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Assaâd El AKREMI, Patrice ROUSSEL & Georges TREPO

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LIRHE - Unité mixte de recherche CNRS/UT1
Université des Sciences Sociales, Bat. J, 3ème étage
Place Anatole France, 31042 TOULOUSE Cedex

Site Internet : http://www.univ-tlse1.fr/LIRHE/
Tél : 05 61.63.38.63 - Fax : 05 61.63.38.60

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# CEO COMPENSATION STRATEGIES: CONSEQUENCES ON THE STRUCTURE AND MANAGEMENT OF EXECUTIVE PAY[1]

Assaâd El AKREMI - Assistant professor of Human Resources Management at Tunis University, Institut Supérieur de Gestion;

Patrice ROUSSEL - Professor of Human Resources Management at Toulouse University - Lirhe UMR 5066 CNRS;

Georges TREPO - Professor of Human Resources Management at l'école des Hautes Etudes Commerciales - HEC Paris.

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***Abstract :*** The aim of this research is to study compensation strategies for Chief Executive Officers (CEO) from various economic, political and symbolic perspectives. A theoretical model was developed to study the hypothetical influence of several phenomena suggested by theoretical work on executive compensation. An empirical study was carried out in France on a sample of 106 chief executives from firms amongst the top 700 rated by sales. A structural equation model was tested using Lisrel. The results suggest that agency theory offers *a priori* the most solid explanation of CEO compensation because of the links observed between the control exercised by the Principal, the intensity of short-term incentives and the sensitivity of direct pay to performance. A detailed analysis of the results also seems to provide substantial support for political and symbolic perspectives. The balance of power between board members and top executives seems to be a determining factor in the determination of the structure and management of CEO compensation. The results of the research suggest that the political perspective remains coherent with agency theory by supposing that CEOs can be tempted to make use of their privileged position concerning compensation decisions.

Key words : CEO, compensation strategies, structure and management of executive pay, economic, political, power and symbolic perspectives, agency theory.

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Are top French chief executives finally going to reveal their pay slips? According to a recent survey, they sometimes earn more than a million francs a month (*Expansion*, 2001)[2]. Medef (the French employers' union) and Afep (French association of private firms) have recommended to firms quoted on the stock exchange that they publish the elements of compensation of executives appointed by boards of directors. French Parliament is studying the possibility of making this publication obligatory and on 2 May 2001 adopted the definitive text of a bill on new economic regulations. This exercise in transparency seems all the more delicate since executive compensation is marked by both concrete and theoretical ambiguities and differences. *"It is amazing how little we know about executive pay in spite of the massive volume of empirical work available on this topic... Even more discouraging, when taken as a whole, results are conflicting and disappointing"* (Gomez-Mejia, 1994, p. 199). Controversies concerning the determinants, the levels and the composition of executive pay divide practitioners and scholars alike for various reasons.

Firstly, compensation for top executives has three implications for board members and human resource managers: economic, political and symbolic (Magnan, Saint-Onge, Craighead & Thorne, 1998; Zajac & Westphal, 1995). On an economic level, CEO compensation can be used as an instrument for creating value for shareholders by the improvement of a firm's performance. On a political level, CEO compensation can be a political transaction resulting from a power struggle which calls into question the real power of a board of directors (Finkelstein & Hambrick, 1989). On a symbolic level, there is a necessity to justify decisions concerning CEO compensation in such a way that the decisions appear fair and effective for all the stakeholders (Zajac & Westphal, 1995). These implications are all the more important and passionate in circumstances where the salaries and bonuses are judged too high and with no link to the performance of firms often confronted by crises, social restructuring and policies of austerity (Murphy, 1997).

Secondly, the question of executive compensation seems constrained by the predominance of arguments concerning effectiveness. The economic perspective, essentially based on agency theory (Jensen & Meckling, 1976), is centred on an analysis of the link or sensitivity between CEO compensation and firm performance, in such a way that compensation is used as a means of control permitting a better alignment of the interests of shareholders with those of the executives. However, *"the overall explanatory power of the empirical model for pay-performance sensitivity is quite low... There is little evidence of the use of relative performance as one might expect. This remains a puzzle in the analysis of executive compensation"* (Garen, 1994, p. 1198). This has led proponents of agency theory to encourage research on other non-economic explanations related to the question of CEO compensation in order to make up for the inadequacies of this theory (Jensen & Murphy, 1990). Having recourse to other perspectives, namely political, institutional, social comparison, equity, human capital and resource management, seems to lead to a better understanding of the determinants of executive compensation, even though the multiplicity of theoretical perspectives increases the complexity of the analysis.

[2] Expansion, " Révelations sur l'argent des dirigeants ", n° 645, 10 to 23 May, 2001, pp. 60-80.

Thirdly, research on executive compensation suffers from numerous theoretical weaknesses. Gomez-Mejia and Wiseman (1997) consider that a considerable amount of confusion exists between the criteria, the processes and the consequences concerning studies in this area. According to these authors, three dimensions need to be distinguished when analysing executive pay: the first dimension concerns the criteria used to determine the compensation (e.g. organizational performance, size of firm, responsibilities and role of the executive, personal characteristics); the second dimension corresponds to the consequences on the modes of compensation (e.g. amount of salary, proportion of variable pay, level of risk); the third dimension relates to the processes which link the criteria to the consequences of the compensation (e.g. contract mechanisms, methods of control, transparency). A certain amount of confusion is due to the weakness of some of the concepts recurrent in studies of executive compensation. Finkelstein (1992) proposes a new conceptualisation of the sources of CEO power and validates measures of this power. Wiseman and Gomez-Mejia (1998) criticize the simplistic and naï ve conceptualisations of risk in agency theory. These authors incorporate diversity, instability and the contextual character of the preferences of the agent with regard to the risk in order to have a better understanding of executives' decision-making mechanisms.

Fourthly, with a few rare exceptions, the literature seems to have neglected contextual factors, such as the strategy of the firm, the environment, internationalisation, information systems and the decision-making contexts which can all play an important role in the structuring and management of executive compensation (Gomez-Mejia & Wiseman, 1997; Barkema & Gomez-Mejia, 1998). The analysis of the interactions between strategy and executive compensation can be undertaken in two different but complementary types of research. The first type consists in studying the relation between the strategy of the firm and the executive compensation. The objective in this case is to clarify the direction of the relation, that is, to know if the structure of executive compensation results from the strategy of the firm or if, on the contrary, it orients strategic choices (Gomez-Mejia, 1994). Research in this area has analysed several factors: the impact of a defender or prospector strategic orientation on the appropriate formula of incentives (Rajagopalan, 1997); the link between internationalisation, high levels of compensation and long-term incentives (Sanders & Carpenter, 1998); the effect of the alignment between the autonomy of the CEO and his or her compensation on the performance of the firm (Finkelstein & Boyd, 1998). These studies suggest that the effectiveness and pertinence of a CEO compensation system depends above all on its coherence with the contingency factors specific to each firm. Congruence between the practices of executive compensation and the internal and external contextual characteristics of the firm seem essential for improving performance. The second type of study takes a particular interest in the strategies of executive compensation. Along the lines of the preceding studies, Gomez-Mejia (1992) showed that different compensation strategies can ensure the effective setting up of different diversification strategies. Each strategy refers to a different package of compensation elements. CEO compensation is also the result of a strategy because it is based on criteria of legitimacy which are

entrenched in a changing social context. The essential aim would therefore be to give plausible explanations for the logic which underlies the practices of executive compensation (Zajac & Westphal, 1995). In other words, executive compensation is strategic because it has a double role. It contributes to the performance of a firm when it is coherent with the idiosyncratic contingency factors of this firm. It also has a symbolic role, as does the essence of any strategy, which consists in justifying and legitimizing the decisions and actions in an organization. Analysing the determinants and consequences of compensation strategies therefore seems to be necessary but rarely touched upon in the literature.

The purpose of this article is to contribute to the elaboration of a pertinent and coherent theoretical framework for analysing CEO compensation strategies. The research has four objectives. The first consists in showing the pertinence of a strategic approach for understanding executive compensation. The numerous differences and confusion could lead to the belief that CEO compensation obeys no logic, particularly when the link between this compensation and firm performance proves to be very weak. For certain critics, CEO compensation is similar to "*madness*", "*chaos*", "*pillage*", "a *scandal*" (Crystal, 1989, 1990; Loomis, 1982; Woodworth, 1987). According to Kerr and Bettis (1987, p. 661), "*there is no rational basis for the compensation paid to top management*". The present research aims to verify whether CEO compensation results from a strategy which clearly meets one or several aims. The second objective of this research is to propose a coherent framework which integrates several alternative theories developed in economics, sociology and organizational theory to analyse the structure and management of executive compensation. Despite the interest of the principal-agent model, the economic approach seems to be too simplistic. A combination of several theories would be more capable of embracing all the complexity of CEO compensation (Baron & Cook, 1992; Lambert, Larcker & Weigelt, 1993). The third objective is to distinguish between the criteria and the processes which underlie compensation strategies and the consequences in terms of practices which are revealed in the composition, structure and management of executive compensation. The ambition is to answer the question as to how firms compensate executives when they wish to meet a particular aim of performance or motivation, of selection or retention of top management. It is also a question of distinguishing the role and the complementarity between the different compensation schemes such as short-term incentives (bonuses) and long-term incentives (stock-options). The fourth objective of this research is of an empirical and methodological nature. Few empirical studies exist in France on the compensation of CEOs in large organizations (Charreaux, 1997). This research is based on data collected by questionnaire from 106 chief executives of firms established in France, amongst the top 700 rated by sales.

