Managerial Incentive Systems -
Reasons Behind Use and Design

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Abstract

Managerial incentive systems have for a long time been criticized by different disciplines within the academia for contributing to a short-term focus among managers, which undermines the long-term interest of shareholders. Despite the critique put forward by business scholars and behavioral scholars, short-term structures are still prevalent within managerial incentive systems. This study explores why large cap firms have not aligned their managerial incentive systems to the critique from business scholars and behavioral scholars. Furthermore, this study aims to contribute to a deeper understanding of the existence and development of managerial incentive systems. In order to address the aim of the study, eight small case studies were conducted at eight large cap firms. The findings of the study indicate that short-term structures are considered pivotal in attracting and retaining managerial talent, directing the attention of managers to important targets in generating shareholder value and motivating the managers to perform at the top of their capacity. Furthermore, the study shows that the short-term structures, criticized within the academia, are reinforced and institutionalized by stakeholder pressure and organizational contingencies.

Keywords: Managerial incentive systems, short-term structures, agency theory, motivation crowding theory, institutional theory, stakeholder pressure, qualitative approach.
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1. Introduction

1.1. Background

The question about how to compensate corporate executives and managers traces back to the days of the industrial revolution. During this period of time the owners of factories hired people, often in the form of managers, to run their businesses as a way of dealing with the scope and complexity of them. As a consequence of this new way of organizing the businesses, the ownership and the control of them were separated between the owners and the managers (Fama, 1980; Jensen & Meckling, 1976; Berle & Means, 1932). With the transfer of control to the managers, a potential problem evolved in finding a way to align the interests of managers, in such a way that they corresponded to the interests of the business and its owners.

In the management literature, the problem of diverging interests within firms is depicted in the Agency theory as the agency problem, first placed in an organizational context by Jensen and Meckling (1976) in their article Theory of The Firm. The authors propose that a principal (owner) engages in a contractual agreement with an agent (manager) to perform a task in the interest of the principal. However, under the conception that the two parties seek to maximize their own utility, their interests will diverge in some situations. In order to deal with this problem, the principal expends costs which have the purpose of limiting the risk of divergence and align the interests of the agent to those of the principal. These agency costs incurred by the principal take, for instance, the form of monitoring costs, which are connected to control mechanisms of different kinds that hinder the agent from acting deviant in relation to the interests of the principal. The control mechanisms used include budget restrictions, auditing, formal control systems and incentive systems. The incentive system implemented by the principal serve to conform the interests of the agent to the principal’s (Jensen & Meckling, 1976). In an organizational setting this means making the interests of the owners to the interests of the executives, which will make these more inclined to work for better firm performance.

1.2. Problem Discussion

This line of thinking, about how a firm aligns the interests of its top management to those of its owners, has had great influence on the practices of firms (Drucker, NY; Frey & Osterloh, 2005). As a result of this influence, large firms have incentivized its top management through monetary incentives (Frey & Osterloh, 2005; KPMG, 2013), for instance through cash bonuses and stock options. However, these practices have led to extensive debates among
scholars within the academia, as well as different stakeholder groups in society. At the center of discussion lies the matter of how these monetary incentives affect firm performance. Proponents of the agency theory have argued that sub-par performance of firms, caused by executives acting in self-interest, is the result of poorly designed incentive systems, in which the link between the monetary incentives provided and firm performance is inadequate (Jensen & Murphy, 1990; Bebchuk & Fried, 2003; Hall, 2003). Jensen and Murphy (1990) propose that this shortcoming would be solved by making executives within top management substantial owners of company stock. Furthermore, they stipulate that compensation schemes, in the form of bonuses and stock options, should be structured so as to provide great rewards for outstanding performance and real penalties for sub-par performance. In doing so, the link between executive compensation and organizational performance would be reestablished, they argue.

However, the quantitative studies performed on how compensation-schemes built on stock-based incentives and cash bonuses affect firm performance have rendered inconsistent results: Mehran (1995) indicated a positive relationship between firm-performance and the stock-ownership and stock options of CEOs, whereas Dalton et al., (2003) found a non-significant relationship between stock ownership and firm performance. Furthermore, Habib and Ljungqvist (2005) suggested a positive relationship between CEO’s stock ownership and firm value, while they found a negative relationship between stock options and firm value. Along these lines, there are studies which have found a positive relationship between cash bonuses and firm performance (see for instance Bruce et al., 2007) and those which have concluded that cash bonuses do not increase firm performance (Hall & Liebman, 1998; Kaplan, 1998).

1.2.1. Critique from Advocates of Agency Theory

Furthermore, Jensen and Murphy (1990) argue that these incentives would make executives act in the interests of shareholders as value-maximizing entrepreneurs. However, it is difficult to determine if these incentives have led executives to engage in value-maximizing behavior (Murphy, 1999). Along these lines, many scholars have argued that the short-term elements of the incentives have led executives to act in self-interest and to focus on short-term profits, while they neglect the shareholders and the long-term prosperity of the firm (Osterloh & Frey, 2004; Salter, 2003; Cassidy, 2002; Lambert et al, 1989). In addition, advocates of the agency theory-paradigm have acknowledged that the prevailing systems of executive compensation, especially those that incorporate stock options, are insufficient, as they direct the focus of the top management to short-term gains (Jensen, 2002; Fuller & Jensen, 2002; Bebchuk & Fried,
These problems could take the form of thresholds within the incentive system instead of a linear setup, or the use of prior-year performance benchmarks, which inspire managers to take short-term decisions (Murphy & Jensen, 2011; Jensen et al., 2004). The short-term focus has also been expressed by chairmen of boards and CEOs in large cap firms as the major shortcoming of current managerial incentive systems (Unionen, 2011). Consequently, according to these scholars, the managerial incentive systems fail to align the interests of the top management to those of the outside shareholders, which is the long-term prosperity of the firm (Rappaport, 2006). The proponents of the agency theory do, however, stand by the fundamental idea of aligning the interests of executives through incentives, if these are properly designed.

1.2.2. Critique from Behavioral Economic Scholars

Furthermore, scholars within the field of behavioral economic science have concluded that short-term monetary incentives have a negative effect on the performance of tasks which require cognitive skills and creativity (Ariely et al., 2009). This is problematic, since problem-solving skills and creativity is required as an executive or manager. Scholars within this field argue that the problem with such monetary incentives is that they generate extrinsic motivation, while they could crowd out the intrinsic motivation of individuals (Frey & Osterloh, 2005; Frey & Jegen, 2001). Along those lines, these monetary incentives cause the individual to get motivated by the potential reward, rather than the task itself (Kohn, 1993). This shift in focus narrows the individual’s attention to focus on the incentive, which impedes the cognitive ability of the individual (Ariely et al., 2009). An example of how the cognitive ability of the individual is affected by potential monetary rewards is the tendency to make decisions, based on their effect in relation to the incentivized targets. As a consequence, the long-term effects of the decisions are neglected, which could affect the prosperity of a firm negatively in a long-term perspective (Cheng et al., 2005; Ordonez et al., 2009). Although these scholars criticize monetary incentives as a whole, it is important to mention that they have, in their experiments, focused on incentives that render in payout instantly and a short-term perspective. Therefore, the long-term perspective has, to an extent, been ignored.

1.2.3. Research Problem

The discussion above indicates that managerial incentive systems, which focus on the short-term perspective, could have negative effects on firm prosperity. Yet many large firms within the large cap segment at the Stockholm stock exchange adopt this type of incentive programs to influence the behavior of its top management. More importantly, reports indicate that such
incentive programs increase among these firms (PWC, 2013; KPMG, 2013; Unionen, 2011), while the critique towards top management incentive systems from the rest of society is persistent (Bengtsson & Hedberg, 2012; Logothetis, 2015; Unionen, 2011). With this in mind, there is a mismatch between the results presented by some scholars within the academia and the practices of these large firms. This is because the managerial incentive systems incorporate elements (short-term incentives and thresholds within the incentive system) that contribute to a short-term focus among managers. These components within managerial incentive systems could undermine the long-term performance of firms and, thereby, the long-term interests of their shareholders. Consequently, it is clearly of academic and practical interest to investigate the rationale of these managerial incentive systems, as these incentive systems affect the people who are ultimately accountable for the performance of firms. Therefore, the following research question has been chosen:

*Why are large cap firms’ managerial incentive systems designed the way they are considering the critique from the academia?*

1.3. **Purpose**

The purpose of this study is to explore why managerial incentive systems at the top management level are not aligned to the above mentioned critique from the academia, with respect to two different lines of critique: firstly, the structural problems within these systems highlighted by advocates of agency theory. Secondly, the critique against the use of short-term incentives from behavioral scholars. By considering these two dimensions, the study aims to contribute to a deeper understanding of the existence and development of these systems. Furthermore, in order to fulfill the purpose of exploring why these incentive systems are not aligned to the critique highlighted above, this study will account for how these systems are designed as well as why.

1.4. **Contribution**

The problem regarding the short-term focus of firms’ incentive systems has previously been demonstrated by scholars, who have determined reasons for why firms have short-term incentives (Cäker, 2013; Merchant & Van der Stede, 2012; Westerman & Strandberg, 2009). These motives are accounted for in section 2.2. However, we aim to provide a deeper understanding for why these short-term structures exist, in relation to the critique of the scholars highlighted above, as this is something which has not been given by previous
research. Hence, this study will make a theoretical contribution to the literature on managerial incentive systems.

1.5. Definitions
Managerial incentive systems mainly consist of different forms of monetary incentives, which are defined as performance-based rewards which are cash-based or could easily be converted into cash (Merchant & Van der Stede, 2012). These kind of incentives could take the form of cash-bonuses, stock options or company stock. Monetary incentives are commonly divided into two categories: short-term incentives, which are monetary incentives based on the measured performance of an individual or group within one year and long-term incentives, which are monetary incentives based on performance during a period of time that exceeds one year (typically 3-4 years) (Merchant & Van der Stede, 2012). Furthermore, we define a threshold within an incentive system as a specified target-level which must be reached in order for the individual to receive a predetermined payout. A linear setup is defined as a setup in which the relationship between performance and pay starts at zero and the payout is determined by the relative goal-fulfillment (in terms of percent), without any ceiling (Jensen et al., 2004). Lastly, large cap firms will in this study be defined as companies with a market value above $5 billion, which is an often used definition of a large cap firm according to NASDAQ (2015).
2. Theoretical Framework

The following section includes the theoretical perspectives which constitute the theoretical framework of the study. The section has the following outline: firstly, Agency theory is described. This is followed by motives for the use of monetary incentives. Thereafter, structural problems within managerial incentive systems are described. Subsequently, behavioral scholars’ perspective on how monetary incentives affect the human motivation is accounted for. In the final section of the theoretical framework, Institutional theory and the concept of isomorphism is introduced.

The perspectives within the theoretical framework have been chosen for different reasons: Agency theory has been included for several reasons. Firstly, it has had great influence on the development of managerial incentive systems (Frey & Osterloh, 2005). Secondly, advocates of the agency theory claim that managerial incentive systems are insufficient, since they have led to a short-term focus among managers, which undermines the long-term prosperity of firms. Thus, the theory serves as a point of reference in determining why firms have not aligned their systems to the critique. By the same token, motives for using monetary incentives, which have been determined in the literature are accounted for. Structural problems within managerial incentive systems have been incorporated as these constitute an important part of the critique against these systems from advocates of agency theory.

The perspective of behavioral scholars on how monetary incentives affect the human motivation has been included in the framework as it enables us to derive possible explanations for why firms have not aligned their systems to the critique. Such possible explanations have been derived through a comparison of the organizations’ perspectives to those of behavioral scholars.

Institutional theory and the concept of isomorphism have been incorporated in the framework based on our empirical observations. This concept has the purpose of contributing to a deeper understanding of managerial incentive systems by highlighting the forces which affect them.

