

# *Executive pay in a world of truthiness*

Facts and myths in the pay debate

February 2017





# Executive pay in a world of truthiness

Coined by *Late Show* host Stephen Colbert, the word ‘truthiness’ was voted Word of the Year by the American Dialect Society in back in 2005. They defined it as ‘the quality of preferring concepts or facts one wishes to be true, rather than concepts or facts known to be true.’ If 2005 was the year truthiness was born, 2016 has surely been the year it came of age. Indeed Oxford Dictionaries awarded their comparable 2016 award to the more prosaic ‘post-truth’.

Executive pay is an area where truthiness, and its more cerebral kin ‘confirmation bias’, are endemic. Everyone is an expert in pay, and facts should not get in the way of a good soundbite.

Since early 2016, PwC has been working with the *Purposeful Company Taskforce*. This group of prominent academics, business people, practitioners, and economists was set up by the *Big Innovation Centre* to consider how the UK business ecosystem could be altered to support development of more companies driven by long-term purpose, given the clear evidence that this could be highly beneficial to the economy and to society. One workstream where we’ve been closely involved is on executive pay. Through this process we’ve

worked with academics on the taskforce to review the best and most rigorous evidence available on executive pay – and there’s a lot of it. Policy makers should give it a read. The Steering Committee published its *Interim Executive Pay Report* in November 2016.

Out of this research we’ve identified four common myths about executive pay. These matter, because believing these myths can lead to false conclusions: wrong diagnosis leads to the wrong treatment and no cure. One of the big risks for the Government in the executive pay area is that expectations for change are set which are not met by the policies implemented. That will just lead to more public disillusionment and anger in future.

Here our aim is to take findings that are the result of rigorous academic research, and illustrate them for a practitioner audience, using UK data.

The views expressed here are our own and should not be taken to be the views of the Purposeful Company Steering Committee. However, we’d particularly like to thank Professor *Alex Edmans* of London Business School for guiding us through the academic research and inspiring us to explore many of the ideas in this paper.

## So what are the four myths?

### **Myth 1: Companies ignore shareholders on pay**

In fact, companies receiving more than 20% vote against their remuneration report increase their vote one year later by 17% points on average. Only 2% to 3% of companies either lose a vote or get more than 20% vote against for two years in a row.

### **Myth 2: The increase in CEO pay over the last three decades is unjustifiable**

80% of the increase in UK CEO pay since the early 1980s can be explained by the six-fold real increase in size of a typical FTSE-100 company since that time.

### **Myth 3: There’s no link between pay and performance**

Most analysis of pay and performance ignores basic adjustment for company size and fails to take account of the impact of previously awarded equity. Allowing for these two factors, performance explains 80% of the variance in total CEO pay in the UK.

### **Myth 4: Incentives don’t work**

Research shows that incentives do influence CEO behaviour – not always positively. High and long-term shareholdings, however, are found to encourage better long-term performance.

Don’t take this to mean that we think executive pay in the UK is perfect. It certainly isn’t. Pay design needs to be reformed and trust needs to be rebuilt. But there’s a danger of shooting at the wrong target. To be successful, executive pay reform must be based on evidence.

## Myth 1: Companies ignore shareholders on pay

The fact that BP had their remuneration report voted down but Bob Dudley still got paid his bonus is held up as evidence that the current shareholder voting system is toothless. It's certainly true that a non-binding vote is, well, not binding. There are no *direct* consequences for a company losing an advisory vote, beyond the reputational. But this doesn't mean that companies ignore such votes – far from it. Set aside the fact that shareholders probably wouldn't have voted BP's report down if it had been a binding vote (they generally think Bob Dudley's doing a good job and wouldn't have wanted him to forgo his bonus entirely). The evidence is that our non-binding system, combined with the triennial vote on policy, is pretty effective, given the reluctance of most companies to incur the reputational damage of repeated low pay votes.