## *CEO COMPENSATION STRATEGIES: AIMS AND CONSEQUENCES*

According to strategic management of human resources, the conceptualisation and setting up of an appropriate compensation system is necessary for the creation of a competitive advantage for

human resources (Milkovich & Newman, 1996). CEOs, just as other salaried personnel in a firm, can be motivated to accomplish specific performance objectives. CEOs are not only motivated by their pay as such, but also by the symbolic value attached to it, that of the leader holding the highest responsibilities (Gomez-Mejia, 1994 ; Roussel & Trepo, 1996). A strategic approach to CEO compensation must therefore allow for the articulation of four main complementary objectives: organizational performance, motivation to work, attraction and loyalty of the best executives. The notion of total compensation would thus correspond to the most appropriate formulae which make it possible, at one and the same time, to meet economic imperatives, maintain the motivation of executives and ensure the stability of the organization. Total compensation integrates all the fixed/variable, extrinsic/intrinsic, immediate/deferred components which make up the mix of the compensation system.

**Total compensation of executives**

A strategic approach to the management of compensation can be identified through various characteristics. Firstly, managers have the possibility of choosing between diverse options. Firms have at their disposal more and more flexibility in the choice of executive compensation "packages", thanks to the addition of various schemes in terms of basic salary, bonus, share plans and fringe benefits. The composition of executive compensation can vary considerably between firms similar in size, performance and domain of activity (Gerhart & Milkovich, 1990; Gomez-Mejia & Wiseman, 1997). Secondly, the choices made take into account the global strategy of the firm as well as its environment. The compensation strategy is therefore contingent on several conditions, insofar as, on one hand, different organizational and environmental characteristics suppose different compensation policies and practices, and on the other hand, the relative effectiveness of these policies and practices varies in relation to the evolution of the contexts. This implies that significant deviations from congruent compensation formulae regarding the internal and external characteristics of a firm can weaken performance (Gomez-Mejia & Balkin, 1992). Thirdly, the decisions taken can favourably influence the behaviour of executives with regard to attaining a firm's performance objectives. This set of demands is embodied in the notion of total compensation.

Applying the notion of total compensation to executives consists in elaborating a mix which combines the various components of compensation according to the proportions of variable *vs* fixed pay, deferred *vs* immediate payment, monetary *vs* non-monetary compensation, short-term *vs* long-term compensation (Sanders, 1995). This segmentation offers the possibility of devising judicious combinations which enable a balance to be found between fixed and variable, or short and long-term pay. The different components of the total compensation can also be in line with multiple organizational objectives of performance, internal and external equity, selection and retention of talented executives (Gomez-Mejia & Balkin, 1992; Gomez-Mejia & Wiseman, 1997; Roussel & Trepo, 1996; Zajac & Westphal, 1995). To optimize the choice between the different components,

their combination and management, firms must define the objectives of their executive compensation policy with precision. According to the desired objectives, the mix and the management would be different. The notion of total compensation therefore favours a choice of practices which would be (1) satisfactory for the shareholders through strong links with performance; (2) attractive to the executive by meeting his or her expectations and preferences; (3) competitive in relation to other firms by paying attention to external equity; (4) simple, clear, fair and coherent in order to be justifiable with regard to the employees, the other stakeholders and the public. The notion of total compensation also makes it possible to differentiate between the impact of various compensation components on the different internal and external constraints, and their impact in relation to the multiple objectives of the organization. In addition, it constitutes a coherent framework which permits the integration of the different theoretical approaches concerning executive pay. The general proposition on which this research is based consists in postulating the plausibility and pertinence of applying the notion of total compensation to the domain of executive pay. Having recourse to different theoretical approaches could add support to this proposition. The application of a confirmatory factor analysis to the empirical data would also facilitate the testing of the reliability and validity of total compensation in terms of structure (mix, package) and method of management. The different theoretical approaches taken into account are those of the principal-agent model, the power perspective, equity and social comparison, and human resource management.

**Agency theory**

The study of firm governance mechanisms deals with two connected problems: that of creating an optimal contract and that of the mode of control between the parties in a situation of exchange. Agency theory focuses on the mechanisms which facilitate the management of conflicts of interest between shareholders (the principal) and top executives (the agent). It is based on three postulates: (1) the first is that there is a potential divergence of interest between shareholders and the CEO; (2) the second is the existence of an information asymmetry which makes it difficult for the shareholders to monitor the activities of the CEO; (3) the third is that the CEO, as a rational agent, seeks to maximize his or her utility and at the same time has an aversion to risk (Eisenhardt, 1989; Jensen & Meckling, 1976; Levinthal, 1988). Given the divergence of interest, the principal and the agent can pursue conflicting objectives. Shareholders seek to increase their wealth and the value of the firm, while the CEO can take advantage of his or her position as decision-maker for self-serving purposes even if this is to the detriment of the shareholders' interest. It is the CEO who decides and takes action. This action not only influences his or her utility, but also that of the shareholders. The problems of information asymmetry are all the more important in situations of dispersal of capital (Gomez-Mejia & Balkin, 1992) and complexity of the CEO's activities (Eisenhardt, 1989). The shareholders have a limited amount of information concerning both the decisions and actions of the executive and his or her personal traits in terms of capacities, preferences and intentions.

By delegating the power of decision to the CEO, shareholders take the risk of adverse selection (a bad choice of CEO) and also take a moral risk (possibility of opportunism on the part of the agent). The control of the agent's actions therefore becomes the fundamental worry of the principal (Tosi *et al*., 2000). To confront this problem, shareholders have recourse to two solutions, or often to a complex balance between the two: (1) develop a system of supervision to ensure that the actions of the CEO are not in conflict with the interests of the shareholders; (2) adopt compensation programmes based on measures of performance which thus safeguard the shareholders' wealth (Gomez-Mejia & Wiseman, 1997; Tosi *et al*., 2000). However, supervision of the CEO's behaviour is all the more costly and difficult in situations where his or her activities are non programmable and the information asymmetry is extensive (Eisenhardt, 1989). Having recourse to compensation systems which permit a better alignment of the shareholders' interests with those of the CEO becomes the most viable control mechanism because it induces a form of "self-control" by the agent (Bloom & Milkovich, 1998; Tosi & Gomez-Mejia, 1994; Welbourne, Balkin & Gomez-Mejia, 1995). According to the normative agency theory, the choice of an optimal compensation programme consists in creating a balance between the basic pay linked to behaviour and incentive pay linked to performance. The focus of this balance is to provide the appropriate incentives to the agent and optimal risk-sharing between the principal and the agent. This balance is complex because one has to arrive at a combination which permits the incentive pay to align the shareholders' interests with those of the CEO, without transferring too much risk through the variability of the compensation paid to the CEO (Jensen & Murphy, 1990; Sloan, 1993). In order to ensure an effective control of the executive, agency theory presumes that it is necessary to make executive compensation contingent upon the firm reaching its performance objectives, and consequently increasing the shareholders' wealth. Several choices are therefore made between the components of executive compensation in terms of fixed and variable pay, short and long-term pay, and between the different indicators of performance (share value, profits, profitability indicators) in order to closely link compensation with the success of the firm (Gomez-Mejia & Wiseman, 1997; Welbourne, Balkin & Gomez-Mejia, 1995).

Linking the compensation of the agent with the interests of the principal supposes: (1) splitting the compensation into fixed pay (basic salary) and variable pay (incentive and performance-contingent pay); (2) having recourse to different forms of short-term incentives, such as bonuses, and long-term incentives, such as stock options; (3) fixing performance objectives which determine the attribution of incentives; (4) choosing measures of performance (Gomez-Mejia & Balkin, 1992). The control which shareholders exert by means of compensation presumes that performance-contingent, variable, at risk and long-term pay permit the alignment of shareholders' interests with those of the CEO. Performance-contingent pay is based on a reinforcement of the link between compensation and performance; this link is called "pay-performance sensitivity" (Gomez-Mejia & Wiseman, 1997). A strong link between the evolution of compensation and the evolution of a firm's performance makes it possible to both control payroll costs and ensure the reversibility of compensation. Since performance can never be guaranteed on account of the potential divergence

of interest and information asymmetry, it is therefore essential not to guarantee the level of the CEO's compensation. Variable pay reinforces contingency with performance and at the same time diversifies short-term and long-term incentives which could motivate the CEO to act in the interests of the shareholders (Bloom & Milkovich, 1998; Gomez-Mejia & Balkin, 1992; Roussel & Trepo, 1996). It also permits part of the risk to be transferred to the CEO's charge in order to favour a mutual adjustment between the interests of the principal and the agent, to make the CEO take responsibility for the consequences of his or her actions and to minimize the decisions which maximize the welfare of an executive having an aversion to risk to the detriment of the enrichment of shareholders (Tosi *et al*., 2000; Wiseman & Gomez-Mejia, 1998). Having recourse to long-term incentives such as stock options reinforces the identification of the CEO with the firm and its durability, limits opportunistic behaviour and the non optimal use of resources, reinforces the elements of uncertainty in the compensation, and strengthens the links between the CEO's interests and those of the shareholders (Jensen & Meckling, 1976; Zajac & Westphal, 1995). According to agency theory, the control exerted by the principal (the shareholders) over the agent (the CEO) by means of compensation programme choices can be expressed by the following hypotheses:

*Hypothesis 1a. The control of the CEO by the shareholders is positively associated with the extent of the variable pay in the total compensation.*

*Hypothesis 1b. This control is positively associated with the linkage of compensation components to the firm's performance.*

*Hypothesis 1c. This control is positively associated with the long-term components of compensation.*

**The political perspective of CEO compensation**

Agency theory suggests that shareholders exert their control over top executives through the board of directors. It is therefore based on an assimilation of the interests of the shareholders and those of board members. The principal-agent model does not integrate the power games which can exist between the actors of firm management and the actors of control within the firm (Finkelstein & Hambrick, 1989; Westphal, 1998). This limit could explain the weak explanatory power of this model in the analysis of the link between performance and executive compensation (Jensen & Murphy, 1990).

