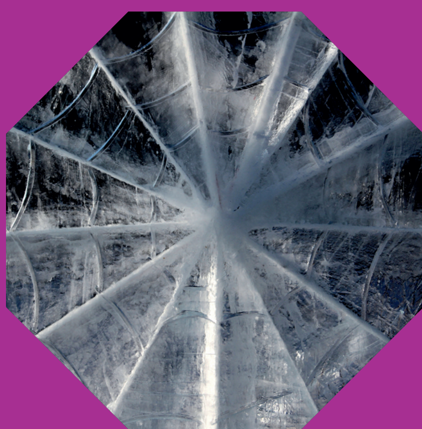
Department of Accounting

Essays on Political Corporate Governance and Governance Reforms: Consequences from Sociological Perspectives

Leena Kostiander



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Abstract

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Abstract

This doctoral dissertation seeks to understand the existing political remuneration governance arrangements in Finnish state-owned enterprises and study how the governance processes and their outcomes are influenced by interest group politics, and how interest group politics can impede governance reforms. It engages in the current debate on tightening corporate governance and the desire for political remuneration reforms: why are reforms designed and with what consequences? The dissertation consists of three essays. The first essay analyses the meaning of remuneration reform in Finnish state-owned enterprises (SOEs) and the outcomes that result. The second essay explores the remuneration consultant-client relationship, focusing on what consultant and clients actually do under strong political remuneration guidelines. The final essay, inspired by the findings of essays one and two, introduces a multitheoretical and cross-disciplinary sociological approach, a balanced framework with which to explore governance mechanisms of overlapping structures. The empirical analysis indicates that political experimentation with remuneration guidelines does not come without costs and may lead to inefficient governance. The guidelines may decrease management's motivation to take risk and create shareholder value, put pressure on the board of directors to raise fixed salaries and bonuses, and legitimize the same bonus levels for all SOEs regardless of their size, thereby benefitting small companies. Furthermore, loopholes can be found in the guidelines that serve to encourage opportunistic behavior by management. The unintended consequences of this process extend into remuneration consultant-client relationships, as empirical evidence indicates that remuneration consultants are not independent and may serve management regardless of remuneration guidelines. The mechanism of the consultant market also play a significant role in the remuneration design process because the competition between consultancies influences the forms, levels, and structures of remuneration designs, thereby explaining ever-increasing levels of executive pay. In addition, the research questions the independence of CEO directors in remuneration committees because, as CEOs, they are possible former, current, and future clients of consultants, and therefore not necessarily independent in their decision-making. This research contributes to management accounting and corporate governance in at least three ways. First, it highlights the importance of human factors in political reforms, and shows that reforms are unable to protect against unintended consequences and opportunistic behavior. Second, the study provides important understanding of the ways routine practices can bypass rules as well as rich analysis of the types of consequences caused by forced change. Third, it provides a balanced sociological framework with which to explore the governance mechanisms of overlapping structures that neither under-socialize nor over-socialize human action.

Keywords Corporate Governance, remuneration reform, executive remuneration, SOE, structuration theory, structural hole theory, meso-level analysis

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Helsinki, February 2011

Leena Kostiander

CONTENTS

PART I

OVERVIEW OF THE DOCTORAL DISSERTATION

INTRODUCTION

There is great deal of disagreement on how good or bad the existing corporate governance mechanisms are. Complaints about corporate governance and pressure to improve such governance have existed for as long as corporations themselves (Smith, 1776; Hermalin, 2006), but many of the issues debated by early writers (e.g. Berle and Means, 1932) still remain an important topic today. The shareholder and stakeholder complaints and pressure, driven, for example, by world-wide privatization over the past three decades, deregulation of capital markets, the series of scandals and corporate failures not only in the US but also in other countries, and the financial crisis of 2008-2009, have had real effects, leading to various changes in corporate law and regulation. These changes include, for example, the Sarbanes-Oxley Act of 2002, the OECD Principles of Corporate Governance 2004, and the UK Financial Services Authority's (FAS) "Revising the Remuneration Code" of 2010.

The financial crisis of 2008-2009 has intensified the ongoing debate about the role that shareholders and stakeholders should play in corporate governance. To some, increasing shareholder power and facilitating shareholder intervention when necessary, is part of the essential reforms. To others, activism by shareholders who potentially have conflicting interests (e.g. politicians, hedge funds) is part of the problem, not a solution. In response to a string of scandals, corporate governance reforms have taken place in many countries, boosting the nomination of independent boards of directors and auditing and remuneration committees, enhancing transparency, and strengthening shareholders' rights and regulators' power, making the board more dependent on external guidelines and governance in the process.