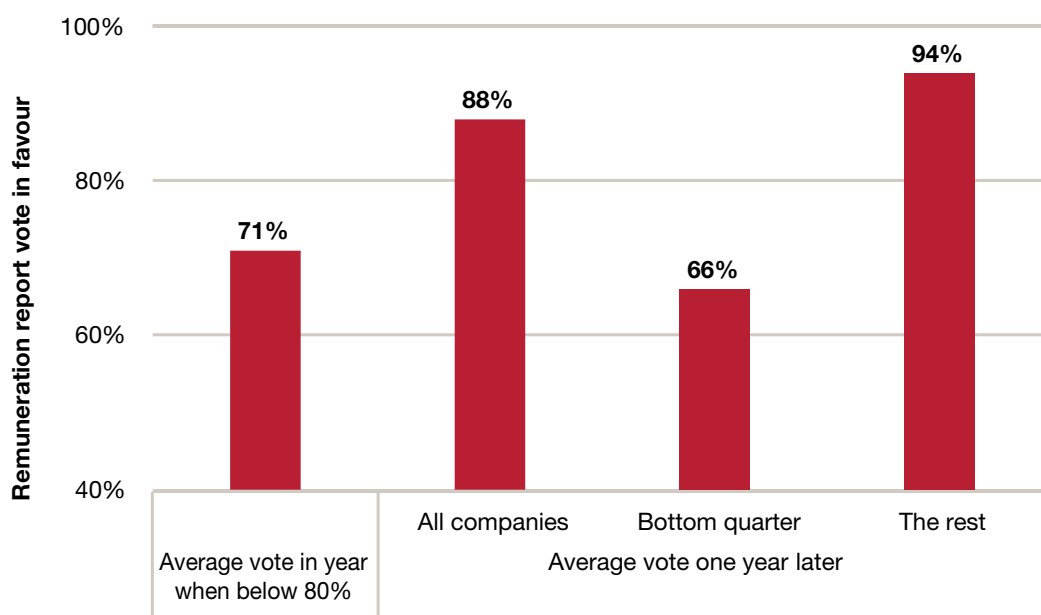
A common benchmark used for 'significant opposition' to a proposal is a vote in favour of less than 80%. This has been adopted both by the GC-100 group and Legal & General when considering whether companies should take relevant action in response. Over the last three years around one in ten FTSE-350 companies received votes in favour below the 80% threshold, suggesting it represents broadly a lower decile level of support. On average these companies received the support of 71% of shareholders. One year later, the average vote for the same companies was 88%, an improvement of 17% points on average, suggesting they had achieved significant improvement and that they had responded to shareholder concerns.

However, this aggregate data conceals a split population. Between a fifth and a quarter of companies also received a vote in favour below 80% in the subsequent year – indeed in these companies the average vote *fell* slightly from 69% to 66%. The remaining three quarters of companies improved their vote from an average of 71% to 94%, a level suggesting essentially complete shareholder support.

This analysis does not suggest an endemic problem of companies ignoring shareholders. Instead it suggests that just 2% of companies are prone to consistently low levels of support, in addition to the 1% or fewer who have their remuneration reports actually voted down in a given year.

Furthermore detailed international evidence<sup>1</sup> provides support for the effectiveness of say on pay regimes. A detailed international review across 11 countries implementing say on pay regimes found that they were highly effective in reducing executive pay inflation and improving pay practices, particularly in the firms with the most problematic governance. The evidence also found that non-binding regimes were, if anything, more effective than binding regimes. As Sacha Sadan, head of corporate governance at Legal & General Investment Management recently wrote in the Financial Times: the combination of pay votes and re-election of directors means that shareholders already have the means to address any problems with executive pay.

**Figure 1: Voting outcome for FTSE-350 companies receiving below 80% vote for advisory remuneration vote 2013 – 2015**



Source: Proxy Insight, PwC analysis

<sup>1</sup> Correa, R. and LeL, U. (2014), 'Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation around the World', FRB International Finance Discussion Paper No. 1084, SSRN: <http://ssrn.com/abstract=2328678>

## Myth 2: The increase in CEO pay over the last three decades is unjustifiable<sup>2</sup>

The argument that there's a market failure in executive pay is often based on the fact that it's gone up. For example, it is often quoted that executive pay has gone up roughly threefold since 2000 whereas the FTSE-100 is only trading broadly in line with its level of that time.