Furthermore, we are aware that the theoretical framework incorporates theories which are built on different assumptions. However, as we will explain further in the method section this is an explorative study, which makes use of theory in order to better understand the empirical findings, not to confirm the theories per se. With this in mind, it is important to acknowledge...
that scholars, such as Ghoshal (2005), argue that empirical studies indicate that the setup proposed by agency theory does not generate better performance. As such, the prevalence of agency theory relies on the indoctrinated view of managers as money-driven, which stems from the business education provided by universities (Ghoshal, 2005). Furthermore, the research which constitutes the foundation of the critique from behavioral scholars has, to a great extent, been done outside a business context (see Deci et al., 1999), which might have implications for the applicability of the research inside large cap firms.

2.1. Agency Theory

The following theory provides a theoretical perspective on the complications that occur when an owner (principal) of an organization enters into a contractual agreement with a manager (agent) to run the business in the interest of the owner. Agency theory deals primarily with two kinds of problems: firstly, the diverging interests of the principal and agent which generate agency costs (Jensen & Meckling, 1976). Secondly, the diverging attitudes toward risk between the principal and agent which create a risk-sharing problem (Eisenhardt, 1989a). Within agency theory, the owner should try to minimize the agency costs attributable to misbehavior and monitoring. This perspective has been developed further by agency theorists in the optimal contract approach to correspond to the compensation practices of firms (Bebchuk et al., 2002). Within the optimal contract approach, the costs for inducing a manager to take and retain the position are included besides the agency costs for misbehavior and monitoring. Since this study focuses on the compensation practices of large cap firms, these costs are included in the depiction below.

2.1.1. The Agency Problem

In order for an owner to attract and retain a competent manager, Bebchuk et al. (2002) stipulate that an owner must offer a contract that includes a compensation package which meets or exceeds the opportunity cost of the manager. This process generates costs for the owner which are categorized as contracting costs (Bebchuk et al., 2002). When the contract between the owner and the manager has been settled, the ownership and control of the organization is separated between the owner and the manager (Fama, 1980; Berle & Means, 1932; Jensen & Meckling, 1976). With this separation, the owner does not have access to perfect information about how the business is managed any longer. This information-asymmetry between the owner and the manager is seen as problematic for the owner under the condition that the two parties strive to maximize their own utility (Jensen & Meckling, 1976). The reasoning behind this is that differences in ownership between the owner and the
manager and their different roles lead to diverging interests (Jensen & Meckling, 1976; Eisenhardt, 1989a; Arrow, 1985). These diverging interests are the core of the agency problem.

However, there are different dimensions of the agency problem which need to be separated. Firstly, there is, according to the theory, a risk that the manager will not fully invest the time and effort needed in serving the interests of the owners. The reasoning behind this is that the manager does not own any company stock (or only a small part of it) and, therefore, only receives a fraction of the value his or her work generates for the organization. Under such circumstances the manager has an incentive to work less and instead enjoy the benefits of non-work activities or leisure time (Bebchuck et al., 2002; Bång & Waldenström, 2009).

Secondly, the theory stipulates that, due to the limited ownership, the manager is more inclined to make decisions which serve the manager’s self-interest, rather than the interests of the owners. These type of decisions can take the form of excessive expenditures on perquisites, which do not generate any value for the owners (shareholders) (Jensen & Meckling, 1976; Ross, 1973; Bebchuk et al., 2002; Bergström, 2012). The reason for this is that the manager fully benefits from these expenditures, while he or she sustains only a fraction of the costs. The point here is that the manager will not act in line with the interests of the owners when there are alternatives which serve the manager’s interests better (Arrow, 1985). When the manager does not act in line with the interests of the owner it generates costs for the company, which are categorized as agency costs and, more specifically, agency costs of misbehavior.

In order to mitigate this problem of diverging interests and reduce the agency costs of misbehavior, the owners should implement different control mechanisms, which serve the purpose of aligning the manager’s interests to those of the owner (Jensen & Meckling, 1976; Ross, 1973; Eisenhardt, 1988). The control mechanisms take the form of budget restrictions, formal control systems, auditing and compensation systems (monetary incentives). Imposing such a structure of mechanisms, in order to control the actions of the manager, generates agency costs which are categorized as monitoring costs (Jensen & Meckling, 1976; Eisenhardt 1988, Shapiro, 2005). By providing the manager with monetary incentives (short-term and long-term), the manager will be more inclined (motivated) to exert effort and the interests of the manager are aligned, to a greater extent, to those of the owner. The owner should give incentives to the manager until the point where the additional cost of providing these incentives outweighs the additional value generated from these incentives. Along these lines,
the owner should try to minimize the sum of the contracting costs, the costs for misbehavior and the costs for monitoring the manager.

2.1.2. The Risk-Sharing Problem
Connected to the problem of diverging interests is the problem of risk-sharing, which occurs when the two parties in the principal-agent relationship have different preferences about taking risks (Eisenhardt, 1989a). In the principal-agent literature the agent is seen as risk-averse, while the principal is considered risk-neutral. The reasoning behind this classification is that the fortune of the agent (manager) is tied to the organization (Coles et al., 2006), whereas the principal (owner) has the opportunity to diversify his or her portfolio by investing in other firms (Fama, 1980). Under such circumstances the manager's actions could diverge from the interests of the owner (Eisenhardt, 1989a), which is to increase the prosperity of the firm through risk-taking (Jensen & Meckling, 1976). Due to the uncertainty regarding whether the manager will act in line with the interests of the owner or not, the owner will impose outcome-based incentives, which have the purpose of altering the risk-preferences of the manager (Eisenhardt, 1989a). This setup will make the manager more inclined to accept risk and, thereby, act in line with the interests of the owner, as his or her personal wealth will increase as the firm's performance improves (Coles et al., 2006). However, when the owner contracts the manager based on the performance of the business, the owner transfers risk to the manager. This means that the owner has to pay a premium to the manager, which is not optimal when there are macro-variables affecting the performance of the company (Eisenhardt, 1989a; Holmström, 1979).

2.2. Motives for Using Monetary Incentives
In line with the reasoning within agency theory and the optimal contract perspective, there are many different perspectives on why monetary incentives are incorporated in the management controlling systems of organizations. A compensation system built on variable pay provides an organization with the possibility to differentiate pay according to the contributions of its employees (Merchant & Van der Stede, 2012). By implementing such a system, in which the individual’s work is recognized, an organization encourages its employees to achieve outstanding results. This view corresponds well to Bonner and Sprinkle (2002) and Merchant & Van der Stede (2012) who argue that incentives have the purpose of motivating and improving the performance of individuals by establishing links between the tasks of individuals and the goals of their organization.
Furthermore, connecting incentives to targets enables the organization is able to signal what targets are important for the organization (Merchant & Van der Stede, 2012; Cäker; 2013) and direct the focus of individuals to these targets (Cäker, 2013), which increases their effort and ultimately the overall performance (Bonner & Sprinkle, 2002). Thus, incentives serve the purpose of directing the effort of the employees within an organization (Merchant & Van der Stede, 2012).

Another purpose of variable pay is that it enables the organizations to share the risk of sub-par performance with the employee so that the compensation expenses of the organization become variable to the performance of their employees. Thus, the total compensation expenses of the organization will correspond to its earnings which means high payouts when the organization is doing well and low payouts when the organization is experiencing more difficult times (Cäker, 2013; Merchant & Van der Stede, 2012).

In order for an organization to realize its long-term prosperity it needs to have access to the experience and competencies necessary to be successful. Therefore, variable pay often has the purpose of attracting and retaining highly qualified personnel which possess the knowledge and competencies that the organization deems as important for their success (Cäker, 2013; Merchant & Van der Stede, 2012; Malmi & Brown, 2008).

2.3. Structural Problems within Managerial Incentive Systems

The approach promoted within the agency theory has influenced the organizational practices of many firms. However, the practice of using incentive systems in order to align the interests of the top management to those of the owners (shareholders) has generated additional problems.

As stated in the problem discussion, the short-term focus in incentive systems is often highlighted both by academia (Jensen, 2002; Fuller & Jensen, 2002; Jensen et al., 2004) and practitioners (Unionen, 2011) as a major flaw. The short-term focus facilitates and incentivizes manipulation of numbers. If the compensation is based on stock price a certain date, CEOs can act in order to overvalue the stock price that specific date although it results in a lower price in the future (Aboody & Kaznik, 2000). This behavior is further stimulated when the stock market focuses on short term profits (Bolton et al., 2006). Along these lines, if thresholds, are used in the pay-for-performance relationship, managers tend to act according to what is favorable in a short-term perspective. This reasoning is based on the following conception. By employing thresholds within the incentive system, the firm creates situations
in which a manager who perceives the chances to reach a threshold as small, or has already reached the ceiling, has an incentive to postpone actions which could generate value for the company, to the following year. This is problematic as value might be lost in postponing these actions. Thresholds also lead to budget-gaming, in which the managers strive to set the target-levels lower than their expected performance-level. Furthermore, thresholds incentivize managers to take larger risks than they would, if the relationship between goal fulfillment and payout was completely linear (Jensen et al., 2004; Murphy & Jensen, 2011). Another problem which is highlighted in relation to the pay-for performance-relationship is setting the target levels based on prior-year performance. Such a structure incentivizes managers to slack, as good performance this year is indirectly penalized by harder targets next year (Murphy & Jensen, 2011).

In order to mitigate the short-term focus among managers, companies include restricted stock as a part of their total compensation package. However, instead of reducing other parts of the compensation package by the value of the restricted stock or demanding that managers should invest private funds in corporate stock, the value of the restricted stock is added to the total compensation. Under such circumstances, the managers will not be more inclined to act in the interest of their shareholders, as the restricted stock is essentially given to the managers for free (Jensen et al., 2004).

### 2.4. How Monetary Incentives Affect the Human Motivation

According to Behavioral Scholars

As described above, companies often incorporate monetary incentives, in their organizational practices, under the conception that these incentives will increase the motivation of their employees and, thereby, the performance of the firm (Merchant & Van der Stede, 2012). However, such a straight-forward relationship between monetary incentives and the human motivation contradicts the views and results presented in behavioral science.

In behavioral science, distinctions are made between different forms of motivation and how these are affected by external elements, which has led to other conclusions than the positive view conveyed in the agency theory.

Behavioral scholars divide the human motivation into two different forms of motivation: *intrinsic* and *extrinsic* motivation. Intrinsic motivation comes from the individual's own interest in the task itself, whereas extrinsic motivation prevails whenever a task is performed in order to achieve a separate outcome, for instance, a monetary reward (Stone et al., 2009).
According to behavioral science, the extrinsic motivation of an individual increases when a task is reward-contingent, whereas the effect on the intrinsic motivation is situation-dependent. This perspective on the human motivation is highlighted by Deci and Ryan (2000, 1985) in Self Determination Theory (SDT). How the intrinsic motivation is affected by a monetary reward depends on how it is perceived by the individual. If the individual interprets the reward as a means of controlling the individual’s actions, the intrinsic motivation decreases. As a consequence, the motivation of the individual shifts from intrinsic to extrinsic. What this means is that the individual has lost the interest in the task itself and is now only motivated by the reward. Under such circumstances, the individual will perform worse than if he or she was intrinsically motivated to perform the task. However, if the reward is perceived as a token of appreciation and, as a result, makes the individual feel autonomous and competent, the intrinsic motivation of the individual will increase (Deci & Ryan, 1985; 2000; Stone et al., 2009).

