or better. Two thirds of the award will vest at the median. No part of the award will vest for performance below median.

For return on invested capital, the award will vest in full if Pearson's 2007 return on invested capital is 9.0% or better. A quarter of the award will vest for return on invested capital of 7.5%. No part of the award will vest for return on invested capital below 7.5%.

For sales and earnings per share growth, the measures work inter-dependently i.e. this element does not pay out at all unless there is growth in both sales and EPS. The threshold for payout, at which 30% of the award vests, is compound annual growth of at least 3% in both sales and EPS. Subject to threshold performance being achieved, this element of the award pays out in full only for significant growth of at least 10% per annum compound in either sales or EPS or good growth in both.

The market price of the shares on the date of the award was 657p. The vesting date of this award is 23 September 2008. A participant may call for three quarters of the shares that vest within six months of the vesting date. However, the remaining one-quarter of the shares that vest may be called within six months of the second anniversary of the vesting date but only if the participant has not disposed of any shares in the first three-quarters other than those that may be released in order to satisfy personal tax liabilities.

Marjorie Scardino, David Bell, Rona Fairhead and John Makinson hold shares under this plan. Details of these awards are set out in table 4 and itemised as b on pages 32 and 33 of this report.

Table 5: Movements in directors' interests in share options  
Shares under option are designated as: a executive; b worldwide save for shares; c premium priced; and d long-term incentive; and \* where options are exercisable.

Date of grant	1 Jan 05	Granted	Forfeited	Cancelled	31 Dec 08	Option price	Earliest exercise date	Expiry date	Date of exercise	Price on exercise	Gain on exercise
<b>Dennis Stevenson</b>											
b	30/4/04	3,556			3,556	—	991.8p	1/8/11	1/2/12		
Total		3,556			3,556						
<b>Marjorie Scardino</b>											
a*	14/9/98	176,556			176,556	973.3p	14/9/01	14/9/08			
a*	14/9/98	5,660			5,660	1090.0p	14/9/01	14/9/08			
b	15/5/98	2,839	2,839		—	686.7p	1/8/05	1/2/06	17/8/05	685.0p	(148)
b	9/5/03	2,224			2,224	424.8p	1/8/06	1/2/07			
c*	8/6/99	37,583			37,583	1372.4p	8/6/02	8/6/09			
c*	8/6/99	37,583			37,583	1647.5p	8/6/02	8/6/09			
c	8/6/99	37,583			37,583	1921.6p	8/6/02	8/6/09			
c	3/5/00	36,983		36,983	—	2763.6p	3/5/03	3/5/10			
c	3/5/00	36,983			36,983	3224.3p	3/5/03	3/5/10			
d*	9/5/01	41,550			41,550	1421.0p	9/5/02	9/5/11			
d*	9/5/01	41,550			41,550	1421.0p	9/5/05	9/5/11			
d*	9/5/01	41,550			41,550	1421.0p	9/5/04	9/5/11			
d*	9/5/01	41,550			41,550	1421.0p	9/5/05	9/5/11			
Total		540,194	2,839	36,983	500,377						

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Table 5: Movements in directors' interests in share options continued  
 Shares under option are designated as: a executive; b worldwide save for shares; c premium priced; and d long-term incentive; and \* where options are exercisable.

Date of grant	Class	Granted	Exercised	Rescued	SI Dts. 05	Option price	Earliest exercise date	Expiry date	Date of exercise	Price on exercise	Gain on exercise
<b>David Bell</b>											
a*	14/9/98	20,496			20,496	973.3p	14/9/01	14/9/08			
b*	16/5/99	184		184		913.0p	1/8/04	1/2/05			
b*	9/5/01	202		202		957.0p	1/8/04	1/2/05			
b	10/5/02	373			272	696.0p	1/8/05	1/2/06			
b	9/5/03	444			444	424.8p	1/8/06	1/2/07			
b	30/4/04	1,142			1,112	494.8p	1/8/07	1/2/08			
b	6/5/05	-	373		373	507.6p	1/8/08	1/2/09			
c*	8/6/99	18,705			18,705	1372.4p	8/6/02	8/6/09			
c*	8/6/99	18,705			18,705	1647.5p	8/6/02	8/6/09			
c	8/6/99	18,705			18,705	1921.6p	8/6/02	8/6/09			
c	3/5/00	18,686		18,686		2763.6p	3/5/03	3/5/10			
c	3/5/00	18,686			18,686	3224.3p	3/5/03	3/5/10			
d*	9/5/01	16,350			16,350	1421.0p	9/5/02	9/5/11			
d*	9/5/01	16,350			16,350	1421.0p	9/5/03	9/5/11			
d*	9/5/01	16,350			16,350	1421.3p	9/5/04	9/5/11			
d*	9/5/01	16,350			16,350	1421.0p	9/5/05	9/5/11			
Total		181,627	373	-	19,072						
<b>Rona Fairhead</b>											
b	30/4/04	1,904			1,904	494.8p	1/8/07	1/2/08			
d*	1/11/01	20,000			20,000	822.0p	1/11/03	1/11/11			
d*	1/11/01	20,000			20,000	822.0p	1/11/04	1/11/11			
d*	1/11/01	20,000			20,000	822.0p	1/11/05	1/11/11			
Total		61,904	-	-	-						

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Table 5: Movements in directors' interests in share options continued  
 Shares under option are designated as: a executive; b worldwide save for shares; c premium priced; and d long-term incentive; and \* where options are exercisable.