The year 2000 is a convenient starting point for those wishing to make the most negative case about executive pay. The market had yet to collapse from its dot.com peak (just two years later the FTSE had halved). And the full impact of the great international convergence in executive pay that took place in the first years of this century was yet to play through.

Look over a longer period and a different picture emerges. At the commencement of the FTSE-100 index in 1984, median total pay for a CEO of one of the constituent companies (including the value of final salary pension that was typically offered at that time) was around £200,000 pa. Over the subsequent 30 years pay ballooned by more than 7x in real terms. This sounds a lot, but the median market capitalisation of the index constituents went up over the period from £540m to over £8bn today – a 6.3x increase in real terms. In a seminal

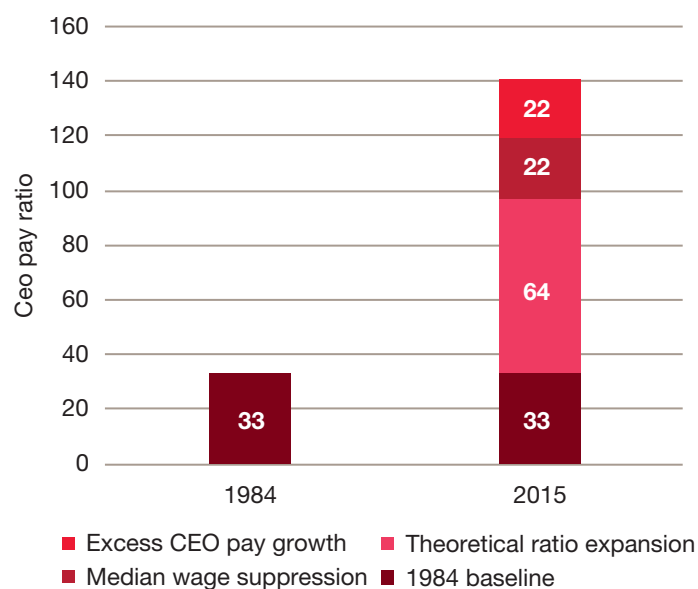
paper<sup>3</sup> Gabaix and Landier observed that it is rational for CEO pay to increase over time in line with the average market capitalisation of companies in the market.

FTSE-100 companies are transformed from what they were three decades ago, and their increase in size can explain 80% of the growth in CEO pay.

The progression wasn't linear. Markets rocketed through the 80s and 90s and FTSE-100 companies became bigger and more complex. Pay took time to catch up as remuneration committees first increased stock option and bonus award levels, and higher payments then came through with a time lag.

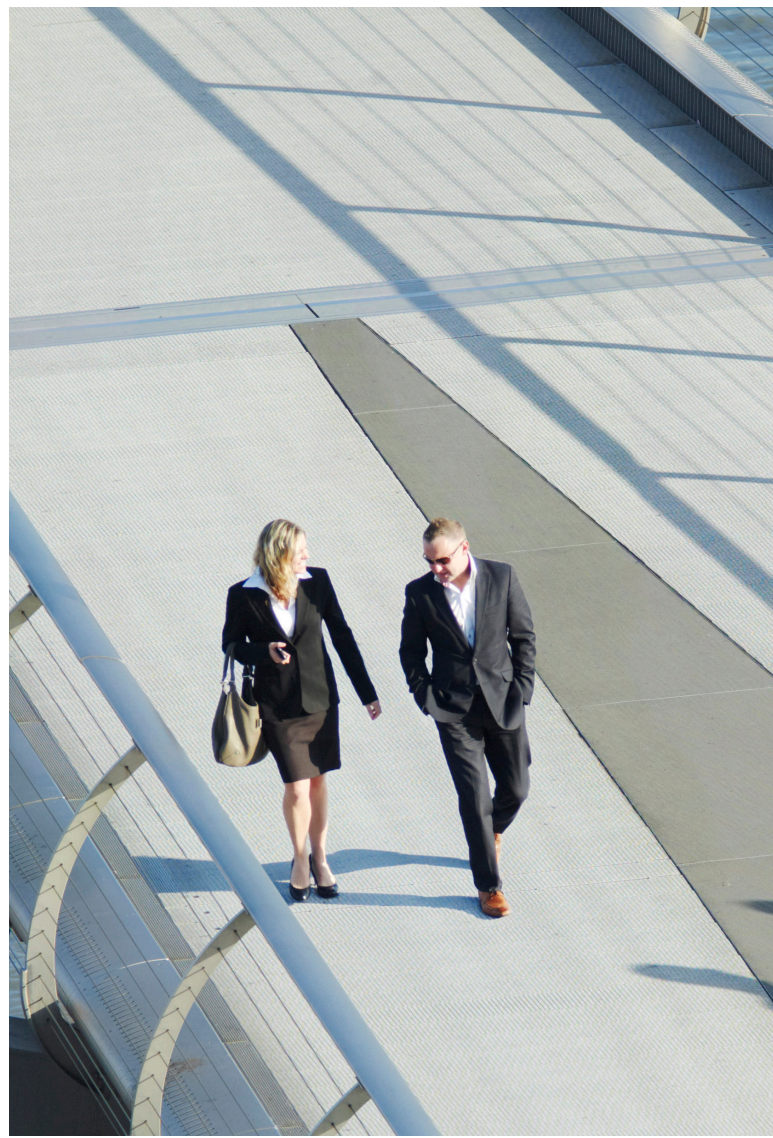
The other argument made against executive pay is based on the pay differential between the CEO and ordinary workers. Over the last thirty years, the ratio of a FTSE-100 CEO's pay to UK median national earnings has increased from 33x to around 140x. Surely no one person is 'worth' 140x another? The manifest absurdity of the ratio is taken by some commentators to make the case that executive pay is out of control.