The board of directors is supposed to represent the shareholders and safeguard their interests. Determining compensation constitutes one means of control which ensures the protection of these interests. The political perspective constitutes a twofold calling into question: (1) that of the similarity of interests of board members and shareholders; (2) that of the real power of the board of

directors in the choice of level and composition of executive compensation (Beatty & Zajac, 1995; Finkelstein & Hambrick, 1989; Lambert, Larcker & Weigelt, 1993). The similarity between the interests of board members and shareholders can be questioned on the basis of two arguments. The first argument concerns the importance of the "demographic" similarity between board members and executives. Members of the board of directors are often executives of other firms. Decisions concerning compensation can be marked by norms of reciprocity, social exchange and mutual support (Westphal & Zajac, 1997). In France, the homogeneity of executives and board members in terms of social origin, education and career path leads to business and career relations between the two (Bauer & Bertin-Mourot, 1996). Social rules of elitist cohesion can induce board members to make decisions which maximize executive compensation and decrease its links with the firm's performance. The second argument concerns the existence of an internal political context which can increase the dependence of the board members on top executives to whom they are indebted for their nomination, their compensation, the granting of service or business contracts with their firms (Magnan *et al*., 2000). Board members can therefore serve the interests of executives with regard to compensation.

The determination of CEO compensation would then be more of a political transaction which depends on the balance of power, notably in terms of control. The balance of power depends on a series of factors which characterize the structure of ownership, the board of directors and the CEO (Barkema & Pennings, 1998). It seems that the presence of majority shareholders and institutional investors influences executive compensation in line with the shareholders' interests by limiting the amount of compensation, reinforcing the pay-performance link and increasing long-term incentives. Given the structure of ownership, the balance of power in this case is unfavourable to executives and thus improves the role of compensation as a means of control (David, Kochhar & Levitas, 1998; Tosi & Gomez-Mejia, 1989). The balance of power also depends on the attributes of the board of directors, such as the relative proportions of internal and external board members, their autonomy and their length of time on the board (Daily *et al*., 1998; Westphal, 1998). The balance of power can be favourable to CEOs who possess certain personal and social characteristics, such as competence, membership of a network, their roots in the firm through stock ownership, social status, experience and alliances (Barkema & Pennings, 1998; Finkelstein & Hambrick, 1989). Calling into question the real power of board members with regard to compensation is thus based on the existence of relations of power and political agreements which can favour the interests of the CEO to the detriment of those of the shareholders. Returning to the postulate of agency theory, according to which the CEO is a rational agent who has an aversion to risk and seeks to maximize his or her utility in the short-term, it is possible to formulate the following hypotheses according to the political perspective:

*Hypothesis 2a. A balance of power favourable to the CEO is negatively associated with compensation linked to the firm's performance.*

*Hypothesis 2b. A balance of power favourable to the CEO is positively associated to a preference for short-term incentives compared to long-term incentives.*

*Hypothesis 2c. A balance of power favourable to the CEO is negatively associated to long-term performance components of compensation.*

**The perspective of social comparison and equity**

Apart from the economic and political aspects, CEO compensation strategies are based on a process of social comparison (Beliveau, O'Reilly & Wade, 1996; O'Reilly, Main & Crystal, 1988). Applying the theory of social comparison to the question of executive compensation underlines the importance of equity and organizational justice (Adams, 1965; Greenberg, 1990). The management of equity with regard to executive compensation can be addressed according to two points of view: (1) the point of view of CEOs who can compare their compensation to that of their subordinates within the firm (internal equity) and to that of CEOs of rival firms (external equity); (2) the point of view of lower-level employees who tend to compare their pay to that of other employees in the firm, including the compensation paid to top executives, in terms of internal coherence (Cowherd & Levine, 1992). Individuals are sensitive not only to comparisons of the levels of compensation (distributive justice), but also to the procedures which surround the calculations, the information, the participation and the negotiation of pay decisions (procedural justice). From the point of view of CEOs, the notion of organizational justice can reinforce the strategies of total compensation for top executives insofar as it introduces the questions of satisfaction and motivation with regard to pay. CEOs compare internal salary differentials with their subordinates taking into account their responsibilities and constraints. They also compare their compensation with that of CEOs of rival firms. Boards of directors and compensation committees seek to reconcile the objectives of internal and external equity. The compensation must be competitive to attract, motivate and retain top executives. The objective of internal equity is very complex because pay differences must be sufficiently large to take into account the responsibilities, competence and risks of executives, but not too large in order not to develop feelings of inequity amongst the other employees (Cowherd & Levine, 1992; Magnan *et al*., 2000; Gomez-Mejia & Wiseman, 1997).

Feelings of inequity result from judgements where pay differences enjoyed by executives are not justified by their efforts or their results. These feelings increase the risks of dysfunctioning and social conflicts. Very high levels of executive compensation and too wide a gap with the salaries of other employees can create a bad social climate, pay claims, strikes and arouse criticism from shareholders, unions and the media (Gomez-Mejia, 1994; Sanders, 1995). Given the symbolic implications, board members are under pressure to explain and justify their decisions concerning CEO compensation so that these decisions will be perceived by the stakeholders as equitable in terms of internal coherence and effective in terms of wealth creation for the shareholders. CEO

compensation strategies are thus essentially based on the management of impressions and thus board members worry more about the message to transmit than the real impact or effective use of a mode or form of compensation (Westphal & Zajac, 1994; Zajac & Westphal, 1995). The logic of balance between internal and external equity implies that compensation strategies must be judged acceptable, desirable, legitimate and credible by all the stakeholders, including the CEOs. Thus, the board of directors must encourage CEOs to increase performance at the same time as attending to their feelings of equity. Pressures of institutional isomorphism can increase the imitation of compensation practices in force in other firms. Imitation can support the impression of equity more than innovation. Compensation strategies are therefore defined according to practices legitimized by the market which Henninger (2000) and Gélinas (2001) explain from an institutional perspective.

Impression management aims to both prevent executive compensation from being questioned or criticized and guard against social dysfunctioning which can result from judgements of inequity. It leads to executive compensation being structured in a way which makes the various social comparisons difficult and ambiguous (Sanders, 1995). Having recourse to variable compensation and long-term incentives seems to meet this logic of impression management for several reasons. Variable compensation can favour internal equity because it is uncertain and reversible. It is supposed to increase the risk linked to compensation in return for the high salaries which CEOs receive. Accepting risk is a contribution which deserves to be compensated (Wiseman & Gomez-Mejia, 1998). Variable compensation favours external as well as internal equity because it is contingent on the future performance of the firm. Shareholders and the other stakeholders find it acceptable and legitimate to link executive compensation to performance given the CEO's status as leader and decision-maker (Zajac & Westphal, 1995). Long-term incentives are more difficult to evaluate than short-term incentives since they are linked to future performance. They limit social comparisons by making them more complex (Sanders, 1995; Westphal & Zajac, 1994). To make these comparisons even more difficult, secrecy often surrounds the levels, composition and management of CEO compensation in France despite diverse pressures for transparency (Roussel & Trepo, 1996). According to the social comparison perspective, it is possible to formulate the following hypotheses:

*Hypothesis 3a. A strategy of internal equity concerning compensation is positively associated to the CEO's exposure to risk in terms of compensation linked to performance.*

*Hypothesis 3b. A strategy of internal equity is positively associated to the long-term components of CEO total compensation.*

*Hypothesis 3c. A strategy of internal equity is negatively associated to the short-term components of CEO total compensation.*

*Hypothesis 3d. A strategy of internal equity is positively associated to the secrecy surrounding CEO compensation.*

*Hypothesis 3e. A strategy of external equity is positively associated to the long-term components of CEO total compensation.*

*Hypothesis 3f. A strategy of external equity in terms of competitiveness is positively associated to the short-term components of CEO total compensation.*

**The perspective of human resource management**

According to Zajac (1990), compensation strategies cannot be separated from those of selection and succession of CEOs in firms. The board of directors is supposed to ensure the recruitment of a CEO who is capable of improving the performance of the firm, and consequently of increasing the wealth of shareholders. The board can choose between an internal candidate (an insider) promoted from amongst the firm's managers or an external candidate (an outsider) recruited from the executive labour market. The board members then decide the forms of compensation which support the actions of the chosen executive in favour of the shareholders' interests in terms of creating value.