### 2.4.1. Motivation Crowding Theory

This view, on how rewards alter the human motivation, has been integrated in economics during the last decades within the Motivation Crowding Theory (Frey & Jegen, 2001). The theory assumes that the human motivation moves along a continuum between intrinsic motivation and extrinsic motivation as rewards are offered to the individual. Rewards typically affect the motivation through two opposite effects, the *crowding-out effect* and the *price effect*. The crowding-out effect is prevalent when the intrinsic motivation of the individual decreases. This effect occurs when the individual perceives incentivized targets as controlling. The price effect, on the other hand, prevails when the reward generates extrinsic motivation and raises the performance of the individual. How the motivation and, thereby, the performance of the individual is affected depends on the relative strength of the crowding-out effect and the price-effect in the specific case. In line with SDT (Deci & Ryan 1985; 2000), Motivation Crowding Theory stipulates that rewards can also facilitate intrinsic motivation, if they are perceived as supportive and empowering. In such a case a *crowding-in effect* is prevalent, and with the price effect the motivation, as well as the performance of the individual increases, since there is no mitigating effect (Frey & Jegen, 2001).

In line with the reasoning above, Deci et al. (1999) reviewed 32 studies, which focused on the relationship between performance-contingent rewards and intrinsic motivation. Their results pointed towards two conclusions: firstly, performance-contingent rewards affect the intrinsic motivation of humans negatively. Secondly, the crowding-out effect is not present when the
reward in question is not anticipated by the individual. Furthermore, other scholars have studied how performance-contingent incentives affect the performance of individuals in terms of problem-solving skills and creativity. Glucksberg (1962) concluded that monetary incentives affect the problem-solving skills of individuals negatively and Amabile et al. (1994) found that artists performed less creative pieces of art when there was a commission involved. Ariely et al. (2009) reached similar conclusions when performing a study that was based on giving monetary rewards for performing tasks which required creativity, concentration and motor skills. The study indicated that higher incentives led to worse performance. All of these studies found that monetary rewards can have a damaging effect on an individual’s problem-solving skills and creativity. Monetary incentives tend to narrow the perception of the individual in such a way that the focus is on the reward rather than at solving the problem. Hence, monetary incentives can be beneficial for mechanical tasks with an already existing formula for how to perform the tasks, but could harm the individual’s performance for tasks that require inventiveness and conceptual understanding (Amabile et al., 1994).

2.5. Institutional Theory

This theoretical perspective aims to explain why organizations within the same markets adopt the same structures and practices. During the first part of the twentieth century organizational scholars perceived organizations as rational entities, in which structural development (i.e. bureaucratization) was driven by the increasing competitive pressures in the marketplace and society (Weber, 1978). Therefore, organizations focused on developing efficient structures, in order to compete with other actors in the market and maximize their prosperity. However, according to the institutional scholars DiMaggio and Powell (1983), the rationale for organizational development has shifted from efficiency and competitive advantages towards alignment with institutionalized rules in society, which have made organizations more homogenous (DiMaggio & Powell, 1983; Eriksson-Zetterquist et al., 2006). This homogenization of organizations is set into motion when a certain industry or organizational field is well established, that is to say, when different actors connected to an industry have established comprehensive relationships to each other. Under such circumstances, the organizations are subject to the pressures exerted by different actors within society such as the state, organizations and different professions (DiMaggio & Powell, 1983). These pressures influence the practices of organizations as they strive to obtain legitimacy from their environment, in order to retain their market position (Meyer & Rowan, 1977). Therefore,
these pressures shape the organizational field in which the organizations conduct their business. What this means is that when an organization changes its practices, it will continuously be influenced by its environment (i.e. the actors within the organizational field) and the pressures exerted by them (DiMaggio & Powell, 1983).

2.5.1. Institutional Forces

In order to understand this process of homogenization to a greater extent, DiMaggio and Powell (1983) apply the concept of Institutional isomorphism which incorporates three types of constraining forces, (1) Coercive isomorphism, (2) Mimetic isomorphism and (3) Normative isomorphism, which leads an organization to adopt the same structures and practices as another organization which faces the same environmental conditions (Hawley 1968).

*Coercive isomorphism* stems primarily from political influence in the form of formal and informal pressures exerted by organizations, which the organization is dependent on (DiMaggio & Powell, 1983; 1991). Another source of coercive isomorphism are the pressures to align to the cultural expectations that prevail within the society, in which the organization conducts its business (DiMaggio & Powell, 1983). However, in some cases, these pressures take the form of government mandates, for instance, tax regulations or emission standards, which means that the organization must adapt accordingly (DiMaggio & Powell, 1983; 1991).

*Mimetic isomorphism* shape the organization when an organization imitates the practices of successful firms due to uncertainty or in order to gain legitimacy in society. Under circumstances in which an organization faces a problem and is uncertain about its causes and how to mitigate this problem, the organization may implement the practices of other organizations which it deems as successful within the problem area (DiMaggio & Powell, 1983; 1991). Organizations which are perceived by other actors within their industry as more successful and legitimate tend to have their practices copied. The knowledge about an organization's practices could be diffused unintentionally through employee turnover or transfer, as well as through consulting firms (DiMaggio & Powell, 1983).

Organizations within an organizational field are also subject to *normative isomorphism*, which concerns how their practices should be formed and carried out. This force stems from the force of professionalization, which refers to professionals within different occupational fields, trying to shape organizational practices according to the conditions and methods preferred by them (DiMaggio & Powell, 1983; 1991; Eriksson-Zetterquist et al., 2006). However, these
professionals have to compromise with regulators, non-professional clients and executives further up in the hierarchy, which means that they do not possess the power to shape the practices of organizations completely (DiMaggio & Powell, 1983; 1991).

The normative force of professionalization is connected to two mechanisms. The first one is the legitimization of professionals in society, which rests on their formal education (DiMaggio & Powell, 1983; 1991; Eriksson-Zetterquist et al., 2006). This mechanism provides the professionals with the legitimacy needed in order to influence organizations. Therefore, universities play a central role in developing the organizational norms of professionals (DiMaggio & Powell, 1983). The second one is the development of professional networks which span across organizations and provide an engine for diffusion of ideas between professionals (DiMaggio & Powell, 1983; 1991; Eriksson-Zetterquist et al., 2006). These ideas are later implemented within the organizations. Along these lines, professionals which have the same occupation tend to act in the same way as their colleagues in other organizations (DiMaggio & Powell, 1983; 1991). Furthermore, the normative pressures exerted by professionals on organizations are reinforced as organizations tend to hire professionals with the same educational background. These practices naturally contribute to the homogenization of organizations as the same type of people switches positions with each other as they climb up the hierarchy within organizations (DiMaggio & Powell, 1983; 1991).
3. Method

3.1. Research Methodology

With the purpose in mind, we have chosen to perform a series of small qualitative case studies. Previous research within the field has concentrated on developing the understanding of how monetary incentives affect the performance of individuals and firms and therefore has chosen a quantitative approach (Ariely et al, 2009; Bruce et al, 2007, Hall & Liebman, 1998; Mehran, 1995). While studies of this kind have provided insights about how firms could design incentive systems, they have left the question of why the managerial incentive systems of firms are not aligned to the critique within the academic discourse, to a great extent, unexplored. In addressing such a question, a qualitative and an exploratory approach is adequate, as it enables us to explore and develop a deeper understanding of the phenomenon (Ghauri & Grønhaug, 2005). Furthermore, by conducting several case studies we have the possibility to capture different aspects of the phenomenon, which could generate rigorous results (Yin, 2003; Baxter & Jack, 2008). As we seek to understand why managerial incentive systems of firms are not aligned to the critique within the academic discourse, through the use of existing theory, this study applies an abductive approach (Alvesson & Sköldberg, 2009). An abductive approach is based on the mutual development of theory and empirical findings (see Figure 1). More specifically, theory is used to contribute to a deeper understanding of the empirical material, whereas the latter serves as a foundation for developing theory (Scapens & Roberts, 1993). Such a combination of deductive and inductive elements has been deemed fruitful (Saunders et al, 2012) as it enables the researcher to discover new important variables in the empirical material through a theoretical framework (Alvesson & Sköldberg, 2009). This corresponds well to the purpose of the study. However, the chosen theoretical framework does not provide the researcher with explanations for a certain phenomenon, it rather serves as an analytic model for interpreting the explanations obtained from the case studies (Scapens & Roberts, 1993).

In line with the reasoning of Eriksson and Kovalainen (2008), these qualitative case studies apply a research method which provides space for complexity and diversity in order to generate a deeper understanding of the rationale within managerial incentive systems. With this in mind, the study applies a perspective in which both emic and etic modes are utilized (Kakkurri-Knuuttila et al., 2008; Dent, 1991). What this means is that the different modes prevail during different stages of the study: during the case studies we are open to our
informants’ accounts and their perceptions of their managerial incentive systems, without imposing a strict definition of it (e.g. following the emic account of the case studies). However, after conducting the case studies we take a more objective stance towards the material by regressing to an etic mode. This enables us to reflect on the empirical findings of the studies in relation to the academic discourse and the chosen theoretical perspectives. We claim that by employing such an approach which enables us to compare the organizations’ perspectives on the inherent logic of their managerial incentive systems to the perspectives provided by scholars within the academia, this study has the potential to contribute to a deeper understanding of why managerial incentive systems are not aligned to the critique from the academia.

![Methodological Approach](image)

**Figure 1: Methodological Approach**

### 3.2. Data Collection

In order to develop a deeper understanding of why managerial incentive systems are not aligned to the critique from the academia and, thereby, fulfill the purpose of the study, semi-structured interviews have been conducted at eight firms. Such an approach allows us to explore and find patterns in the reasoning among firms (Saunders et al, 2012) and thereby, determine reasons for why managerial incentive systems are not aligned to the critique. In order to understand this phenomenon, it is important to understand the inherent logic of the managerial incentive systems within organizations. With this in mind, the questions for the interviews have been constructed through an interrelated process (operationalization) in which the information in the annual reports of the participating organizations has been put in relation to the academic discourse on managerial incentive systems. Thus, the data collection has been
made from two different sources, with the semi-structured interviews being the primary and the public documents being the secondary.

3.2.1. Selection of Firms
With the purpose to generate rigorous results, we have included firms which represent different industries, since it enables us to find coherence, as well as diversity among industries and firms. In doing so, we have neutralized the potential problem of neglecting different reasons for the use and development of the managerial incentive systems which could be industry-specific. Consequently, the risk of not accounting for important aspects is to some extent mitigated by the inclusion of firms representing different industries. As described in the introduction, this study focuses on the managerial incentive systems for the top management within large cap firms, since this has been regarded as an important subject through the academic discourse and in society (Jensen & Murphy, 1990; Hall & Liebman, 1998; Frey & Osterloh, 2005; Logothetis, 2015). Along these lines, this study encompasses eight companies from different industries to ensure that different perspectives on the matter have been taken into consideration. However, two banks have been included, as financial institutions’ managerial incentive systems have received extensive attention from media (Logothetis, 2015; Bengtsson & Hedberg, 2012). Therefore, it is of particular interest to account for these companies’ perspective on managerial incentive systems. Furthermore, one of the case study companies was acquired less than a year ago and is, thus, no longer listed. Nevertheless, the firm has over decades been considered a large cap firm and, according to the interviewee, the firm’s implemented incentive system was still based on the notion of a listed company.

The number of companies included is considered appropriate in relation to the scope of the thesis. Since this study aims to account for different perspectives in order to gain a deeper understanding of the rationale within managerial incentive systems, it serves the purpose well to include many unique respondents. However, one must find balance between generating the empirical material and analyzing the results of the study. With this in mind, the number of companies has been kept to eight.