**Figure 2: Components of growth in pay ratio between FTSE-100 CEO and UK median national earnings since 1984**



<sup>2</sup> For more detail of the analysis underlying our discussion of Myth 2, see our publication *Demystifying executive pay: market or racket?*

<sup>3</sup> Gabaix, X. and Landier, A. (2008), "Why has CEO Pay Increased So Much?", *Quarterly Journal of Economics* 123, 49-100



However, as companies become bigger and more complex, the role of the CEO becomes more important and valuable to shareholders, whereas the role of the typical employee does not. The CEO of a retailer with 7,000 stores is worth more to shareholders than the CEO of one with 700 – yet the role of the store manager is similar in both companies.

CEO actions can scale in a way that of the typical employee cannot. If the CEO of a typical FTSE-100 company takes action to enhance its value by just 1%, this is worth around £100m to shareholders, a vast multiple of the value a typical employee can add.

So to the extent the size of large firms grows faster than the economy, we would expect the ratio of CEO pay in those firms to grow relative to national average earnings. The typical size of a FTSE-100 firm has increased 6.3x in real terms compared to an economy that has slightly more than doubled. This suggests the pay ratio should have tripled – shown as the ‘theoretical ratio expansion’ in Figure 2. In fact it has gone up by over a factor four. The excess growth in the ratio arises broadly equally from median earnings growing slower than the economy, and from CEO pay growing faster than the size of the largest UK companies. This shows that addressing pay at the middle and bottom of organisations is as important as addressing pay at the top if we are to address the inequality coinundrum.

Why might CEO pay have gone up more than the growth in company size would suggest? There are many possible reasons, including the fact that CEO pay became significantly more risky over the period, with reduced contractual protection, the end of final salary pensions, and the growth of long-term incentive plans. The extra pay may just be compensation for the extra risk. Alternatively, the financial services bubble in the UK may

have caused pay contagion, driving average CEO pay too high. Gabaix and Landier identified that the CEO pay market can be sensitive to contagion, a fact borne out empirically in the US.

Arguments that listed company CEO pay in the UK is somehow the result of a market failure also comes up against a wealth of evidence that pay levels are not out of line with CEOs in comparable organisations in many other countries. Furthermore, private equity and hedge fund owners do not cut pay when they take companies private (although they change its structure). And the growth in listed company CEO pay over the last thirty years has been mirrored by the growth in earning power in a range of occupations where there is scarcity of talent, be it in private companies, asset management, media and entertainment, and sports<sup>4</sup>. The market for CEOs is clearly not perfect. CEOs aren’t interchangeable. Recruitment decisions are made on imperfect information. CEO pay is low compared to the costs of losing the right CEO or getting the wrong one, which can lead to reduced scrutiny of absolute pay levels.