The affiliation of agency theory, the power perspective and organizational theory shows that CEO compensation strategies ensue from insider or outsider succession strategies. According to the premises of agency theory, insider succession can reduce the risk of adverse selection and moral risk since the CEO is known to the board of directors. Given the effects of experience and mutual acquaintance, information asymmetry and sometimes even divergence of interest are reduced (Murphy, 1986). Using compensation as a means of control therefore loses its utility. Variable pay therefore becomes less necessary to reconcile the interests of shareholders and those of the CEO (Sanders, 1995). In the case of outsider succession, problems of adverse selection and moral risk are greater, and variable pay is therefore a means of controlling the CEO and an incentive to safeguard the shareholders' interests. CEOs recruited from outside can also accept compensation linked to long-term performance more easily than insiders in order to show their qualities and their ability to bring about significant changes in the firm's performance (Murphy, 1986; Sanders, 1995). The integration of succession choices to agency theory allows the following hypotheses to be formulated.

*Hypothesis 4a. An insider succession strategy for CEOs is negatively associated with the variable components of their compensation.*

*Hypothesis 4b. An outsider succession strategy for CEOs is positively associated with the long-term components of compensation.*

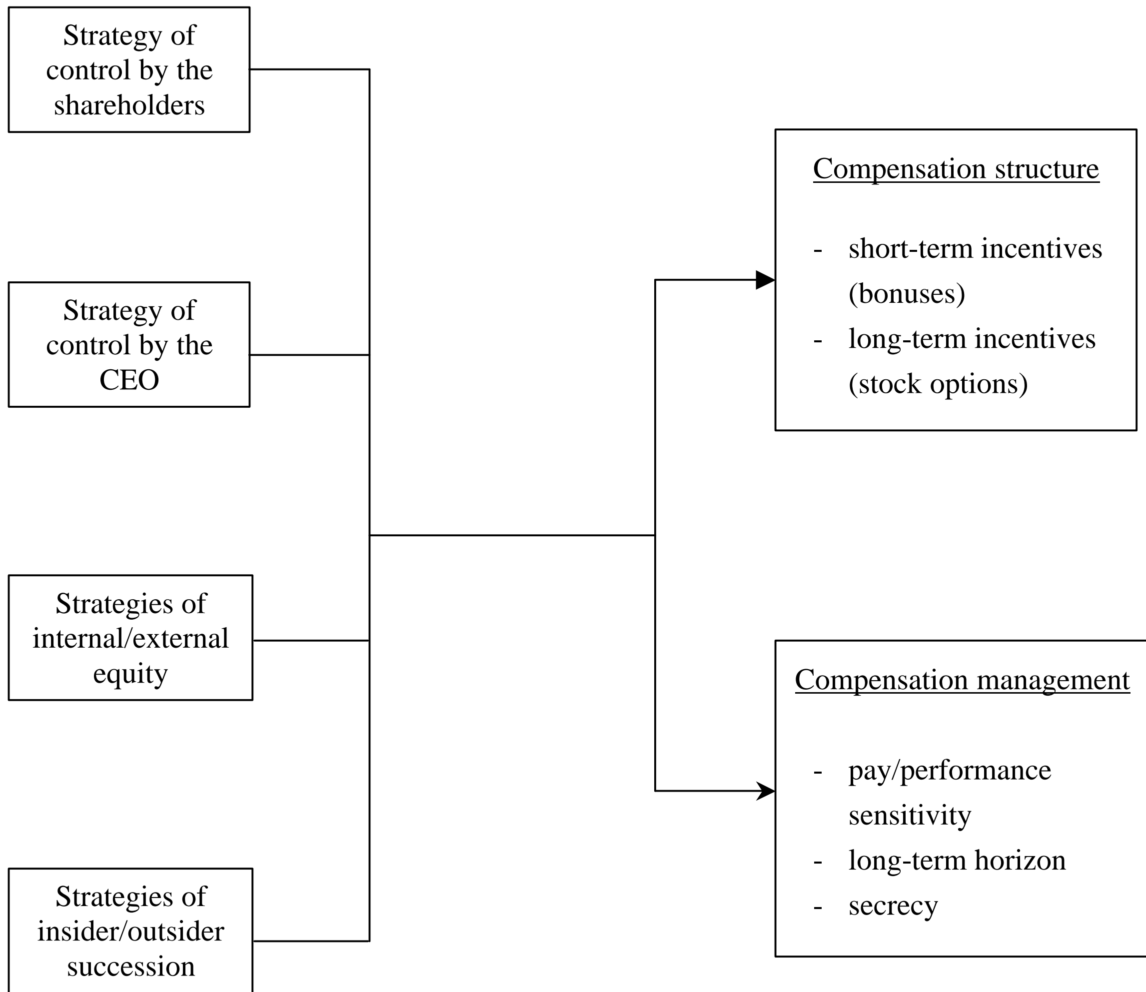
*Hypothesis 4c. An outsider succession strategy for CEOs is positively associated with the linkage of compensation components to the firm's performance*.

However, these hypotheses are not in line with the political perspective or the social comparison perspective. The balance of power between the board members and the CEO can be more favourable to an internal than an external candidate. Insiders can benefit from relational networks and share capital which they have built up within the firm given the length of service. They can also benefit from norms of reciprocity and the extent of similarities with the other board members (Cannella & Lubatkin, 1993; Ocasio, 1999). Given the balance of power which can be in their favour, CEOs recruited from inside can impose their compensation choices on the board members. Short-term components can therefore be relatively important in the CEO's total compensation. According to the social comparison perspective, the problems of equity are the same for insiders and outsiders. However, candidates recruited from inside have more chance of being the referent for the board members and other employees with regard to pay comparisons. Having recourse to long-term incentives when recruiting from outside is therefore less necessary than in the case of insider succession (Sanders, 1995). Depending on the theoretical approach adopted (agency theory, power perspective and social comparison perspective), Sanders (1995) tested opposite hypotheses on the link between the proportion of long-term compensation and the status of CEO as outsider. The hypotheses 5a and 5b fit into the same scheme. They can therefore be formulated :

*Hypothesis 5a. An insider succession strategy for CEOs is positively associated with the short-term components of compensation.*

*Hypothesis 5b. An outsider succession strategy for CEOs is negatively associated with the long-term components of compensation.*

***Figure 1: Conceptual model of CEO total compensation strategies***



## *METHOD*

The majority of empirical studies on executive compensation rely on archival data. Although this kind of data represents objective measures of both the level and composition of executive compensation, and of the performance of firms, it cannot capture the multidimensional and holistic character of the notions of total compensation and performance. According to Tosi *et al*. (2000), the existence of weak and contradictory links between compensation and performance in numerous studies can be explained by a bias resulting from trying to find a relation between objective data on performance and a subjective evaluation of the contribution of CEOs. For these reasons, the present research relied entirely on data collected by questionnaire. The survey was conducted in France with questionnaires sent to the top 700 firms in competitive sectors as rated by their classification in the magazine *"Expansion"* based on 1996 sales. The final sample consisted of 106 firms who replied to the questionnaire, giving a return rate of 15.3%. The respondents were all CEOs (55%) or their deputy managing directors (40%) or human resource managers (5%). The firms belong to different economic sectors, with an average workforce of close to 9000 employees.

### Measures

**The dependent variables**. To measure the structure and management of CEO total compensation, several scales were constructed. The principal components of compensation are bonuses (short-term incentives) and stock options (long-term incentives). They were measured as a proportion of the annual basic salary of the executives. Various benefits including benefits in kind and complementary pensions were finally excluded from the analysis because of the difficulty of evaluating them and their limited weight in the total compensation according to the respondents. The sensitivity between firm performance and trends in executive compensation was measured by the strength of the links between these variables. The time horizon of performance criteria was measured by the frequency of use of short and long-term criteria in the calculations of compensation incentives. The secrecy governing the management of executive compensation was measured by a 5-point Likert scale.

**The independent variables**. The strategic choices concerning executive compensation were measured according to the different theoretical approaches taken into account. With regard to agency theory, the control strategy used by the shareholders (the principal) was measured by the influence exerted by the board of directors, and in some cases by the compensation committee and the parent company, on the modes of executive compensation. According to the political perspective, the balance of power favourable to CEOs was measured by the importance of the roles of CEOs, management committees and human resource managers in the choice of modes of executive compensation. Based on the theory of social comparison, strategies of internal and external equity were measured by 5-point Likert scales. The human resource management perspective was operationalized by Likert scales concerning the existence of formalized procedures

for insider succession of executives as opposed to outsider recruitment from the executive labour market.

**Statistical analysis**

The model of executive compensation strategies was tested by structural equation modelling using LISREL 8.30 (Jöreskog & Sörbom, 1993). The pertinence of using this kind of method is based on several arguments. Firstly, these methods apply to latent variables, that is, hypothetical theoretical constructs which are not directly observable and which cannot therefore be directly measured. They are therefore suited to the variables of control, equity and secrecy. They allow simultaneous testing of a large number of relations between several explanatory and dependent variables. They integrate analyses of correlations, regression and variance. Secondly, they enable the validity of the measurement model to be tested. They therefore constitute a form of confirmatory factor analysis. Another advantage of confirmatory methods lies in the fact that numerous types of measurement and specification errors in the model under study can be taken into account during the analyses. Estimates of regression coefficients are thus more precise than those obtained with traditional methods. Thirdly, structural equation models offer detailed results of correlation, covariance and regression coefficients, as well as results on the overall goodness of fit between the theoretical model and the empirical data thanks to fit indices (Hair *et al.*, 1998).