The majority of the companies were first contacted by mail in which a project plan was enclosed. The project plan explained the purpose of the study, how the study was to go about and also included a preliminary time plan. Anonymity was suggested from the beginning, as incentive systems can be considered a sensitive topic. In fact, this turned out to be a requirement for the participation of several firms.
3.2.2. Selection of Interviewees

The respondents were selected on the basis of their knowledge and insights about the managerial incentive system within their respective organization. In some cases the respondents were contacted directly by us and in other ones they were contacted by someone within the organization. The respondents within this study hold positions as compensation specialists, head of compensation or head of the human resources department within the companies. At the start of this study, we also strived to include respondents who were active in the compensation or remuneration committee in the companies, as these individuals are responsible for the structure of the managerial incentive system. Therefore, the inclusion of such individuals could have generated an even richer empirical material, as different views on the matter had been accounted for. However, as the project proceeded, it was clear that these people, who are generally the chairman of the board or other highly ranked board members, were not able to participate. This view was further strengthened when talking to the respondents of each firm who, in many cases, report directly to the compensation committees. They did not have access to the compensation committee’s material and meetings and stated that the compensation committee is a closed group to which it is difficult to gain access.

Nevertheless, all of the respondents in this study are persons within the case study companies who work with incentive systems on a daily basis and can, therefore, explain and argue for them in a better way than anyone else. However, we are also aware of the shortcoming regarding the lack of perspectives in the empirical material and that the study could have gained rigor and trustworthy by including compensation committee members.

3.2.3. Conducted Interviews

Eight semi-structured interviews were performed between 2015-02-11 and 2015-04-02. A more detailed overview of the participating companies can be seen in Table 1. All interviews lasted for around 60 minutes and were recorded and transcribed in order to improve the reiteration of the material and enable the use of quotations (Walsham, 2006). All the interviews were later followed up between 2015-04-09 and 2015-04-24 with more questions, for the purpose of generating rigorous results. These interviews were done with the same procedure as the first interviews.

Prior to each interview the respondents were asked for permission to record the conversation. Furthermore, after having interviewed, we asked the interviewees if we could quote them in the published material (under anonymity naturally), in accordance with Trost’s (2010) recommendations. All respondents accepted both petitions. Seven out of eight interviews were
conducted on-site at the respective company and one was conducted on telephone, due to the geographical distance involved. Telephone interviews are often seen as inferior to face-to-face interviews due to the lack of visual cues (Novick, 2008). However, despite this disadvantage, we believe that the conducted telephone interview was one of the most rewarding, since the respondent had great experience and knowledge regarding incentive systems in general and the company’s managerial incentive system in particular. The follow-up interviews were either conducted on site, by telephone or by mail, depending on the complexity of the questions. The follow-up interviews lasted between 10 to 30 minutes.

As a point of reference for these interviews, a guide consisting of questions regarding different aspects of the companies’ managerial incentive systems was developed. The guide was sent out beforehand so that the interviewees were able to prepare themselves and give more elaborate answers. The purpose of the guide was to direct the discussion towards the areas of interest, while providing the necessary flexibility to explore the different aspects in-depth (Turner, 2010). In doing so, interesting accounts could be followed up on an ad hoc basis, which facilitated the extraction of valuable information (Turner, 2010; Trost, 2010). The questions within the guide, as mentioned above (see section 3.2), were developed from the information in the companies’ annual reports about their incentive systems and were thus, to some extent, unique for each interview. An interview guide consisting of common questions asked during these interviews is presented in Appendix A. The annual reports gave the foundation to answer the research question and understand how the managerial incentive systems were constructed overall, whereas the interviews further contributed to a deeper understanding of the rationale for these systems, since the firms could argue for why the systems were designed the way they were.

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>INTERVIEW DATE</th>
<th>FOLLOW-UP DATE</th>
<th>INTERVIEW LENGTH</th>
<th>INTERVIEW TYPE</th>
<th>FOLLOW-UP TYPE</th>
<th>RESPONDENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>TELECOMMUNICATION</td>
<td>2015-02-11</td>
<td>2015-04-13</td>
<td>55+25 min</td>
<td>Telephone</td>
<td>Telephone</td>
<td>Head of Base &amp; Variable Pay</td>
</tr>
<tr>
<td>PHARMACEUTICAL</td>
<td>2015-02-13</td>
<td>2015-04-24</td>
<td>55+30 min</td>
<td>Face to face</td>
<td>Telephone</td>
<td>HR Manager</td>
</tr>
<tr>
<td>AUTOMOTIVE</td>
<td>2015-02-27</td>
<td>2015-04-09</td>
<td>50 min</td>
<td>Face to face</td>
<td>Mail</td>
<td>Compensation Specialist</td>
</tr>
<tr>
<td>BANK A</td>
<td>2015-03-16</td>
<td>2015-04-09</td>
<td>50+10 min</td>
<td>Face to face</td>
<td>Telephone</td>
<td>Compensation Specialist</td>
</tr>
<tr>
<td>FAST-MOVING CONSUMER GOODS</td>
<td>2015-03-17</td>
<td>2015-04-15</td>
<td>60+30 min</td>
<td>Face to face</td>
<td>Face to face</td>
<td>Vice President of Comp. &amp; Ben.</td>
</tr>
<tr>
<td>MINING</td>
<td>2015-03-23</td>
<td>2015-04-23</td>
<td>60 min</td>
<td>Face to face</td>
<td>Mail</td>
<td>HR Director</td>
</tr>
<tr>
<td>BANK B</td>
<td>2015-03-24</td>
<td>2015-04-15</td>
<td>75+10=15 min</td>
<td>Face to face</td>
<td>Telephone</td>
<td>Comp. &amp; Ben. Manager + HR Manager</td>
</tr>
<tr>
<td>CREDIT MANAGEMENT</td>
<td>2015-04-02</td>
<td>2015-04-10</td>
<td>60 min</td>
<td>Face to face</td>
<td>Mail</td>
<td>HR Director</td>
</tr>
</tbody>
</table>

Table 1: Overview of Conducted Interviews
3.3. Trustworthiness

Reliability and validity are commonly used as criteria for a study’s trustworthiness in business research. However, these are often seen as appropriate only in positivistic, quantitative research (Saunders et al., 2012; Bryman & Bell, 2005). In qualitative research these measures can be considered as peculiar and misleading. This is mainly due to the difficulty of replicating the results another time by another researcher (reliability) and assuring that the chosen measuring instrument measures what it intends to measure (validity) (Stenbacka, 2001; Trost, 2010; Golafshani, 2003). Stenbacka (2001) argues that reliability has no relevance in qualitative research and that the consequence of using it as a criterion can often be that the study is considered to lack trustworthiness. The reasoning behind this, as Stenbacka (2001) argues, is that repetitive correctness only has value in research settings dominated by the deductive demand for unconditional intersubjectivity. Sykes (1991) further suggests that in qualitative research one should rather create definitions that capture the unique relationship between researcher, data collection and interpretation. The principal quality criterion should regard thorough descriptions of the working process (Sykes, 1991; Stenbacka, 2001). Therefore, this study seeks to use Guba’s (1981) alternative criteria, developed specifically for qualitative studies and acknowledged for their appropriateness (Bryman & Bell, 2005; Saunders et al, 2012; Shenton, 2004). These are transferability, dependability, credibility and confirmability (Guba, 1981).

A common denominator for these four criteria is that they all require the researcher to thoroughly and in detail explain each step of the research process. This is particularly true for transferability, which refers to how well the findings can be transferred into other contexts, and dependability, which concerns the degree of consistency that can be ascribed to the findings from the research process (Guba, 1981). This method section, where we transparently have explained each step of the research project and how we have reasoned regarding methodological choices and what obstacles one faces with these choices, has served to promote the transferability and dependability. These criteria are further strengthened by the recording of the interviews, but are, however, compromised by the fact that anonymity prevails, which impedes thorough description of the respondents and companies participating.

Precautionary actions have also been taken in order to achieve credibility. Firstly, all respondents have received the findings and performed what Guba (1981) refers to as member checking, in order to ensure that the empirical material published in this study reflects the practices of the companies and the accounts of the respondents. Secondly, several different
sources (interviews and annual reports) have been used in order to generate rigorous findings, thereby achieving triangulation (Shenton, 2004; Eisenhardt, 1989). However, in order to preserve the integrity of the participating companies, specific information from the annual reports is accounted for on an aggregated level in the empirical findings, except when permission has been given from the companies to do otherwise.

Furthermore, this study has to ensure confirmability, which refers to the investigators’ concern for objectivity. Thus, the empirical findings must reflect the experiences and opinions of the respondents (Shenton, 2004). Again, in this study member checking has been the most decisive measure in obtaining confirmability. Such a measure, if performed adequately by respondents, should imply a satisfactory level of confirmability.
4. Empirical Findings

What follows is a depiction of the empirical findings from the eight companies. The section commences with a description of the participating companies’ managerial incentive systems which is based on the companies’ annual reports and the respondents’ reasoning about the structure of them (section 5.1). Subsequently, the companies' main reasons for having short-term incentives are put forward.

4.1. Structure of the Managerial Incentive Systems

4.1.1. Short-term Incentive Programs

All firms included in this study incorporated a short-term incentive program (one-year measuring period) into their incentive systems for top management. In general, the short-term programs were based on certain targets, which, if achieved, resulted in a monetary compensation. However, the design and reasoning varied somewhat among companies and industries. Table 2 gives an overview of the principal features regarding the companies’ STI-programs.

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>KPIs</th>
<th>INDIVIDUAL PARAMETERS</th>
<th>THRESHOLD OR LINEAR</th>
<th>DEFERRAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>TELECOMMUNICATION</td>
<td>Several</td>
<td>Yes</td>
<td>Thresholds</td>
<td>No</td>
</tr>
<tr>
<td>PHARMACEUTICAL</td>
<td>Several</td>
<td>Yes</td>
<td>Thresholds</td>
<td>No</td>
</tr>
<tr>
<td>AUTOMOTIVE</td>
<td>1</td>
<td>No</td>
<td>Mixed</td>
<td>No</td>
</tr>
<tr>
<td>BANK A</td>
<td>Several</td>
<td>Yes</td>
<td>Thresholds</td>
<td>Yes</td>
</tr>
<tr>
<td>FAST-MOVING CONSUMER GOODS</td>
<td>Several</td>
<td>Yes</td>
<td>Thresholds</td>
<td>No</td>
</tr>
<tr>
<td>MINING</td>
<td>Several</td>
<td>Yes</td>
<td>Thresholds</td>
<td>No</td>
</tr>
<tr>
<td>BANK B</td>
<td>Several</td>
<td>No</td>
<td>Mixed</td>
<td>Yes</td>
</tr>
<tr>
<td>CREDIT MANAGEMENT</td>
<td>1</td>
<td>No</td>
<td>Mixed</td>
<td>No</td>
</tr>
</tbody>
</table>

Table 2: Overview of Short-term Incentive Programs

4.1.2. Long-term Incentive Programs

Four out of eight companies used a long-term incentive program (Table 2). The two banks, the Automotive Company and the Mining Company did not have a pronounced long-term program. Even so, their short-term programs included a long-term element in the form of restricted shares and/or a deferral function, which is explained below. None of the case study companies’ long-term incentive programs included stock options. Prior to the financial crisis, some of the companies used stock options. However, as a result of the public debate regarding
companies’ incentive systems, which followed upon the financial crisis, these companies abandoned their old practices. Other companies had excluded stock options on the basis that a program based on stock options was difficult to administrate.