Problems of separation of ownership and control, agency problems (Jensen and Meckling, 1976), arise in both dispersed (private companies) and in concentrated ownership structures (e.g. state-owned enterprises, SOEs) because in both cases owners seldom manage the day-to-day operations of the firm. To solve these problems, academic research suggests the use of incentives to align the interests of owners and management (e.g. Jensen and Murphy, 1990). Although private sector remuneration reforms have received academic interest (Matsumura and Shin 2005; Thompson, 2005; Bender and Moir, 2006), less attention has been paid to remuneration reforms of state-owned enterprises, most renowned for multiple and conflicting objectives, opacity, political interference and poor performance (Shleifer and Vishny, 1997; Shirley and Walsh, 2000). The main argument against state control and ownership arises from the combination of power and potential political opportunism (Shleifer and Vishny, 1993). However, privatization is not always politically possible (Perotti, 2004), resulting in partial state ownership of some listed enterprises. This mixed state ownership introduces regulatory problems: "how to establish a credible time path for the retreat of the direct control role of the state and the emergence of genuine, more accountable forms of regulation?" (Perotti, 2004: 13).

While most corporate governance mechanisms (e.g., codes, laws, remuneration guidelines) are economic and legal by nature, they can only be altered through political processes – for better or worse. The change process of these mechanisms is, above all, social because it requires human interaction, mostly collective (Burt, 1995; Giddens, 1984, 1990). Because regulation is politically controlled, shareholders and stakeholders of SOEs (including tax payers) should ensure that regulators act in an independent fashion towards mutual goals. However, this type of monitoring is seldom possible because regulation, for example in the form of remuneration reform, is a rather opaque process to outsiders, embedded in institutional realms (Giddens, 1990; Granovetter, 1985).

This study contributes to management accounting and corporate governance research by focusing on remuneration guidelines that both restrict and enable action, in the process of SOE remuneration reform. It engages in the current debate on tightening corporate governance and the desire for political remuneration reforms: why are reforms designed and with what consequences? More generally, it answers the call from Bebchuk and Weisbach (2009:25) to understand the existing governance arrangements and study how the governance processes and their outcomes are influenced by interest group politics, and how it can impede governance reforms. Regulators can establish guidelines, but how those guidelines are followed, what type of behavior the guidelines drive in those that apply them, and what are the unintended consequences of the implementation processes are of interest. This research also contributes to management accounting and corporate governance by proposing a multitheoretical and cross-disciplinary approach to research that strives to understand how accounting systems are constructed, maintained, changed, and used through human action that is embedded in social relations.

The research consists of the overview of the doctoral dissertation and three essays. The first essay analyses the meaning of the remuneration reform in Finnish state-owned enterprises and the outcomes that result. It shows how politicians, through entrepreneurial action, push their political values into remuneration plans via remuneration guidelines, and how politicians manage to control and maintain the control of the remuneration practices in SOEs, partly replacing the independent remuneration committee and the board of directors in the process. The second essay explores the remuneration consultant-client relationship, focusing on what consultants and clients (managers) actually do under strong political remuneration guidelines. The focus is on the outcome of remuneration reform, on a process that follows the release of the guidelines. The final essay, inspired by the findings of essays one and two, introduces a theoretical approach that intertwines two sociological approaches (structuration theory, Giddens, 1984; structural hole theory, Burt, 1995) together providing a balanced framework with which to explore governance mechanisms of overlapping structures. The power of this framework lies in its ability to focus on embedded agency (Granovetter, 1985), acknowledging that structure and agency are equally important (Burt, 1995; Giddens, 1984). The empirical evidence in this field study is primarily based on interviews conducted in the 23 largest Finnish stated owned enterprises (essays 1 and 2). Interviews of remuneration consultants, politicians, civil servants and institutional investors further enrich the unique data. Essay 3 applies Covaleski and Dirsmith's (1988a and 1988b) field study of the University of Wisconsin budgeting system, enriched with archival records.

This dissertation overview is structured as follows. First, corporate governance research – which illustrates how this study is related to previous research – is briefly reviewed. The research is presented using two themes – independent board of directors, and process of remuneration design – under which remuneration committees, remuneration consultants and reforms of remuneration guidelines are discussed, and are followed by an introduction to theoretical perspectives. Thereafter, research design is presented, including methodology, company selection and method. The original papers are then summarized. The summaries consist of research objectives, findings and contributions. The overview ends with a conclusions section.

RELATED PRIOR RESEARCH

A wave of recent, well-publicized corporate scandals has brought corporate governance reforms to the forefront of the regulatory and political agenda. In response, researchers have become increasingly interested in the effectiveness of internal corporate governance controls and their power to prevent opportunism. The following review of previous research concerning reform of corporate governance controls is organized under two themes: 1) independent board of directors, and 2) process of remuneration design. The themes present the state of current knowledge concerning corporate governance reforms and the outcomes. The research gaps not yet covered are discussed at the end of the section.

Independent board of directors

The board of directors is an important governance mechanism because all corporations have boards. Boards are at focus when things go wrong. As a consequence of corporate scandals and ongoing concerns about corporate governance boards of directors has been at the center of the policy debate concerning governance reforms and the focus of considerable academic research (e.g. Adams, Hermalin and Weisbach, 2009).

The main duties of boards are to monitor and advise the chief executive officer (CEO) and top management (Jensen, 1993). Boards set strategy and corporate policies, hire and fire the CEO and top management, and monitor shareholders' interest (Demp and Neubauer, 1992). While past research viewed boards as passive (Lorsch and MacIver, 1989) recent research finds that boards have become more active, evolving from activities that can be described as "rubber-stamps" to active and independent monitors (MacAvoy and Millstein, 1999; Kaplan and Minton, 2006).