But overall the evidence suggests that the growth in listed company CEO pay can largely be explained as being part of a broader economic phenomenon relating to the wages commanded by those with scarce skills in an increasingly complex and interconnected world. Claims that CEO pay is a racket are overblown. This does not make the political problem of inequality any easier to solve. If anything the opposite. But it does suggest that an excessive focus on the levels of CEO pay is unlikely to yield the desired results and could even accelerate the recent dramatic decline in the number of listed companies in the UK, simply pushing the ‘problem’ into other segments of the economy.

### ***Myth 3: There’s no link between pay and performance***

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A favourite pastime for those wishing to discredit pay practices is to compare bonus and other pay outcomes with performance over a period and to find there is low correlation. Studies of pay and performance are notoriously difficult because of the presence of many distorting factors. For example, weak companies may have to pay more to attract good executives, giving the impression that poor performance is being rewarded. Also levels of buy-out can have a significant impact on pay, but have more to do with performance at the previous organisation than the new one. But even at a more basic level these studies are often poorly framed.

A typical example is a recent MSCI study<sup>5</sup>, which claimed to find that in the US over the last decade or more, companies that paid below median outperformed companies that paid above median. This study is now being regularly quoted as evidence that pay and performance don’t correlate.

**But unfortunately it suffers from two common flaws:**

#### ***Inadequate controls***

When making statements of correlation or causation it’s important to control for known factors that may influence the result. This is a standard statistical procedure. In the case of executive pay a key control is company size. It’s well known that pay is correlated to company size. This is one of the most robust and consistent findings in executive pay. It is also logical – if you have a £100bn company at stake it’s worth paying much more to get the right CEO than is the case with a £1bn company.

However, the MSCI study does not control for size. And the measure of performance is percentage total shareholder return (TSR), which again does not account for size (10% TSR on a £100bn company represents much more value added than 10%

<sup>4</sup> Kaplan, S. and Rauh, J. (2014), ‘It’s the Market: The Broad-Based Rise in the Return to Top Talent’, Journal of Economic Perspectives 27, 3, 35-56; PwC (2014), ‘What Goes Up Must Come Down’, PwC research paper

TSR on a £1bn company). So the study may just reflect the fact that, over the period of analysis, Small Caps in the US (which pay less) outperformed Large Caps (which pay more). The result tells us nothing about the impact of pay levels more generally.

### Incomplete view of incentives

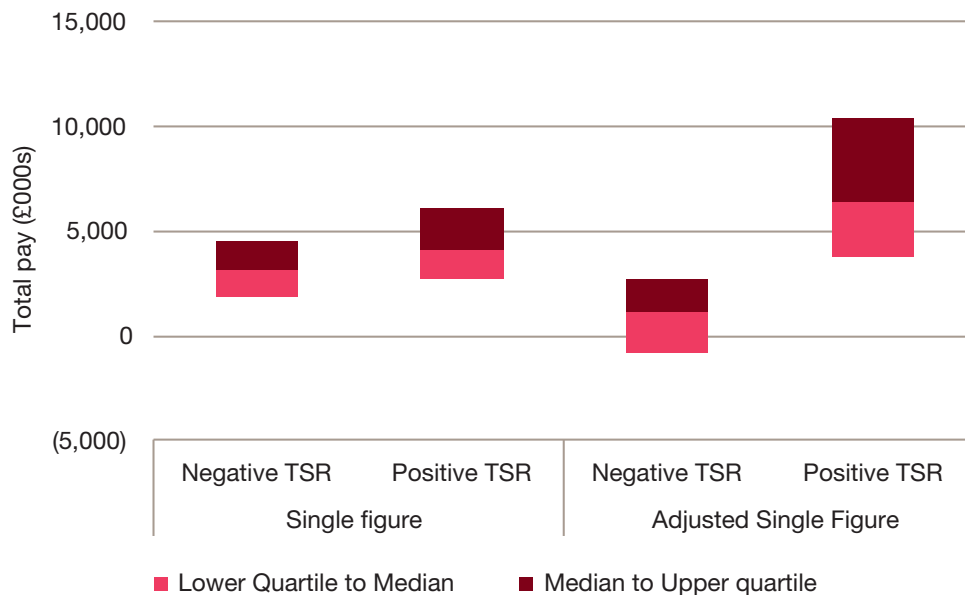
The second issue is in how pay and incentives are measured. Pay-performance analysis is often based on ‘flow measures’ of pay – salary, bonus, and long term incentive (LTI) paid in the year. Comparing these against performance over any period is problematic because the timeframes of reward elements do not match up nicely with any one period (LTIs are over three years, bonus over one for example). Indeed the MSCI study was particularly problematic as it defined pay based on the grant value of equity awards not the value that was ultimately realised. But a further issue is that a major element of incentives for a CEO relate to previously granted equity. Performance in the year affects not just what is paid that year, but the outstanding value of other stock held. The median amount of vested stock held by a CEO in the FTSE-100 is