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>CASH BASED</th>
<th>INVESTMENT IN STOCK</th>
<th>THRESHOLD OR LINEAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>TELECOMMUNICATION</td>
<td>No</td>
<td>Yes</td>
<td>Thresholds</td>
</tr>
<tr>
<td>PHARMACEUTICAL</td>
<td>No</td>
<td>Yes</td>
<td>Thresholds</td>
</tr>
<tr>
<td>AUTOMOTIVE</td>
<td>-</td>
<td>Yes</td>
<td>-</td>
</tr>
<tr>
<td>BANK A</td>
<td>-</td>
<td>Yes</td>
<td>-</td>
</tr>
<tr>
<td>FAST-MOVING CONSUMER GOODS</td>
<td>Yes</td>
<td>Yes</td>
<td>Thresholds</td>
</tr>
<tr>
<td>MINING</td>
<td>-</td>
<td>Yes</td>
<td>-</td>
</tr>
<tr>
<td>BANK B</td>
<td>-</td>
<td>Yes</td>
<td>-</td>
</tr>
<tr>
<td>CREDIT MANAGEMENT</td>
<td>Yes</td>
<td>Yes</td>
<td>Mixed</td>
</tr>
</tbody>
</table>

Table 3: Overview of Long-term Incentive Programs

4.1.3. Measuring Period

The two banks, the Mining Company and the Automotive Company relied on a setup with short-term targets (one-year measuring period) without long-term objectives. The reasoning for this kind of setup within the four companies was two-folded. Firstly, such a setup corresponded well to the other intra-organizational practices of the companies. The respondents at Bank A and Bank B explained that having a longer measuring period than one year would lead to extensive administrative processes, especially the accounting of the incentive programs would get more complex. Secondly, by incorporating long-term targets there is a risk that the incentivized targets and the every-day work of the individual manager get disconnected from each other. More specifically, the individual might perceive the long-term target as unclear in relation to the daily work and, as a result, not perform as well as if the target had been set on a short-term basis.

In contrast, the managerial incentive systems of the other companies incorporated both short-term and long-term incentives. The long-term incentives were typically based on the condition that certain KPI-averages were reached over a time-period of three to five years. Furthermore, the incentive systems within the Pharmaceutical Company and Bank B were structured in such a way that the total amount paid to the top managers and employees on lower levels, depended on the overall performance of the company. This amount was divided among the managers and other employees according to their individual performance.
4.1.4. **Investment in Company Stock**

All of the case study companies’ managerial incentive systems incorporated a condition which stipulated that the managers should invest a certain percentage of their incentive payout (short-term and/or long-term) in restricted shares. However, the companies used different systems for achieving this. The two banks, the Pharmaceutical Company and the Telecommunication Company converted the payout into shares directly, whereas the Fast-moving Consumer Goods Company, the Credit Management Company and the Automotive Company demanded that the managers themselves invested in shares after tax deduction.

Furthermore, within the Mining Company and the Telecommunication Company, the managers had to invest personal funds, which equaled a certain percentage of their base salary, in the company’s shares, as a prerequisite for participating in the incentive programs. The Automotive Company did not practice such a setup as it could harm the possibilities to retain key employees. Furthermore, the two banks, the Pharmaceutical Company and the Fast-moving Consumer Goods Company had no such condition, as these companies’ managerial incentive systems were, to a great extent, already built on restricted shares. Through this, the purpose of getting the managers to work in the interest of the owners had been fulfilled, according to the respondents. Furthermore, within the studied companies, any increase of restricted shares meant that another element would have to be decreased by the same amount, as the companies incorporated a total compensation perspective in remunerating their managers.

4.1.5. **Deferral**

The two banks’ incentive programs were structured around short-term objectives (one year) combined with a restricted right of disposal of 3-5 years. More specifically, the incentive payout for the current year was converted into corporate stock or the synthetic equivalent for 3-5 years. This setup also incorporated a deferral function which entailed the possibility to withdraw and adjust the incentive payout during the time-period. It is a prerequisite for financial institutions to have a setup which incorporates a restricted period of disposal and a deferral function in order for their setups to correspond to the regulation of financial actors. The purpose of such a setup is to work preemptively against excessive risk-taking or manipulation of figures, which could pose a threat to the financial stability of the banks.
4.1.6. Thresholds and Target-setting

All of the studied companies incentive systems contained thresholds. The HR Director within the Mining Company pointed out that a setup without thresholds does not eliminate budget-gaming as the manager would still benefit from inducing the board to set lower target-levels than what is reasonable. Thus, the risk of manipulation would still be present and excessive risk-taking would be promoted within a system without a payout ceiling. Moreover, an incentive system which provides money to managers without due performance would not be perceived as fair by the company or its shareholders.

Although, the majority of the case study companies did not oppose the rationale of implementing a completely linear setup, the respondents highlighted other reasons for using thresholds. The Head of Base and Variable Pay at the Telecommunication Company explained that thresholds serve as an important tool in separating the performance of the individual from external factors. More specifically, by setting a lower threshold which corresponds to the market expectations and a ceiling, the company avoids paying for performance, which does not meet these expectations or paying for high performance that is not attributable to the actions of the managers. Such a setup is in line with what shareholders and other stakeholders perceive as fair and appropriate, according to the respondent.

The Fast-moving Consumer Goods Company utilized thresholds within its managerial incentive system, as a way of ensuring that the total payout would not exceed the budget over time and to meet the recommendations imposed by regulators. Along these lines, large financial institutions, such as the two banks, must have a ceiling. Furthermore, the respondents within Bank B argued that the phenomenon of managers getting paid without having delivered even close to market expectations would be perceived as strange by shareholders, whereas the respondent at Bank A meant that a linear setup would give the managers money for free. The incentive system within the Pharmaceutical Company incorporated a ceiling in order to eliminate financial risk.

The long-term incentive program at the Credit Management Company was structured around thresholds as a way of dealing with the financial expectations of its customers and shareholders. Within the credit management sector, where the competition is fierce, the companies are expected to continuously deliver better performance at a lower price. With this in mind, the company utilized thresholds to deliver accordingly.
The use of prior-year performance benchmarks in the target-setting process was relatively limited among the case study companies. However, the Credit Management Company incorporated such a condition in order to meet the market expectations for continuous improvement. The Fast-moving Consumer Goods Company used such a structure to meet the current expectations and conditions in the market and to increase its market share. Furthermore, a part of the incentive system within the Automotive Company was based on such a setup in order to realize the organization’s long-term strategy. The other case study companies set the target-levels on a year-to-year basis in line with the market expectations and conditions.

4.2. **Recruit and Retain**

The short-term incentives played an important role in the companies’ total compensation package and the reasoning behind offering them was relatively homogenous. One of the most important reasons was to have a competitive compensation package that attracts and retains competent employees, which was confirmed by the annual reports of the companies, except in two cases. Furthermore, all respondents mentioned this aspect as one of the main reasons for having short-term incentives, with the exception of the HR Director at the Credit Management Company. The respondents within the Automotive Company and Bank B stated that the fundamental reason for having their incentive programs was to be a competitive company that could recruit and retain competent people. The respondents at the Mining Company, the Telecommunication Company and the Fast-moving Consumer Goods Company mentioned that it would become more difficult to recruit talented people, if the short-term incentives could not be included in the compensation package. When digging deeper into why short-term incentives were considered necessary in order to recruit and retain competent employees, the main reasons were that competitors use incentives and that managers benchmark between companies.

4.2.1. **Benchmarking**

All the studied firms used benchmarking as a tool when designing their incentive systems. Not only did they benchmark in order to find the best practice, but also in order to align their incentive systems to their competitors. The compensation specialist at Bank A argued that no company wants to stand out from the rest too much regarding the incentive system’s design and the HR Manager at the Pharmaceutical Company said that everybody follows each other and no one wants to be different from everybody else. Furthermore, the Vice President of Compensation and Benefits at the Fast-moving Consumer Goods Company stated that the
major reason for having short-term incentives is to ensure that they offer compensation packages which are similar to their competitors. He indicated a desire to change the short-term elements in the incentive system but admitted that the company would experience difficulties if it had a completely different system than the competitors:

“We would have a hard time recruiting and retaining people, so it is a ‘follow-the-leader’ mentality, unfortunately”

According to the respondent this homogenization and view on incentives started in the U.S in the 70s when companies became obliged to account for CEO compensation publicly. This led to an overall increase in compensations, since managers could compare their total compensation among each other. The prestige of not earning less than a colleague within another firm was of utmost importance among managers. Therefore, variable compensation was a way for companies to please these key employees, while not taking too much risk. This approach further expanded to the rest of the western world and led to short-term incentives being standard among firms.

This view was somewhat confirmed by other respondents who argued that managers benchmark different firms’ incentive systems. The respondents at the Pharmaceutical Company and the Telecommunication Company argued that managers tend to compare the total earnings opportunity among different firms when being offered a compensation package. The reason for this is that the possibilities to earn a higher total annual compensation increase with a variable compensation element included in the compensation package. As a result, firms feel obliged to offer incentives in order to attract the most talented people and to retain them. Thus, variable compensation is almost taken for granted by most managers in big firms. This view is demonstrated in the following quote from the Head of Base and Variable Pay at the Telecommunication Company:

“Those things [incentives] are taken as a given. You don’t differentiate yourself as a company or as an employer in a positive way when you say ‘I offer incentives’ but you differentiate yourself in a negative way if you say ‘I don’t offer it’.”

The respondent from the Automotive Company also stated that there are expectations from managers when being recruited that variable compensation should exist, while the HR Director of the Mining Company argued that the short-term incentives are a necessity for staying competitive:
“I believe there would be reactions [among new employees] if we only offered fixed salary and long-term [incentives]. They would say: ‘Are you a state-owned company or what’s the deal?’ The rumor would naturally spread fast on the market and it would not be to our advantage. I’m completely sure of that. [...] If fixed salary and barely no other benefits were to become common practice, then it would be completely different for us. But this is a competitive world and you must align with the rest.”

4.3. Stakeholder Pressure

Apart from the influence of competitors and managers on the design of the managerial incentive systems, the companies experienced pressure from other stakeholders.

The two banks experienced pressure both from the European Union and Finansinspektionen regarding the design of their incentive systems. This pressure had intensified over the last years, following the financial crisis, which had led to new directions almost every year. The compensation specialist at Bank A explained that since the design of the company's incentive system is almost completely driven by regulations, the company has almost no flexibility to work with different designs. Financial institutions in general are subject to extensive regulation and their incentive systems are therefore restricted to a greater extent than other companies, he argued. The respondents at Bank B also meant that the incentive systems of financial institutions are, to a great extent, affected by regulations.

The Vice President of Compensation and Benefits at the Fast-moving Consumer Goods Company also described how the requirements from the European Union affect their incentive system. The “Say on pay” movement, which is underway in the European Union, makes it harder for companies to differentiate themselves when it comes to incentive systems. The reason for this was that a system that is very different in relation to other companies, requires a much more detailed explanation, which can be difficult to offer for the company.

Furthermore, the respondent depicted how interest groups, such as ISS (Institutional Shareholder Services) in the U.S., tend to give advice to large institutional owners, like insurance companies, regarding companies’ incentive systems and make these owners oppose against systems which are different from the norm. The respondent highlighted the problem of being different and how shareholders often react upon this, due to outside pressure:

“What I want to emphasize is the difficulty to break patterns without having problems among shareholders, to achieve transparency and get them to understand why we have constructed them [the incentives] the way we have”
Similarly, the Pharmaceutical Company stated that the short-term goals are considered important due to the nature of the company. As a stock listed company, short-term financial numbers are important in order to attract investors. If the company does not perform well financially, investors leave. Thus, according to the respondent, these short-term targets must unfortunately be viewed upon with importance.

The pressures, exerted from the companies’ stakeholders, had also generated an increased long-term focus within these systems. In the aftermath of the financial crisis, the structures of the managerial incentive systems were questioned by the public in general and by the shareholders in particular. As a result of the public discussions, the stakeholders came to demand that the companies restructured their managerial incentive systems in such a way that the long-term perspective was emphasized to a greater extent. What this created was a movement within some of the case study companies towards managerial incentive systems, in which the horizon was set on the long-term, to greater extent, than the short-term.

However, this movement within the companies originated from different sources and took different forms. The two banks had to conform to the changes in regulation of incentive systems within the financial sector, since following the regulation imposed by Finansinspektionen is a prerequisite for conducting their business. Consequently, the two banks restructured their managerial incentive systems according to these regulations by, for instance, incorporating the deferral element in the systems. In other cases, companies had felt a need to adjust their setups according to the public discussions, as was the situation within the Telecommunication Company. In order to respond to the environment, the company altered its managerial incentive system in such a way that more emphasis was put on the long-term perspective. This change was achieved through a greater focus on long-term incentives within the system and by changing the KPIs which were connected to the long-term incentives.