Board members are usually divided into two groups: inside and outside directors. Outside directors are often taken to be independent (Cohen, Frazzini and Malloy, 2008), whereas directors whose primary employment is with the firm are not. The presumption is that the interests of independent directors are better aligned with those of minority shareholders than the interests of inside directors. Recent research, though, questions outside directors' independence. Cohen et al. (2008), for example, find that firms appoint "cheerleaders for management", directors who are overly sympathetic and poor monitors. However, as public and political pressure and regulatory requirements have led firms to have boards that are larger, meet more often, and have greater responsibility and risk, a general requirement has also been that a board should be made up of a majority of outsider or independent board members (Adams et. al., 2009).

CEOs of other firms are a major source of candidates for board positions because they are assumed to be independent. According to Fich (2005) the extent of institutional ownership is positively linked to nomination of CEO directors. Due of their past and current positions, the CEO directors have an unusual amount of authority and experience, and can be ideal for monitoring or advising the CEO of another firm. For CEO directors, the board seat signals a chance to build their human capital (Conyon and Read, 2006), prestige and networking opportunities (Kramarz and Thesmar, 2006; Perry and Peyer, 2005), which can hamper (Larcker, Richardson, Seary and Tuna, 2005) or benefit board's monitoring role. Brickley, Linck and Coles (1999) show that appointments of former CEOs to other firms' boards are more likely after good accounting performance at the appointee's firm. In other words, a good performance record helps CEOs to gain board seats in other firms. In contrast, negative publicity, such as shareholder class action lawsuit (Fich and Shivdasani, 2007), harms directors' reputation and leads to a decline in outside directors' board seats.

Adams et al. (2009:42-43) discuss the reputational tradeoff of directors. While public reputation as a poor monitor hurts the director with regard to the number of board seats he/she holds, a private reputation as a poor monitor – as someone unlikely to "rock the boat" – may in fact help in obtaining a board seat if an appointing firm's CEO is looking to acquire power at the expense of the board of directors. The same argument could also apply for boards where the director nomination process is, for example, blockholder driven. In such a case, it might be in the blockholder's interest to favor the appointment of "independent" outside directors, not interested in "rocking the boat", thus benefitting the blockholder at the cost of minority shareholders.

Firms may also seek to appoint an outside CEO to their board in order to buy into the CEO's reputation and to certify to the market that the firm is doing well. Alternatively, outside directors are hired to advance the interests of the CEO at the cost of shareholders. Two recent studies investigate these issues with US data, discussing costs and benefits of CEO directors. Fahlenbrach et al. (2008) examined determinates of appointments of outside CEOs to boards, and how these appointments impact the appointing companies. They found neither positive nor negative evidence of CEO directors' impact on the appointing firm's performance, decision-making, remuneration of its CEO, or on the monitoring of management by the board. While the results of Fahlenbrach et al. (2008) were more consistent with the notion that outside CEOs certify the quality of a firm to the market (although they do not impact the firm much), Faleye (2010) finds evidence that CEO directors do not necessarily create value, but can also destroy it. He finds that CEOs are paid significantly more when other CEOs serve on their boards, and their remuneration is less sensitive to firm performance when other CEOs serve on their boards. Furthermore, board monitoring is weaker, implying that the potential value effects of CEO directors coming to the firm is more likely through their advising (in acquisition context) than monitoring role.

Sometimes the roles of CEOs interlock: the current CEO of firm A serves as a director of firm B, and the current CEO of firm B serves as a director of firm A. In studying these interlocks in America's largest companies Hallock (1997) found that CEOs that lead interlocked firms earn significantly higher remuneration. This can be called "mutual back-scratching" (Adams et al., 2009:30): "the implicit threat of what the first CEO can do for or against the second in the first's role as director causes the second to act more favorably toward the first in the second's role." Similar results have been found with French data presented by Kramarz and Thesmar (2006), highlighting the importance of distinguishing "formal" from "real" director independence. While directors may be formally independent (not, for example, an employee or customer), he/she can be well tied with the CEO through a social network that prevents him/her from standing openly against CEO's decisions. In prior research (e.g. Fich, 2005) these directors are labeled "gray" directors. Other studies on board interlocks also find evidence that CEO directors benefit management at the expense of shareholders, for example with regard to job security (Fich and White, 2005) and declining firm performance (Fahlenbrach et al., 2008).

The reason for discussing the independent board of directors in length is that the board decides upon executive pay, even after the reforms of corporate governance that aimed to strengthen the monitoring and advising duties of boards with a committee, often called either the remuneration (in Europe) or compensation (in US) committee. Usually, the committee members are also members of the board of directors. Most of the current codes and guidelines require that remuneration committees should be independent; they should be free of executive influence from the appointing firm. However, as the roles of board members and committee members (especially with the chairman, who generally chair both) often interlock, the findings of previous research with independent boards can be extended to studies on remuneration committees. This is discussed from different angles in the next section.