equivalent to around £6.5m or 850% of salary. A 10% fall in the share price therefore costs them £650,000, equivalent to a pay-cut of £1.2m pre-tax.

Analysing pay using only the amounts paid in a year but ignoring previously awarded equity is like analysing investment returns based on dividends but ignoring capital gains. In other words, it doesn’t make sense.

The chart below compares the single figure of pay for CEOs in the FTSE-100 for their most recent reporting year. This comprises base salary and benefits, bonus for the year, and long-term incentive pay-outs. The companies are split between those that delivered a positive Total Shareholder Return (TSR) over the year and those where TSR was negative (just over one-third of the companies). The left-hand bars show the reported single pay figure. The right-hand bars show the reported single figure plus or minus the pre-tax change in value of previously granted equity (vested shares still held by the executive and unvested deferred awards).

**Figure 3: CEO pay for positive and negative TSR companies, before and after adjustment for previously granted equity**



Companies delivering positive TSR over the year had a slightly higher median single figure of pay – £4.1m as opposed to just over £3m for those companies that delivered negative TSR. This is a difference of one-third at the median, however, there is significant overlap between the quartiles of pay for the positive and negative TSR companies. While this analysis itself is not subject to rigorous controls, note that the median market capitalisation for both the negative and positive TSR groups was almost identical. So there is no obvious size effect distorting the results.

The right-hand set of bars adds the change in value of previously granted equity. The impact of declining share price on the negative TSR companies reduced the pay of the CEOs of these companies by nearly one half at the median, or about

£1.5m. Indeed, for nearly one-third of the companies delivering negative TSR, the fall in value of shares held more than offsets the single figure of pay received in the year, meaning that those CEOs in effect received negative pay.

Using the adjusted figures, the difference between the pay of the negative and positive TSR companies increases to a factor of five and there is no overlap in the quartiles.

More detailed analysis<sup>6</sup> shows that adjusting for size and the wealth impact of previously granted equity results in an R-squared coefficient of nearly 80% between pay and performance in the FTSE-100.

This analysis demonstrates the importance of ensuring CEOs are significant shareholders in their business. It also creates a case for amending disclosures to make it easier for investors to see the impact of previously granted equity on total effective pay for the year.

## Myth 4: Incentives don't work

About a year ago, John Cryan, then co-chief executive of Deutsche Bank, said: 'I have no idea why I was offered a contract with a bonus in it because I promise you I will not work any harder or less hard in any year, in any day because someone is going to pay me more or less.' Dan Cable and Freek Vermeulen at London Business School built on this sentiment to argue in Harvard Business Review in February that we should 'Stop Paying Executives for Performance'.<sup>7</sup>

In fact the evidence overwhelmingly shows that incentives do work for CEOs, just not always in the way intended. 'You get what you pay for' is as true for CEOs as others. And this is part of the problem. CEO jobs are complex and performance targets have a tendency to over-simplify the reality. Large scale studies<sup>8</sup> have shown that when a major block of equity is about to vest, or a performance target is about to be triggered, CEOs are more likely to undertake short term actions to ramp up the stock price or ensure the trigger is met. This may include cutting R&D, cutting capital investment or managing news releases – actions not obviously supportive of long-term value creation. Research also shows that CEOs are able to have significant influence over the setting of the targets against which they are measured – a finding supported by the fact that four out of five FTSE-100 companies typically pay out bonuses above target every year.