Similarly, the Credit Management Company had gradually incorporated more long-term elements in its system to comply with the expectations and guidelines put forward by its shareholders. Prior to 2008 the company’s long-term program was based on stock options, but during 2008 the program was restructured to a cash-based program, focusing on the average development of a specified KPI over three years. Although the development of the long-term program could not be entirely attributed to the public pressures in the aftermath of the financial crisis, they had certainly played a part in the development towards setups which emphasizes the long-term perspective, according to the HR Director at the company.
Furthermore, the company had taken additional measures to ensure that the expectations of the shareholders were met. An example of these measures came in the form of a petition which entailed that top managers should invest a percentage of their compensation in company stock. Overall, the respondents within the companies highlighted the importance of ensuring that the remuneration of the company’s top management, in general, reflects the interests of the shareholders and is in line with public demands.

4.4. Adjustment of Compensation Costs

Another reason for why the case study firms incorporated short-term incentives in their total compensation packages, was that such an element provides them with the possibility to adjust the compensation costs of the firm to the performance of their employees. With this setup the companies have the possibility to pay competitive amounts of money to their employees when the company performs well and smaller ones when the performance is subpar, which ensures the financial state of the company or as expressed by the Head of Base and Variable Pay at the Telecommunication Company:

“We want to align the company cost to how the company is doing. So, if the company is doing not so good, not meeting its targets, it will, of course, also mean that our incentive participants will not meet their targets and, therefore, the incentive payout will be low, or even zero, and that basically secures that we have an automatic adjustment of our cost according to the weak financial result.… In the same way, the other way around, if we have a very good performance, a very good year, then we avoid discussions on increases because then, of course, the incentives will pay out at a high level, and that is at a time when we can afford high costs”

The important attributes of short-term incentives were highlighted further by the HR Manager at the Pharmaceutical Company as he argued that the setup of the compensation package, whether it is built on short-term incentives or fixed salary, does not really matter as long as the company performs well. However, under circumstances when the company does not meet its targets it is important to have the flexibility which the short-term incentives provide:

“It is like trading apples for apples, as long as the company is doing well and that is why we have variable pay, because when the company hits a slump you must have the possibility to save money and the system takes care of that”

Furthermore, the short-term incentives do not only provide the financial security which the companies seek, they also provide companies with a setup that makes it easier for them to stay
competitive in terms of compensation. This perspective was highlighted by the respondents at the Telecommunication Company and the Fast-moving Consumer Goods Company who explained that their ability to maintain a competitive compensation package is, to some extent, contingent on a structure that includes short-term incentives. The reasoning behind this was that a structure disconnected from the performance of the company would render high costs no matter how the company performed. The Vice President of Compensation and Benefits at the Fast-moving Consumer Goods Company illuminated this point with the following example:

“The public thinks that it’s terrible that they [members of the top management] get annual bonuses. Well, the alternative is that they only get fixed salary. The salary would perhaps only increase by 50 percent of the annual bonus, but, in such a case, we would never have the possibility to decrease the salary accordingly”

The importance of aligning the total compensation to the performance of the company was also emphasized by the Compensation Specialist at the Automotive Company. She argued that, since their system is aligned to the overall performance of the company, the company has the possibility to realize the incentives and, thereby, retain the employees that possess competencies which are of great importance for the long-term prosperity of the firm.

Although the case study companies highlighted the short-term incentives as a means for adjusting their compensation costs to the performance of the company, this could not be confirmed when scrutinizing the companies’ annual reports, with the exception of one company.

4.5. Direction, Motivation and Performance

A majority of the respondents saw the short-term incentives as an essential tool for directing the individual’s attention to targets that the company (the shareholders) finds important. Thus, the incentives, to some extent, make managers focus on the right things. The HR Director at the Mining Company saw it as the most important reason for using annual incentives, while the respondents within the Telecommunication Company and the Fast-moving Consumer Goods Company perceived this aspect as one of the main reasons for having short-term incentives. Furthermore, the HR Manager at the Pharmaceutical Company also highlighted this when being asked if there is a risk that too much of the individual’s focus is put on the targets in the incentive system:
“Well, quite frankly, our hope is that these incentives make people more focused on the targets. I think we rather have the opposite problem, people working away from the targets. [...] That is what we aim to control.”

However, this reason for using short-term incentives was not evident within the annual reports of the companies, except in one case.

Within the case study companies, different perspectives, on how short-term incentives affect the performance of managers at the top management level, were accounted for. Although the majority of the respondents, argued that the short-term incentives had been incorporated into their compensation practices with the purpose of inspiring and motivating the top management to perform well, this was only evident within some of these companies' annual reports. Furthermore, the relationship between short-term incentives and motivation was perceived by the majority of the respondents as intricate and context-contingent. The difficulties in proposing a straight-forward relationship between short-term incentives and performance were apparent, when the respondents were questioned about how a system without short-term incentives would affect the performance of the top management. The majority of the companies could not determine, through their organizational practices, whether monetary incentives actually had led to better performance. However, some respondents were quite certain about the relationship. The Compensation Specialist at Bank A argued that the managers would probably not perform as well without the monetary incentives, as people within the bank, and companies in the financial sector in general, focus heavily on the targets which are connected to the monetary incentives:

“What you see within companies, I myself have worked as a consultant, is that a lot of attention is paid to numbers, that you make the numbers which are set within the incentive programs [...] it’s very important [reaching the targets] and they [the managers] care very much about reaching these targets”

Furthermore, due to the financial focus within the company, the monetary incentives were perceived as something which could only have positive effects for the motivation of the managers at the top management level. The compensation specialist further explained this view by arguing that if people at these positions performed worse due to monetary incentives, they would not retain such a position as these typically involve extensive incentive programs.

The view that a compensation package without the short-term incentives would probably affect the performance of the top management negatively was shared by the HR Director at
the Credit Management Company, who highlighted the motivation and performance aspect as the most important one for using short-term incentives. His opinion was based on a benchmark the company had performed, which indicated that companies without short-term incentives performed worse than those companies which utilized short-term incentives. Nevertheless, the respondent acknowledged the potential risk of demotivating the managers under circumstances when monetary incentives is the only thing that is considered in motivating employees. This was the case within the Credit Management Company as the nature of the company’s business promoted a financial focus and discussions about money on an every-day basis. Consequently, it was difficult to shift the focus of the business and its organizational practices, according to the respondent.

The Compensation Specialist at the Automotive Company explained that it is difficult to know whether a system without monetary incentives would affect the top management’s performance or not. By the same token, the HR Director at the Mining Company argued that it is impossible to account for the effects in such a hypothetical scenario. The point of having a short-term element within the total compensation package is that the different elements, combined, generate a deeper commitment among the managers towards the company, which in the end of day might motivate the managers to perform, he argued. Furthermore, the two respondents supported the practice of using monetary incentives as they argued that the effect of monetary incentives depends on the how the incentive program is designed. Along these lines, the Compensation Specialist at the Automotive Company highlighted the importance of finding an adequate balance between monetary incentives and non-monetary incentives as a way of mitigating the possible negative effects which the monetary incentives could generate in isolation. This design aspect was further emphasized by the HR Director at the Mining Company who argued that the key to offset the possible negative effects of monetary incentives lies in setting targets which are not too narrow:

“If I as a manager feel that I have to put all my effort into three relatively narrow areas, which will not create any value for the company as a whole, then I will feel restrained and lose my sense of motivation. However, once again, it all depends on what parameters you set.”

The importance of the target-setting process was also highlighted by the respondents within Bank B, which also utilized incentives as a means for motivating the managers to perform well. According to them, the risk with incentivized targets is connected to the practice of setting targets which implies that the manager has to engage in extensive risk-taking.
Furthermore, in order to mitigate this risk of extensive risk-taking, the targets which are set have to be graspable and measurable for the manager.

The view that the removal of short-term incentives would affect the performance of the top management indefinitely was not shared by everyone.

In contrast, the respondent at the Pharmaceutical Company had the perception that the effect of such an action is contingent on what time-perspective that is applied. He further explained that the removal of the short-term incentives might impact the performance of the managers in the short-term perspective, as the managers had become accustomed to these incentives. With this in mind, the respondent proposed that the managers could feel demotivated during a shorter period of time. However, in the long-term perspective a system without short-term incentives would not affect the performance of the managers. Furthermore, as the incentive system of the company was based on the collective performance of the company, the risk of managers just focusing on the incentive and not on the task itself was non-existent, according to the respondent.

In line with the reasoning above, on the effects of removing the short-term incentives, other respondents argued that short-term incentives do not serve as a motivator for top managers. Incentives could on the contrary, demotivate these managers if the incentives are structured in an inadequate way as explained by the Head of Base and Variable Pay at the Telecommunication Company:

“No, I don’t see incentives as a motivator. Money in general is not a good motivator, maybe short-term, but not really long-term. And if you speak to executives at the company, I guess that hardly anyone would tell you ‘I work harder because I have an incentive’ It’s just the other way around, you can demotivate, of course, with incentives, if there’s none, or if the perception is that they are unfair, target levels are unfair or a couple of things that are perceived as not competitive”

Along these lines, the Vice President of Compensation and Benefits at the Fast-moving Consumer Goods Company made it clear that the company did not perceive short-term incentives as a means of getting the managers to perform better:
“I don’t think it would affect the performance of top managers [...] and I could quote our CEO on this. He thinks that STI [short-term incentives] are rubbish...literally...period. [...]. Managers at the top-level of organizations have to perform well regardless of the structure of their compensation, otherwise they would get replaced.”

Furthermore, the argumentation of the respondents within the Telecommunication Company and Fast-moving Consumer Goods Company, corresponded well to the information in the companies’ annual reports, since motivation was not highlighted as a reason for having short-term incentives within these reports.
5. Analysis

In this section the empirical findings are compared and analyzed in relation to the study's theoretical framework. Firstly, the empirical findings are put in relation to agency theory and behavioral scholars' view on the human motivation. Secondly, institutional theory is applied to generate a deeper understanding of the empirical material.

5.1. Recruit and Retain - and Adjusting Compensation Costs

The empirical findings of the case studies indicate that the incorporation of short-term incentives in the managerial incentive systems of firms is based, to great extent, on other reasons than simply motivating the top management to outstanding performance on behalf of the owners, as traditionally stipulated within agency theory (Jensen & Meckling 1976; Bebchuk et al., 2002). The majority of the case study companies argued that their possibilities of attracting and retaining the competence needed, in order to remain successful, would be limited, if they did not provide these incentives (compare with Cäker, 2013; Merchant & Van der Stede, 2012). However, there are several dimensions which need to be highlighted. The pivotal point in attracting and retaining managers through remuneration (there are other important factors, such as the job itself and the company) is the compensation-level or the earning opportunities provided in relation to competitors. Therefore, companies typically rely on short-term incentives instead of fixed salary, since such a setup provides the companies with the ability to offer a competitive compensation package, while the compensation costs can be adjusted to the performance of the company (Cäker, 2013).

In relation to agency theory (Jensen & Meckling, 1976) and the optimal contract approach, it is reasonable to argue that, within some companies, the short-term incentives, to a greater extent, have the purpose of inducing the managers to take and retain the position and limiting the contracting costs for the company (Bebchuck et al., 2002), than motivating managers. This reasoning is based on three arguments. Firstly, these two aspects were highlighted throughout the case studies, while some of the companies disregarded the motivational effect of short-term incentives. Secondly, the recruit-and retain aspect was highlighted to a greater extent than the motivational aspect within the annual reports of the companies. Thirdly, it is reasonable to argue that the reason of having short-term incentives for motivating managers is second to attracting and retaining competent managers (in most companies), since having the right competence is pivotal for companies to prosper.
Following this reasoning and the risk-sharing problem, the short-term incentives, within some companies, serve more as means to secure the financial health of the company, rather than the purpose of generating better performance through risk-taking, as traditionally stipulated within the theory (Eisenhardt, 1989a). This reasoning is further strengthened by the fact that the individual payout within two of the case study companies was contingent on the overall performance of these companies. Therefore, the inherent uncertainty (risk) in utilizing incentives (Eisenhardt, 1989a; Holmström, 1979) was, to a greater extent, transferred to the individual manager from the company than what is the case within other setups. With this in mind, the interests of the shareholders is taken into consideration in a different way than inducing the manager to generate value to the company through risk-taking.