Process of remuneration design

> Remuneration committees are now seen as key agents in the process of choosing a remuneration package, ensuring that it is calibrated in a way that ensures the incentives faced by the executive directors are such as to incentivise the executive towards those decisions and actions necessary to best deliver the company's chosen strategy.
> Jackson, Main, Pymm and Wright (2006:7)

The process of remuneration design consists of three governance mechanisms that intertwine (e.g. Bender, 2010; Main, Jackson, Pymm and Wright, 2008): 1) the remuneration committee that assists the board in monitoring and developing executive remuneration, 2) external resources, such as consultants, who assist the committee in carrying out its role, and 3) corporate governance regulations, guidelines, and codes that set the rules of the game. While there is previous research on these issues, and some of it is cross-sectional covering two of these mechanisms, there is no research that intertwines all three mechanisms together.

Remuneration committees

Research on remuneration committees is a relatively new area, possibly due to the difficulty of accessing data (Adams et al, 2009). However, there is a handful of research, mostly qualitative, with a focus mainly on UK companies. The early research on remuneration committees focused on measuring the extent to which the committees had been adopted in Britain after the widespread public attention concerning the growth of executive pay (prior to Cadbury Report of 1992), describing the composition and effect of remuneration committees (Main and Johnston, 1993). More recent research (Spira and Bender, 2004) has focused on the work of board sub-committees, finding many similarities between the work of audit and remuneration committee, and on tensions (particularly with remuneration committees) between their advising (achieving an effective agency theory type pay mechanism) and monitoring (following rules and codes of governance) roles. Building on these tensions Main et al. (2008) propose that concerns for legitimacy push remuneration committees towards imitation (institutional isomorphism) in processes and practice. Performance criteria of remuneration designs, for example, can be chosen less because of the linkage with firm strategy and more because of their common acceptance and use within the sector. Main et al. (2008) highlight the role of the chair of the remuneration committee in the process of remuneration design, and the time commitment the committee should make in considering the complex issues of the executive pay setting process.

While research on remuneration committees is still restricted by difficulties in accessing data (Adams et al., 2009), there are studies that approach the issue indirectly through the process of executive pay setting, and more recently through the role of consultants in the pay setting process. These studies have found that the level and structure of remuneration are influenced by the "market" benchmark (Bender, 2003), and highlight the problems of determining a suitable comparator market (Faulkender and Yang, 2010). Furthermore, according to Bender (2004), many companies adopt performance-related pay structure despite a belief that the money does not motivate executives. Performance-related pay was seen as a symbol of the director's success, both internally and to his or her peers in other companies. Executive pay was found to rise for a number of reasons in large UK companies, including increases due to being below-market levels; changing performance-related schemes that did not pay out or paid less than expected; changes in the company's culture or strategy; changes to senior personnel; and compliance with good practice in human resource management and in corporate governance (Bender, 2007).

Remuneration consultants

The majority of recent executive remuneration and remuneration consultant research reports that executive pay is generally higher in organizations that are the clients of consultancy firms (Armstrong, Ittner and Larcker, 2008; Cadman, Carter and Hillegeist, 2010; Conyon, Peck and Sadler, 2009; Kabir and Minhat, 2010; Murphy and Sandino, 2010; Voulgaris, Stathopoulos and Walker, 2010). Although one of the main tasks of the consultant is to generate benchmark data (Bizjak, Lemmon and Naveen, 2008), consultants may also provide a variety of services to remuneration committees and the management of organizations. While consultants are expected to offer independent and legitimate advice (Bender, 2010), the services provided to management in other sectors raise potential conflicts of interests. According to critics (e.g. Bebchuk and Fried, 2004) the CEOs of companies with weak governance use compensation consultants, who are reliant on the organization for current and future business, to design and justify excessive pay packages. Owing to difficulties in accessing data (e.g. Conyon et al., 2009) this claim has not yet been empirically verified, and consultants' influence on executive pay remains an open academic debate. While some, for example Voulgaris et al. (2010), view consultants as a solution to the agency problem by designing optimal pay contracts, others (e.g. Murphy and Sandino, 2009:25) find interesting anomalies in their results: for example, firms using consultants working exclusively for the boards are likely to pay more rather than less to their CEOs than other firms using consultants. This is set against the assumption that an independent board reduces remuneration consultants' conflict of interest relating to repeat business with the firm (Murphy and Sandino, 2010:17) and the general assumption that independent boards are effective governance mechanisms in decreasing agency problems (Bebchuk and Weisbach, 2009:7).

Reform of remuneration guidelines

Although there is considerable research on corporate governance reforms, mostly with juridical perspectives, there are only three studies that particularly address remuneration reforms. Two of these focus on UK firms (Thompson, 2005; Bender and Moir, 2006), the third (Matsumura and Shin, 2005) discusses reforms in the context of publicly traded US firms.