The procedure followed in this research was conducted in two stages and according to a step-by-step specification procedure (Jöreskog, 1993). The first stage consists in a confirmatory factor analysis (CFA) which aims to test the reliability and validity of the measurement model. If the quality of the model is confirmed, the second stage then consists in testing the linear relations between the different variables of this model (Anderson & Gerbing, 1988). Owing to the small size of the sample (n = 106), the estimation method used is that of maximum likelihood. Despite the constraint of the multinormality of the variables, this method suits the size of the sample and generally gives better results than asymptotic methods which require very large samples (Chou & Bentler, 1995). Several criteria were used to evaluate the goodness of fit between the conceptual model and the empirical data collected. A battery of indicators is recommended to evaluate the quality of the model retained (Didellon & Valette-Florence, 1996; Medsker, Williams & Holahan, 1994). The empirical rules consist in using the ratio of the Chi Square to the degree of freedom (df) which depends on the number of parameters estimated in the model, the GFI (*Goodness of Fit Index*), and the AGFI (*Adjusted Goodness of Fit Index*). The RMSEA (*Root Mean Square Error of Approximation*) and the ECVI (*Expected Cross-Validation Index*) are considered very reliable as they have a confidence interval which allows one to appreciate the variability of the results obtained: the more this interval is reduced, the better the stability of the estimated model (Browne & Cudeck, 1993). Apart from these fit indices, the evaluation of the significance of the hypotheses is based on the Student T test (t    1.96), as well as on the determination coefficient equivalent to $R^2$.

## *RESULTS*

The correlations and descriptive statistics of the variables retained from the confirmatory factor analysis are indicated in table 1. The variables which presented problems of strong multicollinearity and missing values were eliminated to permit the convergence of the model (Raykov & Marcoulides, 2000). Multicollinearity constitutes a recurring difficulty in empirical studies on executive compensation (Rabin, 1994). Short-term incentives (bonuses) are very weakly and not significantly correlated with long-term incentives (stock options): $r = .06$. The influence of the board of directors concerning CEO compensation is positively correlated with the proportion of bonuses in the total compensation ($r = .32$; $p = .05$), and negatively, but weakly correlated with the weight of stock options in this compensation ($r = -.11$; $p = .05$). Short-term incentives seem to be the compensation component used by board members in France as a form of control for aligning the interests of shareholders and CEOs. This tendency is reinforced by the positive correlation between the power of the board of directors and performance-bonus sensitivity ($r = .21$; $p = .05$). The influence of CEOs concerning their compensation is positively correlated with the proportion of total compensation given in stock options ($r = .20$; $p = .05$), and negatively correlated with the proportion in bonuses ($r = -.37$; $p = .05$). These correlations seem to go against the hypotheses of agency theory and the power perspective, according to which CEOs, having an aversion to risk, have a preference for short-term components in their compensation. However, the importance of stock options can be explained by the desire to financially motivate the CEOs and reinforce the competitiveness of their compensation in relation to the market. In addition, CEO influence is negatively correlated with performance-bonus sensitivity ($r = -.35$; $p = .05$).

Although differences in compensation between CEOs and other employees is not correlated with feelings of internal inequity, union expression is positively correlated with the weight of variable components in the compensation, along the same lines as the influence of the board of directors for the bonuses ($r = .24$; $p = .05$). The role of the unions is positively linked to performance-bonus sensitivity ($r = .28$; $p = .05$) and negatively, but weakly linked to the secrecy surrounding CEO compensation ($r = -.14$; $p = .05$). This result could be explained by the application of stakeholders theory to CEO compensation strategies which would thus result from compromise and the balance of power between the different parties in interaction in the firm (Finkelstein & Hambrick, 1988; Frooman, 1999). In accordance with the hypotheses of social comparison theory, a strategy of external equity and competitiveness concerning compensation is positively correlated with the short-term components of the total compensation ($r = .48$; $p = .05$), as well as being positively correlated with performance-bonus sensitivity ($r = .28$; $p = .05$). The existence of a formalized selection process for insider succession of CEOs is positively correlated with short-term incentives ($r = .33$; $p = .05$) and with sensitivity between performance and these incentives ($r = .41$; $p = .05$). The selection process is correlated negatively and strongly with the secrecy surrounding CEO compensation ($r = -.49$; $p = .05$). Having recourse to outsider succession is negatively correlated to the link between compensation components and firm performance ($r = -.28$; $p = .05$).

*Table 1: Correlations and descriptive statistics*

| Variables | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. Short term incentives (bonuses) | | | | | | | | | | | | |
| 2. Long term incentives (options) | 0,06 | | | | | | | | | | | |
| 3. Base pay sensitivity | 0,05 | 0,22 | | | | | | | | | | |
| 4. Bonus sensitivity | 0,57 | 0,26 | 0,36 | | | | | | | | | |
| 5. Long term performance horizon | 0,14 | 0,11 | -0,01 | 0,46 | | | | | | | | |
| 6. Secrecy | 0,01 | -0,22 | 0,22 | -0,04 | 0,00 | | | | | | | |
| 7. Board of directors power | 0,32 | -0,11 | -0,17 | 0,21 | 0,16 | 0,04 | | | | | | |
| 8. CEO power | -0,37 | 0,20 | -0,13 | -0,36 | -0,04 | 0,06 | -0,25 | | | | | |
| 9. Feeling of inequity | 0,09 | -0,02 | 0,05 | 0,05 | 0,08 | -0,07 | -0,22 | -0,08 | | | | |
| 10. Union expression | 0,24 | 0,12 | 0,10 | 0,28 | 0,03 | -0,14 | -0,02 | -0,11 | 0,53 | | | |
| 11. External equity | 0,48 | 0,04 | -0,04 | 0,28 | 0,14 | 0,15 | 0,47 | -0,11 | 0,06 | 0,34 | | |
| 12. Insider succession | 0,33 | 0,05 | 0,26 | 0,41 | 0,25 | -0,49 | 0,04 | -0,37 | 0,13 | 0,10 | -0,06 | |
| 13. Outsider succession | 0,13 | -0,06 | -0,28 | -0,11 | -0,09 | -0,05 | 0,13 | -0,20 | -0,18 | -0,11 | 0,13 | -0,28 |

N = 106; Correlations higher than .10 significant at p = .05

## Results of the confirmatory factor analysis

Anderson and Gerbing (1988, 1992) proposed a new procedure of analysis in two stages: the first stage consists in a confirmatory factor analysis of the measurement model; the second stage is dedicated to testing the structural relations between the variables of the measurement model retained by the confirmatory factor analysis. The two stage procedure has the advantage of simplifying the specification procedure. Once an acceptable measurement model has been determined following a step-by-step specification procedure, the estimation of the linear relations can be conducted with less confusion.

The confirmatory factor analysis (CFA) led to the specification of the measures of: (1) CEO compensation strategies; (2) CEO compensation structure; (3) CEO compensation management. Through the CFA, the questionnaire items (the indicators) are confronted with the empirical data in order to verify the fit between the theoretical construction of the concepts and the data collected. Only the indicators having strong and significant factor contributions were retained.

**CEO compensation strategies measurement model.** The strategy of control by the principal was measured by the influence of the board of directors with regard to compensation. The indicators relative to the influence of the compensation committee and parent company were eliminated. The number of missing values for these two indicators was very high (60%). The influence of the parent company also presented very high collinearity with a number of other indicators. In the sample studied, the majority of firms do not yet have a compensation committee. In France, having recourse to this kind of committee is still very limited, contrary to Anglo-Saxon countries (Daily *et al.*, 1998). Despite a certain heterogeneity of the various decision-makers, the power of the board of directors seems to remain important with regard to the control of CEO compensation. Concerning the strategy of control by the agent, only the indicator relative to CEO power was retained. Indicators of the power of the management committee and human resource managers with regard to

compensation had rather low factor loadings and presented problems of multicollinearity. For the other strategies of equity and succession, all the indicators were retained. The strategy of internal equity was measured by the feeling of inequity and the expression of the union faced with compensation differentials between the CEO and the other employees (reversed items).

**CEO compensation structure measurement model.** Contrary to the recommendations of certain Anglo-Saxon studies (Finkelstein & Boyd, 1998; Finkelstein & Hambrick, 1989), short-term compensation components were separated from long-term components. In the sample of firms studied in France, the correlation between these different compensation components was very low (r = .06). Thus, short-term and long-term incentives could not be indicators of the same latent variable. This result is contrary to the conclusions of Finkelstein and Boyd (1998) according to whom trends in the level of short-term components (bonuses) in CEO total compensation follow the same direction as those of long-term incentives (stock options). In the present sample, trends in bonuses and stock options do not appear to obey the same logic or aims. With regard to pay-performance sensitivity, only the indicators of trends in base pay and bonuses were retained, while the indicator of trends in stock options was rejected. The difficulty encountered by the respondents in evaluating this trend and connecting it to firm performance could explain the very low factor loading of the indicator in the latent variable of sensitivity. For the measure of the time horizon of compensation, short-term performance criteria had a very low factor loading. Only the indicator of long-term criteria was therefore retained.