The conclusion is not that incentives don't work for CEOs, but that you need to be careful what you wish for. In a world where CEO incentives can make up 80% of the package, remuneration committees have to be very careful given the amounts at stake. Arguably the level of target-based incentives is now just too high and we've created a system that is too powerful for most remuneration committees adequately to calibrate and control.

But on the positive side, there is a comprehensive incentive measure that can be applied to CEOs that takes into account all aspects of their job – the long-run stock price. Studies have also shown that high levels of stock ownership have a significant and positive affect on long-term performance. A detailed study with robust controls to establish causation rather than correlation, found that high levels of stock ownership improves returns by 4% to 10% a year compared with companies with low ownership<sup>9</sup>. Another study has found that companies adopting a longer-term orientation in their pay plans also led to better long-term innovation and performance<sup>10</sup>.

So provided they meet three clear criteria, incentives should not be abandoned:

1. The structure and performance criteria of incentives are clearly linked to and support the strategy of the company
2. The balance of the package between salary, incentives and shares is such that executives rapidly build up a shareholding that is large enough to dominate, in incentive terms, the amount that they can get from target-based awards vesting in a single year – this is likely to lead to much higher shareholding requirements than are seen today, and may require performance-based plans to be replaced at least in part by fixed pay awarded in shares or by restricted stock awards
3. These shares should be released on a phased basis over a number of years including after the CEO leaves the company to avoid any cliff-release events

<sup>6</sup> For more detailed analysis see our publication *Demystifying executive pay: paying for performance*

<sup>7</sup> Cable, D. and Vermeulen, F. (2017), 'Stop Paying Executive for Performance', Harvard Business Review, February 2016

<sup>8</sup> Edmans, A., Fang, V., and Lewellen, K. (2016), 'Equity vesting and Investment', Review of Financial Studies, forthcoming, SSRN: <http://ssrn.com/abstract=2270027>; Bizjak, J., Hayes, R. and Kalpathy, S. (2015), 'Performance-Contingent Executive Compensation and Managerial Behaviour', SSRN: <http://ssrn.com/abstract=2519246>

<sup>9</sup> Von Lilienfeld-Toal, U. and Ruenzi, S. (2014), 'CEO Ownership, Stock Market Performance, and Managerial Discretion', Journal of Finance 69, 1013-1050

<sup>10</sup> Flammer, C. and Bansal, P. (2017), 'Does Long-Term Orientation Create Value? Evidence from a Regression Discontinuity', Strategic Management Journal, forthcoming, SSRN: <http://ssrn.com/abstract=2511207>



### ***Shooting at the wrong target***

There is a growing popular narrative that executive pay is too high, that pay is not linked to performance, and that this is because companies can ignore shareholders under our current voting system. The public is being led to believe that publication of pay ratios will shame companies into reducing pay and that if that doesn't work then shareholders will do the job through binding votes.

Such a negative view isn't borne out by the evidence and we fear this won't end well. Either the public will be disappointed when the reforms don't work, or they will work to the detriment of UK listed companies, who will inevitably become less attractive for executives than companies in other countries or in other sectors of the economy. Yet the stock market is the way to nurture and grow to scale our great companies of the future. This feels like an own goal.

But executive pay does urgently need reform. And trust does need to be rebuilt: surely no further evidence is needed of the political consequences of the trust deficit in Western democracies. So what is the right path for reform, to meet the Government's entirely laudable objectives of encouraging long-termism and rebuilding trust? As we've written elsewhere, we believe there are five key steps that companies and shareholders need to work on together. It is entirely within their hands to start today, to show they are meaningful about reform.



## **Actions**

We've highlighted some common myths about executive pay, which, if not challenged, could focus reform on the wrong areas. But does this mean executive pay should not be reformed? Far from it. We see five steps as being necessary to rebuild trust in the system.

### **1. Tougher shareholder powers**

Evidence shows that the current system is working well overall. Pay inflation has halted and pay has become tougher to earn. The number of outliers that lose votes or persistently receive large levels of opposition is small. But outliers matter. The nature of the executive pay market is that a small number of companies overpaying can cause wider contagion. There should be no doubt left in the public's minds that shareholders have the tools they need. This is why we support an escalation approach, with companies losing a vote or getting 25% or more vote against two years in a row facing a more stringent voting regime.