Although remuneration codes generally permit flexibility of the choice of remuneration structure, prior research suggests that compliance with codes does not ensure ethical remuneration from the shareholder perspective (Bender and Moir, 2006), and reforms will not necessarily resolve the problems and issues as intended (Matsumura and Shin, 2005; Thompson, 2005), thereby rising questions of agency conflicts and costs (Jensen, Murphy and Wruck, 2004). Thompson (2005) reviewed Cadbury reforms and remuneration practices in the UK and suggested that reforms have not been very successful in linking executive rewards with company performance. However, Thompson (2005) finds that reforms have facilitated the role of institutional shareholders in approving executives' remuneration packages. Bender and Moir (2006) examined the effects of corporate governance on remuneration practices in UK listed firms and found several ways by which following "good practice" might lead shareholders' and managers' interests to conflict. Focusing on issues of market benchmarks, fairness of pay, use of performance related pay, and executive shareholdings, they point out that although transparency is critical in corporate governance it can lead to unethical behavior and gaming. Because there is no correct numbers associated with executive pay, its "fairness" is left for markets to determine, which might not appeal to society. Therefore, conflicts of shareholder, executive, and stakeholder interests are evident.

The review of previous research suggests that although much research has been carried out in the area of independent boards, little is still known of remuneration committees, remuneration reforms, and remuneration consultants; the parties/controls of the process of remuneration design. There are many open questions and interesting links that are insufficiently understood. For example: Why do reforms facilitate the approval of practices (e.g. independent boards, remuneration guidelines, use of consultants) that appear inefficient and inconsistent with the shareholder value premise? What is the mechanism through which the consultants supposedly extract and justify excess pay for executives of companies, and how does it work? Why do the remuneration guidelines not prevent such opportunism? What is state shareholder's willingness and ability to influence executive pay? What are the outcomes of political intervention?

Generally, more research is needed to understand the role of the board and remuneration committees, as well as the various means of governing a firm – are these means complements or substitutes, or does strength in one area correspond to weakness in another? (Adams et al., 2009). In addition, research on social networks is rare in the field of corporate governance, particularly with regard to how social networks affect board work and board dynamics (Adams et al., 2009:47-48), or the process of remuneration reform and its outcome.

As with corporate governance research in general, most research on boards of directors is quantitative by nature and focuses on Anglo-American firms (Adams et al., 2009; Werner and Ward, 2004). However, many "soft" dimensions of corporate governance, such as reputation and trust in the consultant-client relationship, or political power, are not necessarily visible to econometricians. For this reason, more qualitative research is needed, particularly from other than the Anglo-American context. Finally, corporate governance research is agency theory dominated. While agency theory is, in general, meritorious, several authors have noted that it is insufficient as a means to portray the agency problems that are, above all, social by nature (e.g. Bender, 2004, 2007; Main et al., 2008; Matsumura and Shin, 2005). Therefore, there is an evident need for qualitative research (Werner and Ward, 2004) that strives to understand the complex process of executive pay setting process through relationships of economic and political agents (CEOs, board and committee members, politicians, outside experts), the rules and routines guiding the relationship (governance and practice), and the benefits and costs attached to them (motives and risks) from novel theoretical perspectives.

Theoretical perspectives

Research that integrates social relationships into question of imperfect political governance practices is rare due to the difficulties in gaining access to interview and observe board and committee members, CEOs, consultants, and politicians. Since the exchange of these agents is embedded in ongoing social practices (Granovetter, 1985) governed by, for instance, corporate governance and remuneration guidelines, it is essential to focus on what agents actually do, for example, during the process of remuneration design (essays 1 and 2) or a reform of a university's budgeting process (essay 3). Knowledge of these processes and relationships, and their intended and unintended consequences, help to understand structuration theory's (Giddens, 1984) underdeveloped link between action and structure (Coad and Herbert, 2009; Englung and Gerdin, 2008; Macintosh and Scapens, 1990), and the effect of social networks on corporate governance reforms.

To address the effects of social networks in political corporate governance, in governance reforms, and the underdeveloped link of agent and structure (e.g. Coad and Herbert, 2009) in structuration theory (Giddens, 1984), essays 1 and 3 draw on research and thinking in sociology that has yet to be brought into the field of management accounting; the theory of structural holes (Burt, 1995). A structural hole is a role or position in the social structure (Burt, 1995), consisting of "relatively unconnected sets of understandings, practices, rules and organizations" (Yang, 2004). Structural hole theory offers the potential to understand agent's behavior and action in the process of a reform, especially in the case when two systems interact (Whittington, 1992), such as the political and economic (essay 1), or the political and academic (essay 3). Building on modalities of structuration introduced by Giddens (1984, 29) the essays focus on modalities of structural systems, the means by which structures are translated into action (Giddens, 1984; Macintosh and Scapens, 1990), and on agency, referring to an entrepreneurial (Burt, 1995) individual with free will (Giddens, 1984: 5) operating in a social settings. The modalities (e.g. remuneration guidelines and budget guidelines) incorporate the relationship of agents and institutions: agents draw upon certain structures in their daily action and as they do so, they also reproduce those same structures and as a result, eventually legitimate them.

Essay 2 is explorative, relying on previous research on remuneration consultants and management consultants. Although it does not draw on structuration theory or structural hole theory, in exploring and understanding the process that connects restrictive remuneration guidance, the remuneration consultant business, and remuneration design practices, it applies the same network perspective (Granovetter, 1985) as essays 1 and 3. Such an approach helps to avoid undersocialized conception of human action (Granovetter, 1985:483), which allow little impact of social relations on governance practices. The social dimensions of remuneration design are included in the analysis of consultant's influence on executive pay, capturing interaction of individuals and institutions (guidelines).