The confirmatory factor analysis led to the retention of a measurement model for CEO compensation strategies, structure and management in the sample studied. The fit indices are good with regard to the empirical rules. The Chi Square is equal to 30.45 (df = 18; p = .03). GFI and AGFI are respectively .96 and .80. The RMSEA is equal to .07 with a confidence interval of (.0; .12). Table 2 presents all the results of the confirmatory factor analysis.

*Table 2: Results of the confirmatory factor analysis*

| Latent variables | Indicators |
|---|---|
| Strategy of control by the principal | • Influence of the board of directors with regard to CEO compensation |
| Strategy of control by the agent | • CEO power concerning their compensation |
| Strategy of internal equity | • Feeling of inequity by the employees with regard to compensation differentials (reversed item)<br>• Expression of union with regard to CEO compensation (reversed item) |
| Strategy of external equity | • Competitiveness of CEO compensation in relation to the executive labour market |
| Strategy of insider succession | • Formalized selection process made known to managers for the succession of CEOs |
| Strategy of outsider succession | • Recourse to the executive labour market for a replacement |
| Short-term incentives | • Bonus as a proportion of CEO annual base pay |
| Long-term incentives | • Stock options as a proportion of CEO annual base pay |
| Pay-performance sensitivity | • Link between performance and trends in CEO annual base pay<br>• Link between performance and trends in bonuses |
| Time horizon of the compensation | • Frequency of use of long-term performance criteria |
| Secrecy | • Secrecy maintained within the firm concerning CEO compensation |
| **Fit indices of the measurement model *** | *Chi Square* = 30.45 (df = 18, p = .03); *Chi Square* $_{WLS}$ = 28.31 (df = 18, p = .06);<br>*RMSEA* = .07 (.0; .12); *RMR* = .05;<br>*ECVI* = 1.66 (*ECVI* $_{saturated\ model}$ = 1.73);<br>*GFI* = .96; *AGFI* = .80;<br>*CFI* = .97; *NNFI* = .86; *NFI* = .93; *IFI* = .97 |

* For a better fit between the measurement model and the data, the Chi Square/df index must be as low as possible; the RMSEA must be under .08; the ECVI must be under that of the saturated model; the GFI, AGFI, CFI, NNFI, NFI, IFI must be close to 1. The value of AGFI is acceptable since this index is sensitive to the number of parameters which is high in this model in relation to the sample size.

## Results of the hypothesis testing

The model of linear relations between the independent variables of compensation strategies on one hand, and the dependent variables of CEO compensation structure and management on the other hand, is presented in figure 2. The statistical results of the tests of the different hypotheses using LISREL are indicated in table 3. The step-by-step specification procedure recommended by Jöreskog (1993) made it possible to introduce some relations not specified at the beginning, but which allowed the complex links which govern CEO compensation strategies and consequences to be clarified. The goodness of fit between the conceptual model and the data from the sample studied is very good in view of the complexity of the model. The Chi Square, equal to 60.5 for 43 degrees of freedom, is very satisfactory. The RMSEA is .49 for a confidence interval of (.0; .08). The GFI and AGFI are respectively .93 and .84. As the fit of the model is acceptable, it was

possible to proceed to the analysis of the hypotheses testing (Hair *et al.*, 1998; Raykov & Marcoulides, 2000).

***Table 3: Results of the hypothesis testing using LISREL***

| Dependent variables | Independent variables | Regression coefficients | Student T test | Total $R^2$ | Hypotheses |
|---|---|---|---|---|---|
| Short-term incentives (bonuses) | • Strategy of control by the principal (shareholders) | .49 | 4.08* | .53 | • Hypothesis 1a confirmed for the short term components |
| | • Strategy of control by the agent (CEO) | - | n.s.** | | • Hypothesis 2b not confirmed |
| | • Strategy of internal equity | .45 | 3.75 | | • Hypothesis 3c not confirmed |
| | • Strategy of external equity | - | n.s. | | • Hypothesis 3f not confirmed |
| | • Strategy of insider succession | - | n.s. | | • Hypothesis 4a not confirmed for the short term components |
| | • Strategy of outsider succession | .24 | 3.22 | | • Hypothesis 4b confirmed |
| Long-term incentives (stock options) | • Strategy of control by the principal (shareholders) | - | n.s. | .18 | • Hypothesis 1c not confirmed |
| | • Strategy of control by the agent (CEO) | .34 | 3.43 | | • Hypothesis 2b not confirmed |
| | • Strategy of internal equity | - | n.s. | | • Hypothesis 3b not confirmed |
| | • Strategy of external equity | - | n.s. | | • Hypothesis 3e not confirmed |
| | • Strategy of insider succession | - | n.s. | | • Hypothesis 5a not confirmed |
| | • Strategy of outsider succession | - | n.s. | | • Hypothesis 5b not confirmed |
| Pay-performance sensitivity | • Strategy of control by the principal (shareholders) | .44 | 3.69 | 0.35 | • Hypothesis 1b confirmed for the sample |
| | • Strategy of control by the agent (CEO) | - | n.s. | | • Hypothesis 2a not confirmed |
| | • Strategy of internal equity | .49 | 4.10 | | • Hypothesis 3a confirmed for the sample |
| | • Strategy of external equity | - | n.s. | | • No hypotheses formulated |
| | • Strategy of insider succession | .28 | 3.15 | | • Hypothesis 4a not confirmed |
| | • Strategy of outsider succession | - | n.s. | | • Hypothesis 4c not confirmed |

| | | | | | |
|---|---|---|---|---|---|
| Time horizon - frequency of long-term performance criteria | • Strategy of control by the principal (shareholders) | - | n.s. | .23 | • Hypothesis 1c not confirmed |
| | • Strategy of control by the agent (CEO) | - | n.s. | | • Hypothesis 2c not confirmed |
| | • Strategy of internal equity | -0.14 | -1.90 | | • Hypothesis 3b not confirmed |
| | • Strategy of external equity | - | n.s. | | • No hypotheses formulated |
| | • Strategy of insider succession | - | n.s. | | • No hypotheses formulated |
| | • Strategy of outsider succession | - | n.s. | | • Hypothesis 4b not confirmed |
| Secrecy maintained concerning CEO compensation | • Strategy of control by the principal (shareholders) | - | n.s. | .46 | • No hypotheses formulated |
| | • Strategy of control by the agent (CEO) | - | n.s. | | • No hypotheses formulated |
| | • Strategy of internal equity | - | n.s. | | • Hypothesis 3d not confirmed |
| | • Strategy of external equity | - | n.s. | | • No hypotheses formulated |
| | • Strategy of insider succession | -0.63 | -7.27 | | • Negative link with insider succession process |
| | • Strategy of outsider succession | - | n.s. | | • No hypotheses formulated |
| **Fit indices of the structural model: hypothesis testing*****| *Chi Square* = 60.51 (df = 43, p = .04)<br>*Chi Square, normality corrected by WLS* = 53.98 (df = 43; p =.122);<br>*RMSEA* = .049 (.0; .08) with p (RMSEA< .05) = .48;<br>*RMR* = .07;<br>*ECVI* = 1.43 ($ECVI_{saturated\ model}$ = 1.73) *with a confidence interval* of (1.32; 1.64);<br>*GFI* = .93; *AGFI* = .84<br>*CFI* = .95; *NNFI* = .92; *NFI* = .87; *IFI* = .96;<br>*CAIC* = 325.83 ($CAIC_{saturated\ model}$ = 515.37). | | | | |

Probability: *p varies between .06 and .12; **n.s.: link not significant. The coefficients are standardized.