### **2. An agreed industry standard pay-for-performance methodology**

Much pay-for-performance analysis is problematic. ISS have introduced their P4P methodology as part of their screening process for voting recommendations. It has some seeds of good ideas, but also suffers from common flaws. A committee should be established of respected academics, investors, companies and advisers to take the best of academic thinking, make it practical, and come up with a benchmark methodology that the market could use to give an agreed language on pay for performance. This could help build public understanding of executive pay, avoid misleading analysis, and focus debate on the right issues. Disclosures should be aligned to make the chosen analysis as simple as possible. Such a methodology should have a number of key features: it should include the impact of previously granted equity; it should control for a minimum number of key factors, such as company size; it should cover long enough periods to be meaningful; and it should provide guidance on peer group selection (particularly cross border).

### **3. Focus on pay at the middle and the bottom not just pay at the top**

Half of the unexpected expansion in the ratio of CEO to median national earnings is due to suppressed wage growth in the bulk of the population. This is largely a matter for public policy on minimum wages, tax and redistribution, education and training, and other social mobility initiatives. But companies have a role to play too. It is in their interests to engage fully with the fairness debate, given the strains that technology is likely to place on the labour market, and the consequent political pressures large employers will face. This is why we favour the development of a Fair Pay Report that sets out how the company addresses fairness in pay across the organisation, and which would provide an opportunity for meaningful engagement with employees, creating accountability at board level.

## **Actions**



#### 4. A revolution in pay design

Incentives do work, but not always as intended, and you can certainly have too much of a good thing. This is where we have got to now in the UK. The proportion of the package now made up by variable pay is, on average, too great in the UK. The measures chosen are prone to encourage short term behaviour and remuneration committees struggle to calibrate targets with sufficient stretch given the sums at stake, which undermines public confidence. Pay design needs to be rethought to place more emphasis on making executives significant long-term shareholders, and less on target driven incentives (although these will still have their place). Exposure to the share price should be long-term (five years or more) and should extend after leaving the company. This will require some radical departures from current norms. Part (or in some cases all) of performance pay will need to be replaced by long-term share awards. This can be achieved in a number of ways including restricted stock, rebalancing towards fixed pay paid in shares, joining awards of shares vesting over five years as part of the package, and making buy-out awards in restricted stock rather than performance incentives. Pro-rating awards when executives leave should also be reconsidered, as it has the unintended impact of making pay progressively more short-term as executives approach retirement.

These proposals go against the grain of recent trends in shareholder and governance guidance. But it's time to take an honest look at what has and has not worked, and adjust course accordingly.

#### 5. A change in attitude

Executive pay needs to continue to become a less forgiving environment. Average bonus pay-outs, at 75% of the maximum, are simply too high and corrosive of public trust in remuneration committees. This can partly be addressed by placing less weight on target-based incentives in the first place, but in the short term there needs to be a toughening up of target calibration and assessment. Increases in pay opportunity in the current environment should have to pass the highest levels of scrutiny, and it's right that remuneration committees and investors should be sceptical of proposals for increased pay. Our view is that, on average, UK CEOs are not overpaid for what they do. But they are not underpaid either. And with individuals able to make life-changing sums over just a few years, it's right that there's scrutiny on how it's paid and what they need to do to earn it. They should accept the scrutiny with good grace.

A hard look at the evidence suggests there's less wrong with executive pay than the populist narrative would suggest. But there's still work to be done. In substance, the most important reform is to pay design, to ensure pay encourages long-term thinking, and only provides the highest rewards for sustainable long-term performance. But measures to rebuild trust are also vital. This includes boards improving oversight of pay fairness throughout the organisation, more meaningful disclosures of pay and its link to performance, and tougher decision making by remuneration committees. But we should be modest in our aspirations. In the scheme of things, despite its profile, executive pay is not the biggest problem we face as a country. Claiming too much for executive pay reform will lead to future disappointment. But a settlement on executive pay will be necessary to give business the space to create the growth we need.





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