However, this does not mean that the short-term incentives did not deal with the problem of making the managers more inclined to exert effort on the behalf of the shareholders (reducing the risk for misbehavior), within the majority of the companies (Bebchuk et al., 2002; Bång & Waldenström; 2009; Eisenhardt, 1989a). However, based on the findings within the annual reports, it could be argued that this is not the primary reason for having short-term incentives within some companies. From such a perspective, the short-term focus within managerial incentives systems, which has been criticized for undermining the long-term shareholder interests, becomes more comprehensible. The reasoning behind this is that the findings indicate that short-term structures are, within some companies, a product of companies trying to compete with their counterparts for competence, rather than creating shareholder value.

### 5.2. Directing Attention and the Time-aspect

Several respondents mentioned that they used short-term incentives in order to direct the attention of managers to the most important targets for generating value for the company (in line with Cäker, 2013; Merchant & Van der Stede; 2012; Bonner & Sprinkle; 2002). It is important to note that directing the managers’ attention through incentives is inherently connected to the notion of motivating the managers, not necessarily to outstanding performance, but to expend effort on the right targets from the company’s perspective.

However, there are other contingencies, for instance the time-aspect, which could explain why some companies, to a great extent, focus on the short-term perspective, when structuring managerial incentive systems. Four of the case study companies only incorporated short-term targets in their managerial incentive systems. The most important reason for having such a setup, besides accounting reasons, was that incentivized short-term targets direct the manager’s attention and effort, whereas long-term targets carries the inherent risk of
becoming disconnected from the every-day work of the manager. From an agency theory perspective (Jensen & Meckling, 1976; Bebchuk et al., 2002) it is important to acknowledge that such a setup deals with one of the two dimensions of the agency problem, which is to get the manager to invest time and effort in tasks that generate shareholder value (Bebchuk et al., 2002). However, giving the manager cash based short-term incentives in isolation will not make the manager more inclined to act in the interests of the shareholders, which is the second dimension of the agency problem (Bebchuk et al., 2002; Bång & Waldenström, 2009). Considering the budget-gaming aspect, the manager still has the possibility to act in a way that serves his or hers short-term interests better than the long-term interests of the shareholders. From such a perspective, a potential tradeoff develops between the two dimensions, as the low proximity between the daily actions of the manager and long-term incentives might not generate the same amount of value to the company as the short-term targets.

However, in the incentive programs of these four companies, this potential tradeoff between reducing the risk of managers serving their own short-term interests and generating long-term shareholder value had been mitigated, since the companies had imposed a prerequisite on the managers to invest a percentage of the short-term payout in restricted shares. With this in mind, the case study companies' setups were, to a great extent, in line with what agency theory stipulates, since investments in company stock will align the interests of the managers to those of the shareholders (Jensen & Meckling, 1976). Nevertheless, this explanation could explain why companies have adopted a short-term focus.

5.3. Motivation and Performance

The empirical findings indicate that there are divided views on whether monetary incentives, in fact, affect motivation and thereby performance. The views of the case study companies can be described as being spread out along a continuum. At one end of the continuum is the view that incentives play a major role in motivating managers at the top management level to perform and at the other is the view that incentives do not have an impact at all for their performance. The majority of the firms argued that incentives were incorporated for motivation purposes. However, most of the respondents either were uncertain about how the performance of managers would be affected if the monetary incentives were removed, or argued that the performance would not be affected at all.
5.3.1. Industry Differences

Nevertheless, there were also firms that were more in line with Bonner and Sprinkle (2002) and Bruce et al. (2007), that emphasized the importance of monetary incentives for motivating managers to perform. Interestingly, these firms were mainly in the financial sector. The financial companies tended to believe more in incentives as a motivator than firms from other industries. Bank B was an exception, as the respondents at the company explained that the company had always been somewhat different from other financial institutions regarding remuneration principles. An explanation for the prevalence of incentives in the financial sector could be, as stated by the respondent at the Credit Management Company, the nature of the industry. By constantly discussing and measuring money, the monetary incentives become an integral part of the daily practices, which leads to a legitimization of the system and thereby motivates. Similar thoughts were expressed by the respondent at Bank A, who argued that the culture of the financial sector is money-driven and people within it are, generally, more interested in earnings opportunity, than in other industries, and therefore respond well to monetary incentives. The reasoning implies that within industries with a culture, in which monetary incentives are deeply rooted and overall accepted, the incentives are generally interpreted as a token of appreciation, which in turn, leads to increased intrinsic motivation (Deci & Ryan, 1985; 2000; Frey & Jegen, 2001).

5.3.2. Crowding-out Effect

Despite these accounts, which promote the positive effects of monetary incentives, a majority of the companies showed awareness of the potential problems of using incentives and the possible negative effects they could have on intrinsic motivation and performance. However, this motivational conflict was perceived as something which could be solved by attending to certain aspects of the incentive system. One of these aspects which was highlighted as a key factor in offsetting the mentioned negative effects was the target-setting. If the incentives serve the purpose of motivating managers, the incentivized targets should not be connected to narrow areas of interest within the company, as such targets could be perceived as insignificant by the managers. Furthermore, in mitigating possible negative outcomes of incentivized targets, the targets should be graspable and measurable for the manager, as well as balanced in terms of risk. This perspective could to some extent explain why monetary incentives prevail within companies. Within Motivation Crowding Theory (Frey & Jegen, 2001), emphasis is put on the negative effects of connecting monetary incentives to targets. In contrast, from these companies' point of view it was the targets which could lead to negative
effects, not the use of monetary incentives in itself. With this in mind, the companies had a different perspective on what is the focal point of a setup with incentivized targets than what Motivation Crowding Theory stipulates.

Furthermore, there are other contextual contingencies, apart from the target-setting process, which could account for practices of firms in relation to Motivation Crowding Theory, and the studies of other behavioral scholars (Ariely et al., 2009; Amabile et al., 1994) such as the balance of the different parts within the incentive system and its pay for performance relationship. Incorporating a proper balance between non-monetary incentives (such as recognition programs (Morrell, 2011), non-work activities and training (Ballentine et al., 2009)), which are not connected to specific targets and the performance-based monetary incentives might offset the negative effects of monetary incentives within companies. Support for this kind of reasoning can be found in Deci et al. (1999) as their results indicated that the crowding-out effect is not present when the reward is unanticipated.

Moreover, by structuring the pay for performance relationship in such a way that the individual payout is contingent on the individual performance, as well as, the overall performance of the company some negative effects of using monetary incentives could be mitigated. With such a structure the risk that the manager will only focus on the monetary incentive (Ariely et al., 2009) is mitigated, since the individual does not know the size of the payout beforehand. Nevertheless, the manager has an incentive to work in order to achieve the set targets, since the individual payout is estimated in relation to the performance of counterparts within the company. However, such a setup does not necessarily mitigate the crowding-out effect. If the manager reaches the set targets and, therefore, expects a large payout, but the manager’s expectations are not realized due to the overall performance of the company, then the crowding-out effect could prevail (Frey & Jegen, 2001). Under such circumstances a proper balance between performance-contingent monetary incentives and non-monetary incentives might be pivotal in mitigating the crowding-out effect. The structural contingencies within incentive systems of organizations are aspects which have seldom been accounted for within the studies made by behavioral scholars as they have studied other contexts and performed studies with different conditions (compare with Deci et al., 1999). These differences could partially explain why short-term incentives and monetary incentives are incorporated in the managerial incentive systems of organizations.

However, few of the case study companies could determine whether monetary incentives actually contributed to increased performance or not. Still, the majority of them supported the
logic of using monetary incentives in order to motivate managers, for the reasons mentioned above. These accounts indicate that there is an indoctrinated view among companies that monetary incentives will indeed generate better performance. This line of reasoning provides an alternative/additional explanation for why incentives prevail within organizations in contrast to the structural contingencies. Such an indoctrinated view on motivation could stem from the education of managers (compare with Ghoshal, 2005) in which the agency theory has traditionally received more attention than motivation crowding theory.

5.4. Institutional Forces Affecting the Managerial Incentive Systems

5.4.1. Normative Forces and Mimetic Forces
As described above, the majority of the case study companies emphasized the importance of having short-term incentives in order to attract and retain managerial talent. From an Institutional perspective it was evident that perceived normative pressures from managers played an important role in shaping the compensation practices of the firms. This reasoning is based on the respondents’ argumentation for why short-term incentives are instrumental in attracting and retaining managerial talent. Firstly, in order to provide a total compensation package that is attractive for managers, companies want to rely on incentives instead of having high fixed salaries. Secondly, managers expect these kind of incentives to be provided, since their professional counterparts in other companies receive these incentives. Under such circumstances the companies argued that they have to incorporate these incentives or they risk losing competent managers to competitors. This reasoning corresponds well to the discussion of DiMaggio and Powell (1983; 1991) in which professionals try to influence the practices of organizations in such a way that they are aligned to their liking. This perspective, of managerial influence on the organizational practices of firms, is further strengthened by the fact that some of the companies worked with these incentive systems under the conception that a system without short-term incentives would be perceived as strange by the managers, and would make them stand out in an unfavorable manner.

Furthermore, the perceived negative effects of not including short-term incentives in the managerial incentive systems, indicate that the majority of the case study companies perceived that they have to conform to the expectations of managers. Consequently, these perceived normative pressures from managers have contributed to a homogenization among companies and their organizational practices as described within Institutional theory. This line of reasoning differs from what is described within institutional theory where the normative pressures stem from education or the networks of professionals (compare with DiMaggio &
Powell, 1983; 1991) In this case it is managers themselves that exert normative pressures on organizations.

However, the influence of managers on the compensation practices of firms has to be contextually separated from other influences, if the origin of these practices is to be understood. Firstly, based on the premise that managers as a group do not make decisions regarding compensation practices, except for a few individuals, managers have mainly influenced the compensation practices of firms in terms of the compensation level. It is reasonable to argue that in order for companies to attract and retain managers they have to provide a compensation package which is relatively competitive in relation to their competitors. From such a perspective it is the total compensation which is regarded as the most important aspect. The design of the package, whether it is based on fixed salary or short-term incentives, is of less importance in attracting the manager.

Nevertheless, companies have chosen this solution as it gives them the possibility of providing competitive compensation when the company is doing well, while ensuring the financial health of the company during worse times. Under such conditions, a setup based on short-term incentives is efficient.

However, when this setup was first adopted by companies it created a movement towards higher compensation levels, as successful companies competed for managerial talent on the labor market with these setups (compare with section 4.2.1). Consequently, this compensation race generated a trend among other companies to build their compensation packages according to the successful companies. With this in mind, it is reasonable to argue that mimetic behavior among companies has shaped their compensation practices, since the companies have adopted these structures in order to be able to compete for managerial talent (DiMaggio & Powell, 1983). In the light of this development, the adoption of a structure based on short-term incentives is not entirely attributable to the purpose of achieving efficiency, but also legitimacy in the eyes of managers.