RESEARCH DESIGN

Methodology

This dissertation builds on a social constructivist framework (e.g. Gendron and Bédard, 2006), representing a subjectivist rather that an objectivist approach (Morgan and Smircich, 1980). According to this view, new knowledge and shared meanings are created within human interaction. Humans are seen as active agents, knowledgeable of their actions (Giddens, 1984). The CEOs, chairmen of the boards, politicians, and consultants (interviewed for this study) are thus viewed as active participants in the construction of the remuneration governance environment. Corporate governance controls (e.g. remuneration guidelines) and trust, for example, are viewed as active forces in this relationship, where they help to shape the relationship or a network (e.g.Vosselman and Van der Meer-Kooistra, 2009) of actors and institutions.

The chosen framework influences the research techniques (Mir and Watson, 2000) of this dissertation as both essays 1 and 3 incorporate historical analysis of governance practices, and essays 1 and 2 use interviews as a data collection method. Further, all essays link micro (corporate governance, e.g. diffusion of practices: essay two) phenomena to macro (social structure, e.g. market and institutions: essay two) phenomena, which is an important element of constructivist methodology (Mir and Watson, 2000).

Company selection

For this qualitative research, the author chose to study, through field-based research (Hoque, 2006; Ahrens and Dent, 1998), Finnish state owned enterprises representing a wide range of industries (appendix 1). The reason for choosing SOEs for the context for this study is that this group was hit by several pay scandals during 2001-2009, despite a tightening of political remuneration guidance. The remuneration information for these scandals was provided either by the Finnish tax authority (all tax payers), by the state (all state owned companies) or by the company itself (listed companies).

The SOEs have independent boards and remuneration committees, predicting strong internal (Fama and Jensen, 1983) and external control mechanisms[1]. The boards of SOEs comprise of current or former executives of other companies (60 % of board members), state representatives (16 %), independent board members (such as professors, 13 %) and representatives of other owners (3 %). All the boards of listed companies are chaired by current or former executives of other companies, and majority of members are executives as well. Thus, the boards are independent from the company but the mind set is in most cases aligned with the executives.

[1] The Finnish Corporate Governance system is discussed in appendix 3.

SOE remuneration practices are reviewed often by the state and “unreasonable” elements are expected to be removed from pay packages, setting remuneration at a level regarded to be reasonable and competitive by politicians. The ways in which SOEs structure their remuneration to adapt to this constraint and what type of behavior it drives in the remuneration design process is of interest because it offers insights into the ways routine practices can bypass rules, as well as rich analysis of the types of consequence caused by forced change. Interestingly, despite the guidelines, excessive pay continues to hit the headlines.

A two-pronged approach was used that primarily consisted of on-site interviews and observations at all the firms, as well as a review of relevant internal documentation when available, online information, and published material from outside sources including Government Decision-in-Principles on the State’s Corporate Ownership Policy, and annual reports of SOEs. The first part of the data (SOE interviews) was collected by a research team of four that the author conducted in the course of a research project funded by the Finnish Ministry of Trade and Industry concerning compensation issues in SOEs[2]. This took place between November 2006 and January 2007. Altogether, 23 of the largest Finnish state-owned companies were contacted, and none declined. Of these firms, 11 were Nasdaq OMX Helsinki listed companies. This amounted to a total of 40 interviews, consisting of CEOs and independent chairmen of the boards who also acted as remuneration committee chairs. Most of the interviews were conducted through a two (researchers) to one (interviewee) approach. To enrich the data with political and investor views, a former and current minister of trade and industry responsible for ownership policy, and two major institutional investors in Finland, were interviewed to extend the data. This resulted in a total of 44 interviews. These

[2] Ikäheimo, Kontu, Kostiander, Tainio and Uusitalo, 2007. Ylimmän johdon palkitsemisjärjestelmien toimivuus valtionyhtiöissä ja osakkuusyhtiöissä.Yliopistopaino, Helsinki.

interviews formed the database for the first essay “The Intended and Unintended Consequences of Remuneration Reform: Evidence from Finnish State-Owned Enterprises”.

During the SOE interviews it became apparent that all SOEs in this study used remuneration consultants, and their role was significant in remuneration design. To gain a better understanding of consultant’s influence and to capture and detect differences in perceptions, practices, and interpretations of all parties of the remuneration design process, data collection was extended to consultants. In the second phase, the five leading remuneration consultant firms operating in Finland were contacted and four agreed to participate in the study. The interviews were conducted during April-May 2009 by the author and a co-interviewer from the first phase research group. Essay 2 “How Consultants Increase Executive Remuneration Despite Remuneration Guidelines: A Process Approach” relied on data on SOEs as well as on consultants, drawing on 44 interviews.