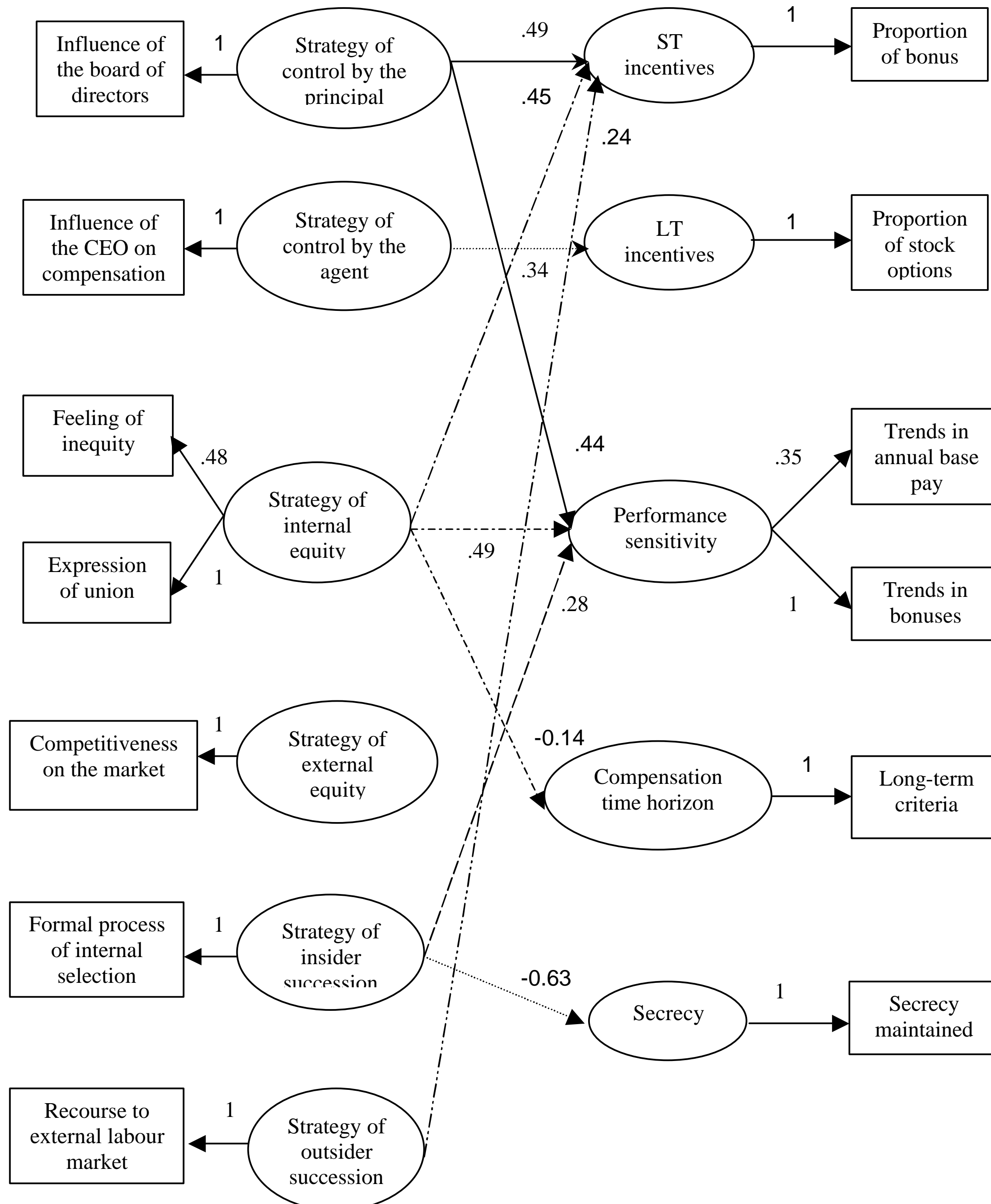
*** For a better fit between the measurement model and the data, the Chi Square/df index must be as low as possible; the RMSEA must be under .08; the ECVI must be under that of the saturated model; the GFI, AGFI, CFI, NNFI, NFI, IFI must be close to 1. The value of AGFI is acceptable since this index is sensitive to the number of parameters, which is high in this model in relation to the sample size.

The model of CEO compensation strategies and their impact on the structure and management of executive pay fits well with the data of the French CEO sample (*cf.* fit indices, table 3). Certain links between the different dependent variables were introduced during the specification procedure (Jöreskog, 1993). Compensation management in terms of linkage to firm performance seems to positively influence the proportion of short-term incentives (*âeta* = .36; t = 3.85; p < .09) and long-term incentives (*âeta* = .38; t = 3.84; p < .10) relative to annual base pay. With regard to the sample studied, this result shows on one hand, the interdependence between executive compensation structure and its form of management, and on the other hand, the upward trend in the proportion of variable incentive compensation to the detriment of the fixed base pay of CEOs. Bonuses and stock options seem to be of increasing importance in the practices of large firms in France (Trepo & Roussel, 1999, 2001). The secrecy maintained concerning CEO compensation appears to be positively linked to the attribution of bonuses (*âeta* = .26; t = 3.67; p < .07), and negatively linked to the attribution of stock options (*âeta* = -.25; t = -4.12; p < .06). This result is interesting in that it reinforces the symbolic, thus not secret, role of long-term incentives in CEO compensation. According to certain studies, stock markets react favourably to announcements of the attribution of stock options to CEOs (Mishra, Gobeli & May, 2000; Westphal & Zajac, 1998). This result can also be explained by the tendency to standardize compensation practices and their external comparability (Magnan *et al.*, 1996).

The model also explains a good percentage of the variance of the dependent variables, represented by $R^2$. For the short-term incentives, the $R^2$, equal to .53, signifies that 53% of the variance for this compensation component is explained by the variables "strategy of control of CEO compensation by the principal", "strategy of internal equity" and "strategy of outsider succession". With regard to the long-term incentives, the proportion of the variance explained is much lower ($R^2$ = .18). Thus, the distinction between short and long-term incentives in the structure of the compensation seems to be pertinent for the sample of firms studied in France since these two dependent variables are explained by different independent variables. The use of long-term incentives is essentially linked to the "strategy of control by the agent (CEO) of their own compensation". The variance explained for pay-performance sensitivity is $R^2$ = .35 and is justified by the influence of the three variables of "control by the principal", "internal equity" and "insider succession". As for the long-term horizon of the compensation, the proportion of the variance explained ($R^2$ = .23) seems to be essentially due to a reaction to performance-contingent compensation. This time horizon is measured by the frequency of use of long-term financial performance criteria for calculating executive compensation. In the sample of firms studied, the secrecy which surrounds CEO compensation seems to be explained above all by the existence of a succession process for CEOs. The explained variance is $R^2$ = .46. Secrecy is linked negatively and strongly to a formalized process of insider succession made known to managers. The fluctuation in the explained variance for the compensation components and their management can be explained by the increasing complexity of CEO compensation strategies (Magnan *et al.*, 2000). The determinants of these strategies are more and more numerous and interconnected (Barkema & Gomez-Mejia, 1998; Gomez-Mejia &

Wiseman, 1997). It therefore proves very difficult, if not impossible, to integrate all the determinants and consequences of CEO compensation practices in a single study.

***Figure 2: Model of CEO compensation strategies using LISREL***




N.B. The links between certain dependent variables are not presented in figure 2 for reasons of clarity. They are all presented in the analysis of the results. All the links represented between the variables are significant ($t \geq 1.96$; $p < .05$). The alternating dot/dash lines indicate a link contrary to the hypothesis tested. The lines with dashes indicate relations which were not hypothesized in the model of analysis. In the measurement model, three significant and theoretically justifiable correlations between indicators (not represented in the figure) were introduced: (1) between the influence of the board of directors and the expression of the union; (2) between a formal selection process and recourse to external

labour market; (3) between trends in annual base pay and secrecy maintained.

The results which are summarized in figure 2 indicate that agency theory seems to have the best explanatory power amongst the alternative theoretical frameworks taken into account. Agency theory is based on the idea that when compensation is judiciously aligned to firm performance it can be an alternative means of controlling the CEO. The results presented in table 3 and figure 2 show that in the case of the firms studied in France the compensation strategies partially corroborate the principles declared in agency theory. Hypothesis 1a postulates a link between the importance of the power of the board of directors and variable pay. This hypothesis is confirmed, but only for the attribution of short-term incentives, that is, for bonuses. Hypothesis 1b, according to which the control of the agent's decisions and actions by the principal is based on linking compensation to performance, is confirmed. However, hypothesis 1c concerning long-term incentives is not confirmed. The attribution of stock options appears to fall outside the field of explanation of agency theory.

The political perspective postulates that the determination of executive compensation results from a political process expressing the balance of power between board members and CEOs. In the case of the sample of firms studied in France, hypotheses 2a, 2b and 2c are not confirmed since significant negative links do not exist between a balance of power favourable to CEOs on one hand, and the alignment of compensation with firm performance or long-term compensation components on the other hand. Hypothesis 2b, according to which the CEO has a preference for short-term compensation in relation to long-term compensation, is not verified. A balance of power favourable to the CEO is positively linked to the proportion of stock options in the total compensation (*Gamma* = .34; t = 3.43). However, this result can be considered as indirect support for a power perspective when set apart from the influence of agency theory. A fundamental postulate of the normative agency theory is that the CEO's preference for short-term compensation stems from an aversion to risk. According to Wiseman and Gomez-Mejia (1998), aversion to risk seems to be more of an aversion to loss which essentially concerns a reduction in base pay. The attribution of stock options can then be explained with reference to the power perspective. It would result from the pressure exerted by the CEO on the board of directors to adopt stock option schemes in the case of expected improvements in the performance of the firm on the stock market (Yermack, 1997). The existence of powerful board members is also linked to a limited attribution of options to buy shares in order to avoid the risk of the CEO making roots in the firm and reversing the balance of power in his or her favour (Magnan, Saint-Onge & Calloc'h, 1999). The existence of a correlation between the influence of the board of directors and union expression for the sample studied can also reinforce the power perspective. In this respect, attribution of incentive compensation seems to be limited during periods of negotiation with the unions (DeAngelo & DeAngelo, 1991). It would be interesting to see if this phenomenon occurs in similar contexts in France, the present data not being able to verify this.