Date of grant	1 Jan 05	Granted	Rescued	Termed	At Dec 05	Option price	Latest exercise date	Expiry date	Date of exercise	Price on exercise	Gain on exercise
<b>Peter Ivanovich</b>											
a* 12/9/97	8,250				8,250	757.5p	12/9/00	12/9/07			
a* 12/9/97	102,520				102,520	676.4p	12/9/00	12/9/07			
c* 8/6/99	32,406				32,406	1372.4p	8/6/02	8/6/09			
c* 8/6/99	32,406				32,406	1647.5p	8/6/02	8/6/09			
c 8/6/99	32,406				32,406	1921.6p	8/6/02	8/6/09			
c 3/5/00	33,528			33,528		2763.6p	3/5/03	3/5/10			
c 3/5/00	33,528				33,528	3224.3p	3/5/03	3/5/10			
d* 9/5/01	31,170				31,170	\$21.00	9/5/02	9/5/11			
d* 9/5/01	31,170				31,170	\$21.00	9/5/03	9/5/11			
d* 9/5/01	31,170				31,170	\$21.00	9/5/04	9/5/11			
d* 9/5/01	31,170				31,170	\$21.00	9/5/05	9/5/11			
d* 1/11/01	20,000				20,000	\$11.97	1/11/03	1/11/11			
d* 1/11/01	20,000				20,000	\$11.97	1/11/03	1/11/11			
d* 1/11/01	20,000				20,000	\$11.97	1/11/05	1/11/11			
Total	459,724	-	-	33,528	426,196						
<b>John Makinson</b>											
a* 20/4/95	20,160		20,160		-	496.7p	20/4/98	20/4/05	13/4/05	642.0p	±31,308
a* 8/8/96	36,736				36,736	584.0p	8/8/99	8/8/06			
a* 12/9/97	73,920				73,920	676.4p	12/9/00	12/9/07			
a* 14/9/98	30,576				30,576	973.3p	14/9/01	14/9/08			
b 9/5/03	4,178				4,178	424.8p	1/8/10	1/2/11			
c* 8/6/99	21,477				21,477	1372.4p	8/6/02	8/6/09			
c* 8/6/99	21,477				21,477	1647.5p	8/6/02	8/6/09			
c 8/6/99	21,477				21,477	1921.6p	8/6/02	8/6/09			
c 3/5/00	21,356			21,356		2763.6p	3/5/03	3/5/10			
c 3/5/00	21,356				21,356	3224.3p	3/5/03	3/5/10			
d* 9/5/01	19,785				19,785	1421.0p	9/5/02	9/5/11			
d* 9/5/01	19,785				19,785	1421.0p	9/5/03	9/5/11			
d* 9/5/01	19,785				19,785	1421.0p	9/5/04	9/5/11			
d* 9/5/01	19,785				19,785	1421.0p	9/5/05	9/5/11			
Total	351,853	-	20,160	21,356	310,337						
Total	1,598,858	373	22,999	114,495	1,461,737						

REPORT ON DIRECTORS' REMUNERATION CONTINUED

Note 1 No variations to the terms and conditions of share options were made during the year.

Each plan is described below.

**1 Executive** – The plans under which these options were granted were replaced with the introduction of the Long-Term Incentive Plan in 2001. No executive options have been granted to the directors since 1998.

All options that remain outstanding are exercisable (all performance conditions having already been met prior to 2005) and lapse if they remain unexercised at the tenth anniversary of the date of grant.

Marjorie Scardino, David Bell, Peter Ivanovich and John Makinson hold options under this plan. Details of these awards are set out in table 5 and termed as a on pages 35 and 36 of this report.

**b Worldwide save for shares** – The acquisition of shares under the worldwide save for shares plan is not subject to the satisfaction of a performance target.

Dennis Stevenson, Marjorie Scardino, David Bell, Rona Fairhead and John Makinson hold options under this plan. Details of these holdings are set out in table 5 and termed as b on pages 35 and 36 of this report.

**c Premium priced** – The plan, under which these options were granted, was replaced with the introduction of the Long-Term Incentive Plan in 2001. No premium priced options have been granted to the directors since 1999.

The share price target for the seven-year tranche of PPOs granted in 1999 and all outstanding PPOs granted in 2000 have yet to be met (the real growth in earnings per share target for PPOs to become exercisable having already been met prior to 2005).

All Premium Priced Options (PPOs) that remain outstanding lapse if they remain unexercised at the tenth anniversary of the date of grant.

Marjorie Scardino, David Bell, Peter Ivanovich and John Makinson hold PPOs under this plan. Details of these awards are set out in table 5 and termed as c on pages 35 and 36 of this report.

**d Long-term incentive** – All options that remain outstanding are exercisable and lapse if they remain unexercised at the tenth anniversary of the date of grant.

Details of the option grants under this plan for Marjorie Scardino, David Bell, Rona Fairhead, Peter Ivanovich and John Makinson are set out in table 5 and termed as d on pages 35 and 36 of this report.

In addition, Marjorie Scardino contributes US\$1,000 per month (the maximum allowed) to the US employee stock purchase plan. The terms of this plan allow participants to make monthly contributions for one year and to acquire shares at the end of that period at a price that is the lower of the market price at the beginning or the end of the period, both less 15%.

Terry Burns, Director

26 February 2006