The interviewed consultants hold a key position in their firms as a partner, co-founder, or CEO, operate actively in remuneration design, and develop new business opportunities. All of these firms had/have customer relationships with SOEs and were/are regularly offering services. Company A, is a market leader in remuneration design, which, in practice, holds a virtual monopoly. Company B focuses on its long-term customers, and essentially offers remuneration design as an additional service. Company C is one of the leading international consultant companies with a small branch in Finland. Company D is the smallest of the interviewed players in the business, focusing on remuneration.

Essay 3, “Modality as a Bridging Mechanism”, draws on different data than that in the other two essays, although it is “empirically inspired” by them. The essay uses the rich description of the University of Wisconsin budgeting system provided by Covaleski and Dirsmith (1988a and 1988b), also applied by Macintosh and Scapens (1990), to illustrate how structuration theory can be used to make sense of the social processes of accounting. Although the case was not originally written from the structuration theory or structural hole perspective, it describes social processes (political game) that can be understood in terms of these chosen theoretical perspectives. An existing case study was chosen because its later adoption (Macintosh and Scapens, 1990) provides a good illustration of structuration. It therefore gives a familiar platform (also discussed by Boland, 1996 and Scapens and Macintosh, 1996) for further analysis. Essay 3 does not solely rely on "old data", but is supplemented and enriched by archival records. These records consist of online information, newspaper articles, and books relating to local politics and history.

Research method

In conducting the interviews for essays 1 and 2, discussion guides were used that moved from company-specific to market-specific issues. Emphasis in all the questions was on how the interviewee framed and understood remuneration practices and process – that is, what the interviewee viewed as important in explaining and understanding events, patterns, and forms of behavior.

The interviews were semi-structured. The interview protocol (appendix 2) was used to elicit responses rather than followed systematically. Basic topics were covered, but the order of questions and their wording were ad hoc according to the prior responses. The interviewee was allowed to take the lead and to dictate the direction and length of discussion of particular questions. New ideas and questions were allowed to emerge in order to gain further insights about a statement made by the interviewee. New issues, for example, the role of consultants and the consultancy market in increasing executive pay – emerged from the interviewees' expanded commentary on specific questions. A total of 48 interviews were collected. The duration of interviews varied between one and four hours. All interviews were audiotaped and later transcribed.

Analysis of interview data was commenced as soon as the early interviews of the first round were completed in the form of short notes taken during the interviews. The purpose of the notes was to collect cues of key issues, tensions, and moments of inspiration. This practice helped to focus the interview, add new questions or refine old ones. Certain tensions and problems in the SOE remuneration design process became apparent very soon after the first interviews with CEOs and chairmen were conducted. The coding process took place after the interviews were transcribed, and reflected these tensions and problems, as well as the solutions to the problems.

During the consultant interviews special attention was given to issues relating to consultants' relationships with clients, their form of influence, and the interpretation of remuneration guidelines. Within this coding process certain themes begun to reappear that were confirmed by the critical, repeated, and careful reading and analysis of the transcripts, and through discussions with the other members of the research team. In the analysis, focus was on the tensions evidenced by the data (Ahrens and Dent, 1998).

Research is always a social process, initiated by the researcher's own interests towards certain issues, and therefore prone to subjectivity. In addition to influencing the research topic and methods, the researcher can also influence the content of research findings. Several measures were taken to avoid bias in research process. Firstly, interview questions were partly drawn from prior corporate governance research. The questions were general by nature taking into account the fact that the prior research is heavily agency theory driven. Further, the interviewees were allowed to take the lead during the interviews and discuss the topic using their own meanings systems.

Secondly, the data collection was not driven by a certain theory; in contrast, the purpose was to avoid prior theory selection. During the research process the data was tested against several theories (e.g. agency theory, actor-network theory, old institutional economics, Porter's theory of competitive advantage, social learning theory, structuration theory, structural hole theory, consultant-client interaction model), highlighting the analysis of tensions in the process (Ahrens and Dent, 1998). For example, although both actor-network theory and old institutional economics perspective analyze similar-looking relationships between actors and networks and rules and routines than structuration theory and structural hole theory, their focus and underlining assumptions are different. Actor-network theory assumes that all actors are of equal importance in the network, including non-humans such as texts and machines (Callon, Law and Rip, 1986). People are not necessarily important. This research, however, focuses on human agents that are active and entrepreneurial –they are agents because of their competence, power, skills and knowledge. Actor-network theory does not consider a pre-existing social structure important (including power) in contrast to structuration theory, which holds that all human action is performed within the context of the pre-existing social structure. In this research the remuneration guidelines are not considered as a technical element that would have an equal role or power in the network of human agents. The guidelines are understood as modalities (structuration theory; Giddens, 1984), the means by which structures are translated into action. The problem with the old institutional economics perspective is that it focuses on institutions and organizations, mainly institutions matter (Hoque, 2006). The structuration theory gives equal weight for both the agent and structure. Also, structural hole theory (Burt, 1995) belongs to the field of new economic sociology that focuses on social consequences of economic exchanges and is therefore in a better position to address corporate governance issues than old institutional economics perspective, which (unlike structural hole theory) rejects neo-classical theorizing that places emphasis on assumptions pertaining to optimization and rationality (Zafirovski, 2005). As a competition theory structural hole theory is well suited to studies that focus on for-profit firms (SOEs and consultancies) and their agents. The selected theories (structuration theory and structural hole theory) were chosen because they enable equal analysis of agent and structure, best fit the evidence and thus provide good explanation power.