According to social comparison theory, the determination of executive compensation is guided by principles of distributive justice which permit differences between compensation inside and outside the firm to be justified and legitimized. The results of the present research provide little support for this perspective. Contrary to the conclusions of Sanders (1995), strategies of internal equity do not appear to encourage an increase in long-term compensation components to the detriment of short-term components. Long-term compensation is supposed to make it difficult to evaluate the monetary value of stock options and thus discourages social comparison. Moreover, the strategy of external equity does not seem to have any influence on the structure or management of CEO compensation. Nevertheless, hypothesis 3a, proposing a positive link between a strategy of internal equity and the CEO's exposure to risk in terms of performance-contingent compensation, is confirmed in the case of the French sample studied. This result gives partial support to the logic of internal equity. This logic is based on a complex process in which individuals compare compensation differentials between the CEO and other employees, taking into account the contributions, characteristics, responsibilities, constraints and risks of all concerned (Cowherd & Levine, 1992). The perception of performance-contingent compensation paid to CEOs seems to be affected by an increase in risk and reversibility. The uncertain character of compensation deserves to be compensated, and compensation differentials in this case would be more easily accepted by the other employees. This result can be supported by the idea that European employees give priority to the security and stability of base pay to the detriment of the risk in incentive compensation; this supposes that they would justify and legitimize compensation differentials according to the degree of risk which the CEOs assume (Nichols & Subramaniam, 2001).

The human resource management perspective is based on a combination between compensation strategies and succession-recruitment strategies as an instrument for the control of CEOs permitting the safeguard of shareholders' interests. The analysis of the results of the hypothesis testing gives some support to this perspective. Hypothesis 4b, according to which an outsider succession strategy for CEOs is positively associated with long-term compensation components, is confirmed in the case of the firms studied in France. Although the other hypotheses for the human resource management perspective are not supported, the confirmation of this hypothesis appears useful. This result can have two explanations which reinforce either agency theory or the power perspective. According to agency theory, outsider succession increases the moral risk and the risk of adverse selection. Having recourse to long-term incentives would enable these risks to be limited by aligning the interests of the CEO to that of the shareholders in the long term. In order to show their qualities and their commitment to serve the interests of the shareholders, CEOs would accept deferred compensation schemes in order to be recruited (Murphy, 1986). Nevertheless, it is possible to question this interpretation in the light of a symbolic reading from the power perspective. According to this perspective, the importance of the attribution of stock options in the case of an outsider succession strategy can be a response to normative pressures and imitation which reflects the balance of power frequently favourable to CEOs. The boards of directors who are subjected to this pressure therefore use stock options to attract, motivate and retain very demanding executives.

In addition, the power of CEOs would also stem from their membership of an elite group and to their social networks (Barkema & Pennings, 1998; Bauer & Bertin-Mourot, 1996; Westphal & Zajac, 1997). This would allow them to take advantage of norms of reciprocity and the balance of power within the different boards of directors. Comparing the results of hypotheses 1c, 2b and 4b leads to support for the power perspective to the detriment of agency theory. Powerful CEOs seem to give themselves an increasing amount of stock options which provides them with a high potential for accumulating wealth without risk and without costs (Bryan, Hwang & Lilien, 2000; Meyer, 1997). The diffused power of CEOs within boards of directors allows them on one hand, to take advantage of norms of reciprocity, and on the other hand, to reinforce compensation practices which are favourable to them on the executive labour market thanks to normative institutional pressures for imitation (DiMaggio & Powell, 1991; Zucker, 1987).

## *DISCUSSION*

The objective of this research was to study CEO compensation strategies from different theoretical perspectives. Despite apparent support for agency theory thanks to a positive association between the influence of the board of directors with regard to executive compensation and pay-performance sensitivity, a detailed analysis of the results provides a higher level of support for the political perspective. The balance of power between board members and CEOs seems to be a determining factor in the determination of the structure and management of CEO compensation (Barkema & Pennings, 1998; Hambrick & Finkelstein, 1995; Tosi & Gomez-Mejia, 1994; Wade *et al.*, 1990). However, the political perspective remains coherent with agency theory on the basis of the premise that CEOs, as rational agents, can be tempted to take advantage of their privileged position for self-serving purposes even if this is to the detriment of the creation of wealth for shareholders.

An interpretation of the results from the political perspective leads to a clarification of CEO compensation strategies in the firms studied in France. The first result concerns the positive link between the power of the board of directors with regard to executive compensation and the high proportion of bonuses in the total compensation. According to agency theory, having recourse to this incentive compensation permits the introduction of a form of control of CEOs in order to encourage them to act in the interests of the shareholders (Jensen & Meckling, 1976). This idea was called into question by agency theorists Jensen and Murphy (1990) when they demonstrated the limited variability of bonuses. *"The low variability of changes in CEO compensation reflects the fact that in spite of the apparent importance of bonuses in CEO compensation, they are not very variable from year to year. The frequency distribution of annual percentage changes in CEO salary plus bonus and total pay are comparable to that of a sample of 10,000 randomly selected workers"* (Jensen & Murphy, 1990, p. 262). These authors also consider that even if the bonuses can represent up to 50% of CEO compensation, their annual change is too low to be able to constitute a form of control which would create a substantial difference in CEO behaviour. Calling into question the variability of bonuses can be supported by the recent criticisms of conceptualisations of risk as

presented in agency theory (Bloom & Milkovich, 1998; Wiseman & Gomez-Mejia, 1998). "*In other words, agents are more concerned with avoiding loss to perceived wealth than to attracting additional wealth (loss avoiders rather than wealth maximizers). Hence, compensation risk bearing results primarily from threats to wealth in the form of base pay (…) To the extent that future base pay is insulated from the threat of loss, agent risk bearing is reduced and agents may therefore be more willing to pursue contingent pay through riskier strategic choices*" (Wiseman & Gomez-Mejia, 1998, p. 141XXX). Moreover, in firms where the CEO decides alone on his or her compensation, payment of bonuses seems to be dissociated from a real progression in performance, and is more likely to be based on subjective evaluation criteria (Trepo & Roussel, 1999, 2001).

The second result concerns the positive link between the influence of the board of directors and pay-performance sensitivity. According to agency theory, linking pay to firm performance would make compensation strategy an instrument to increase the wealth of shareholders. The analysis of the results obtained in this research seems to suggest some support for this premise of agency theory. However, this result is also in line with the political perspective. A review of the studies conducted at an international level shows that the more favourable the balance of power to the CEO to the detriment of board members, the higher the compensation in terms of short and long-term incentives and the greater the links between performance and CEO compensation via bonuses and stock options (Magnan *et al*., 1998). Incentive compensation would therefore not be a determinant of firm performance, but rather a consequence of it (Gomez-Mejia & Balkin, 1992). This interpretation can be supported by the results of a study by Finkelstein and D'Aveni (1994) which showed that CEOs having extensive informal power can profit from the effect of having roots in the firm through their stock ownership when firm performance is good. This effect limits the possibility of a CEO's dismissal *ad nutum*. The symbolic implications of CEO compensation (Zajac & Westphal, 1995) can also support this result insofar as it makes it possible to resolve the dilemma between agency theory and the power perspective. The problem would reside more in the explanation and justification of CEO compensation decisions than in the contents of the decisions themselves. Performance-contingent compensation can thus become a means to justify the amount and the composition of executive compensation more easily. Boards of directors would therefore adopt compensation schemes which convey messages that the stakeholders of the firm wish to hear irrespective of any logic supported by the premises of agency theory (Westphal & Zajac, 1994, 1998). The symbolic effect therefore ratifies the balance of power which exists in the firm with regard to CEO compensation. Board members in France seem to be subjected to strong pressures to justify compensation decisions so that they appear equitable (Roussel & Trepo, 1996).

The third result of this research concerns the positive link between the importance of the CEO's influence and the proportion of stock options in the total compensation. This result goes against the fundamental premise of agency theory, according to which the agent would have a preference for short-term compensation on account of an aversion to risk. This result can have a plausible interpretation from a political perspective for several reasons. The first is the importance of the

potential enrichment linked to stock options in exchange for the risks which they imply. Stock options are generally imputed to stock market prices and not to the results of the firm (Meyer, 1997). The second reason is that the attribution of stock options can be concomitant with a significant improvement in the firm's performance on the stock market, or even anticipate it. This is in line with the CEO's personal interests (Yermack, 1997). The third reason is that the attribution of stock options permits the consolidation of the CEO's position (with roots in the firm) thanks to participation in capital and the accumulation of shares. This can reverse the political balance of power in favour of CEOs (Barkema & Pennings, 1998; Finkelstein & Hambrick, 1989). The fourth reason concerns pressures of imitation. Stock options constitute an increasing proportion of CEO total compensation (Jarrell, 1993). Powerful CEOs can take advantage of the tendency to standardize practices and their external comparability to justify the structure and management of compensation which is favourable to them (Westphal & Zajac, 1994).

## *CONCLUSION*

This research combined different theoretical approaches to try and understand the complexity of CEO compensation strategies. The results seem to support the premises of the political perspective to the detriment of agency theory. These two theoretical approaches are however complementary. In this respect, the positivist approach of agency theory stresses the relations of power and authority between board members and CEOs (Eisenhardt, 1989). The research presents certain limits. The first limit is the reduced number of indicators used to measure the strategies, structure and management of CEO compensation. However, this limit can be explained by the desire of the researchers to limit the length of the questionnaire addressed to CEOs often subjected to pressures of time. The second limit is the absence of control variables in the empirical validation. It can be explained by the already high level of complexity of the model tested using LISREL with a modest sample of firms (N = 106). The reliability of the results necessitated the reduction of the number of variables and the elimination of control variables. Nevertheless, the results suggested by this research seem to be important for the understanding of CEO compensation strategies in France. They stress the interest of combining the power perspective and the institutional and symbolic perspective.

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