Along these lines, as more companies have adopted this kind of structure within their compensation practices, this perspective on how managerial compensation should be structured has spread among managers as they have switched positions within different companies (DiMaggio & Powell, 1983; 1991). From this perspective it is reasonable to argue that the companies have influenced the perception of the managers to such an extent that they expect this type of incentives. This reasoning could explain why managers would perceive a
compensation package without short-term incentives as alien, as it has become an ingrained part of the business culture among companies. With this in mind, the adoption of short-term incentives within companies, as a means of attracting and retaining managerial competence (thereby aligning to the normative pressures regarding the compensation-level through mimetic behavior), has created additional normative pressures from managers regarding the design of the total compensation packages.

By the same token, these additional normative pressures from managers have reinforced the short-term structures among companies, and, thereby, contributed to mimetic behavior among companies. This reasoning is based on the case studies which indicated that companies are hesitant to differentiate their setups from their competitors, as they would lose legitimacy in the eyes of managers. As a result, companies benchmark their competitors to determine whether the company’s compensation practices are in line with the competitors, and whether they should make any adjustments. This line of reasoning further validates the perception that short-term incentives are a means for achieving legitimacy and not only efficiency.

In a long-term perspective, the two forces (normative and mimetic) reinforce each other, as the normative pressures from managers shape the compensation practices of companies (leading to mimetic behavior) and the prevalent compensation practices of firms reinforce the perception of managers about how the compensation practices should be designed. This interplay between the forces has been fueled by the companies themselves, to great extent, since the labor markets (i.e. managers) expectations for short-term incentives originated from the companies’ compensation practices.

5.4.2. Coercive Forces

The empirical findings of this study indicate that there are other stakeholders involved in shaping the managerial incentive systems of firms than managers and competitors, such as regulators, investors, media and shareholders. The vast majority of the case study companies did not directly highlight market pressures, exerted by investors and shareholders, as an important reason for the short-term incentives. However, market pressures reinforce the use of short-term structures within the companies’ incentives systems, since the short-term incentives were used to direct the attention of managers to targets which are important for company prosperity. If companies do not meet the expectations of their stakeholders, they stand to lose potential investors, customers and shareholders to other companies which seem more promising, which can be interpreted as an informal pressure to align to the expectations within the market (DiMaggio & Powell, 1983;1991). This reasoning is strengthened by the
fact that some of the case study companies based their target levels on prior-year performance in order to meet market expectations or to realize their strategy. More specifically, the Credit Management Company utilized such a setup to meet the expectations of the stakeholders, as the competition within the industry was considered fierce and, therefore the motivation- and performance aspect was the most important reason for having short-term incentives.

Following this reasoning it is reasonable to argue that indirect coercive forces (expectations from different stakeholders for short-term performance, not incentives) could be the most important factor within certain industries for the prevalence of the short-term structures criticized by Jensen and Murphy (2011). It is also important to acknowledge that media contributes to this focus on short-term performance through their articles about quarterly performance of companies, which to some extent shape the perception of current and potential investors and shareholders.

Furthermore, the empirical findings of this study indicate that the pay-for-performance structures within companies are not in line with the propositions of scholars (Murphy & Jensen, 2011; Jensen et al., 2004), as these include thresholds. The most prominent reason for why this mismatch exists is that there is a difference between what is rational within economic theory and what is perceived as appropriate and fair by companies, stakeholders and society. Firstly, companies and shareholders do not want to pay for subpar performance even if it, from an economic perspective, would pay them to provide managers with incentives to the point where the cost of doing so exceeds the benefits of them (compare to Bebchuk et al., 2002). Secondly, regulators state that companies should have a ceiling to eliminate financial risk within the incentive system. With this in mind, coercive forces solidifies this type of setups within companies, in the form of formal and informal pressures exerted by regulators and shareholders (DiMaggio & Powell, 1983; 1991).

Similarly, the initiative from the European Union, Say-on-Pay and ISS contribute to the homogenization among managerial incentive systems, since a company which has a system which differs from the norm would encounter resistance and has to provide extensive explanations for its different setup.

Furthermore, it is important to acknowledge that pressures from stakeholders also have contributed to an enhanced long-term perspective within the systems. Regulators, such as Finansinspektionen, have imposed a set of rules and standards which have forced financial institutions, such as the two banks, to attend to the risks associated with a short-term focus. The most prominent one of these standards is the deferral-element which makes managers
consider the long-term implications of their actions, as the incentive payout can be adjusted or withdrawn if the manager's actions have led to negative consequences, which are revealed later on. Furthermore, in the aftermath of the financial crisis, companies adjusted to the demands of their shareholders for incentive systems in which the long-term perspective was reemphasized. This force is still present as the companies argued that they adhere to shareholder guidelines and take influence from the public discussions when designing these systems. Along these lines, some of the companies’ managerial incentive systems diverged from Jensen et al. (2004), since they did not demand that the managers invest private funds in company stock. The reason for this was that the purpose of aligning the interests of the managers to the owners (Jensen & Meckling, 1976) was perceived as fulfilled by the amount of restricted shares that were incorporated in the systems. The only reasonable conclusion that can be drawn from this is that scholars and practitioners sometimes have different perceptions on what is needed in order to achieve something.

5.4.3. The Contextual Implications of the Institutional Forces for Managerial Incentive Systems

Taken together, there are several forces which affect the managerial incentive systems of firms. Normative and mimetic forces are, as argued above, continuously reinforcing the use of short-term incentives within the compensation practices of firms. However, coercive forces, in the form of pressures exerted by regulators, shareholders, institutional stakeholders and the public, have influenced firms to adopt an enhanced long-term perspective in the aftermath of the financial crisis. In relation to agency theory (Jensen & Meckling, 1976; Ross, 1973) and the critique from the academia against a short-term perspective (Jensen, 2002; Fuller & Jensen, 2002), it is reasonable to argue that weak coercive forces for an enhanced long-term perspective, prior to the financial crisis, created an organizational field (DiMaggio & Powell; 1983; 1991) in which the mimetic, normative and the indirect coercive forces ruled supreme. This is not to say that there were no stakeholders which exerted pressures for an enhanced long-term perspective prior to the crisis, but these pressures are certainly more prevalent and stronger in today’s society. Furthermore, when the mimetic, normative and indirect coercive forces ruled supreme, they influenced the managerial incentive systems of firms to focus on attracting and retaining competent managers (the contracting costs) (Bebchuk et al., 2002) and short-term performance. Under those circumstances, the problem connected to misbehavior (aligning interests) within the agency theory and generating long-term shareholder value was downplayed to an extent. Consequently, the short-term perspective was solidified among
companies. This is clearly not the only reason for the prevalence of short-term incentives within managerial compensation, but it has definitely contributed to its stronghold in the aftermath of the financial crisis.
6. Concluding Remarks

6.1. Conclusion

The empirical findings of this study demonstrate that there are several reasons for why companies have not fully aligned their managerial incentive systems at the top management level to the critique against short-term structures from the academia. Firstly, these short-term structures are considered pivotal by companies in competing for managerial talent and adjusting the costs for the total compensation according to the performance of the company, since this ensures the financial state of the companies.

The analysis of this study further indicates that these two purposes for using short-term incentives are inter-related, to an extent, as the competition for managerial talent has driven companies towards these short-term structures. Adopting such a structure improves firms’ competitiveness, to an extent, by providing managers with greater earning opportunities, while it enhances efficient cost management. This competition for managerial talent has shaped the practices and perception of companies, as well as, managers. Consequently, the need to compete for managerial talent has fueled the mimetic forces (the companies themselves) and normative forces (managers), which have contributed to the reinforcement of these short-term incentives among companies. From this perspective, the divergence between the practices of firms and the critique from the academia becomes understandable, since these forces have ruled supreme in relation to the lack of coercive forces promoting a long-term focus, prior to the financial crisis. In the aftermath of the financial crisis, the managerial incentive systems have become more long-term, which indicates that the divergence between the practices of the firms and the academia is not as great as it once was. However, coercive forces in the form of investors and shareholders expectations for short-term gains have also reinforced the use of short-term incentives, the use of thresholds and prior-year performance benchmarks, although these have been criticized within the academia.

Secondly, despite the critique from behavioral scholars, which stipulates that short-term incentives impede the cognitive ability of managers and undermine their intrinsic motivation, short-term incentives were incorporated within the majority of the case study companies in order to motivate the managers. The discrepancy between the practices of the case study companies and the perspectives conveyed by the behavioral scholars could be attributed to structural contingencies within these companies or/and an indoctrinated view on the motivational effects of monetary incentives within these companies.
Thirdly, the purpose of creating value for the company and its shareholders, by directing the attention of managers to the targets which are the most important to the company, could partly explain why companies adopt short-term structures. A managerial incentive system which is built on long-term targets was considered to carry the inherent risk of becoming disconnected from the everyday work of the managers. Under such conditions, the manager's actions will not generate maximum value to the company.

6.2. Contribution

This study indicates that the short-term structures within managerial incentive systems can be attributed to several reasons: (1) the competition among companies for managerial talent (2) directing the attention of managers to important targets in generating value for the company and its owners and (3) motivating managers to perform on the top of their capacity. This study has also contributed to a deeper understanding of the existence and development of managerial incentive systems in relation to the critique from the academia, by showing that the reinforcement and development of these systems, in general, and short-term structures, in particular, stem from institutional forces in the form of stakeholder pressures and organizational contingencies. Hence, our hope is that these findings give scholars new insights regarding the existence and development of managerial incentive systems and that they may build upon these results.

6.3. Limitations

The results of this study are limited in three ways: firstly, since this study did not include any members of the companies' compensation committees, which decides about the structure of the companies' managerial incentive systems, there is a lack of perspectives which could damage the rigor of the results. Secondly, the annual reports of the companies only confirmed the perceived importance of using short-term incentives for recruiting and retaining managerial talent and motivating managers. Thus, future scholars should strive to incorporate compensation committee members in order to validate the results of this study. Thirdly, there are scholars who argue that the relationship between the board and the remunerated individuals within the top management is not at arm's-length (Bebchuk & Fried, 2003), which means that the prevalence of short-term structures could be the result of the potential influence that top managers exert on the board's decisions.
6.4. Further Research

In the light of this study’s findings regarding the existence and development of managerial incentive systems, future research could focus on developing our understanding of how institutional forces affect incentive systems in other organizational contexts. Although our study indicates that the institutional forces reinforce the use of the short-term structures at the top management level within large cap firms, future research could investigate the relative impact of the forces on other organizational levels than top management, or within companies which are not, to the same extent, subject to public discussions, for instance, SME’s. Furthermore, future scholars could investigate the relative strength of the crowding-out effect within different industries, as our results indicate that monetary incentives are perceived as a supportive element within the financial industry.
References


Appendix A – Interview guide

Opening questions

What is your position within the company?

For how long have you been working within the company? In what positions?

Current managerial incentive system

Describe the current managerial incentive system connected to the top management

How does the company set the targets which are connected to the variable pay of the top management?

What time span is used in measuring the top management’s performance on these targets?

Are these targets solid or are the targets adjusted over time?

Describe the link between goal fulfillment and payout of the monetary incentives? Is it linear or are there thresholds involved? Why have the company chosen this solution over other alternatives?

How does the company ensure that the current incentive system does not lead to excessive risk-taking and that it does not counteract the long-term interests of the company?

According to the annual report, the members of the top management must own company stock to a value that corresponds to X of their base salary as well as invest X of their annual bonus in company stock. What are the reasons for having this setup?

What effects would a setup without these terms generate?

How would a setup without short-term incentives affect the company?

How would a setup without short-term incentives affect the performance of the top management?

How does the company measure that the current incentive program generates the desired effects?

Reasons for using the current managerial incentive system

What are the main reasons for using the managerial incentive system at the top management level?
What are the main reasons for having short-term incentives?

Has this view changed over time? Why?

What effects does the company want to achieve with the managerial incentive program?

How do you perceive the stipulated link between monetary incentives and motivation?

**The development of the managerial incentive system**

How has the incentive program evolved over time?

What are the reasons behind this development?

How do you perceive the future development of the incentive program? What improvements could be made?