Thirdly, the data and the interpretations were discussed with other researchers, individuals who were part of the same research team as well as colleagues in seminars and conferences. Finally, triangulation (Stake, 1995) was used throughout the research process; multiple points of view are represented through different theories, and from more than one data source (interviews and archival records).

ESSAY SUMMARIES

Essay 1: The Intended and Unintended Consequences of Remuneration Reform: Evidence from Finnish State-Owned Enterprises

The first essay of the dissertation analyses the meaning of remuneration reform in Finnish state-owned enterprises (SOEs) and the outcomes that result from the remuneration reform. Although remuneration reforms have taken place in many countries it is not clear how effective they have been in altering pay-setting processes (Thompson, 2005), and whether the reforms really have changed executive compensation in the desired direction (Jensen, Murphy and Wruck, 2004; Matsumura and Shin, 2005; Bender and Moir, 2006). Prior research suggests that compliance with regulation does not ensure ethical remuneration from a shareholder perspective (Bender and Moir, 2006), and reforms will not necessarily resolve the problems and issues as intended (Matsumura and Shin, 2005; Thompson, 2005). Reforms have, however, facilitated the role of institutional shareholders in approving remuneration packages (Thompson, 2005). The question of why reforms facilitate the approval of inefficient corporate governance practices motivated this research. We still know little of the influence of politicians in remuneration reform processes although reforms are political. This limits our understanding of effective and ineffective corporate governance.

Agency theory has contributed greatly to corporate governance and remuneration research, but it provides only a limited view of the control mechanisms and their processes in social structures. It also fails to capture action between different structures. In addressing the reasons for remuneration reforms in SOEs and the intended and unintended consequences that follow, this essay draws on structuration (Giddens, 1984) and structural hole theory (Burt, 1995). This novel approach highlights the importance of agency and social networks in remuneration reforms, opening the black box of remuneration reform process. The approach adopted for this research permits analysis from a real world perspective in which behavior and institutions are analyzed in social context (Granovetter, 1985). The focus is on modalities (Giddens, 1984) that both restrict and enable action, or in terms of structural hole theory (Burt, 1995), open and close structural holes.

The empirical analysis indicates that political experimentation with remuneration guidelines does not come without costs and may lead to inefficient governance. The research shows how politicians push, by entrepreneurial action, their political values to remuneration plans via remuneration guidelines, and how these politicians manage to control and maintain the control of the remuneration practices in state-owned companies partly replacing the independent remuneration committee and the board of directors with the guidelines in the process. Although the guidelines lower politicians' monitoring costs, they also create costs that are difficult to value, such as the cost of inefficient governance, borne out of opaque political action. The costs, however, are not borne by politicians, who are mainly interested in political benefits.

Remuneration guidelines can be used for both entrepreneurial and collective purposes because the benefits can be shared with other political agents with similar objectives. However, these benefits do not come without costs: the guidelines may decrease management's motivation to take risk and create shareholder value, put pressure on the boards of directors to raise fixed salaries and bonuses, and legitimize the same bonus levels for all SOEs regardless of their size, thereby benefiting small companies. Furthermore, the guidelines permit loopholes, encouraging opportunistic behavior by management. The unfortunate outcome of the process is that minority shareholder rights suffer if remuneration is not guided by shareholder interests but rather by political interests, and used for other than shareholder value creation.

The essay contributes to the literature on corporate governance and remuneration reform (Thompson, 2005; Matsumura and Shin, 2005; Bender and Moir, 2006) by highlighting the importance of human factors in reforms. The research also contributes to the literature on blockholders (e.g. Holderness, 2003; Shleifer and Vishny, 1997), finding that a politician, acting as a blockholder on behalf of a state, has a great interest to not only to monitor but also influence the designs of managerial remuneration, regardless of the size of the state ownership. In addition, the voluntary codes pushed by a blockholder can hurt the minority shareholders if they are shareholder value destructive. The guidance may serve to make the boards distracted by the political pressure and interests that do not pursue only shareholder value. The guidance also protects the boards of directors from having its remuneration practice questioned, and provides legitimacy to the tighter remuneration policy (Main et al., 2008). Finally, three types of blockholder benefits and minority shareholder costs were identified that were not removed by partial privatization of SOEs: the political ability to control the remuneration design; guidelines substituted partly the board and remuneration committee; and loopholes, opportunities in remuneration guidance, which lead to inefficient remuneration contracts and inefficient corporate governance.

Essay 2: How Consultants Increase Executive Remuneration Despite Remuneration Guidelines: A Process Approach

This study seeks to explore the remuneration consultant-client relationship, focusing on what consultants and clients actually do under strong political remuneration guidance. The majority of recent corporate governance and executive remuneration research reports that executive pay is generally higher in organizations that are the clients of consulting firms (e.g. Armstrong, Ittner and Larcker, 2008; Cadman, Carter and Hillegeist, 2010; Conyon, Peck and Sadler, 2009; Kabir and Minhat, 2010; Murphy and Sandino, 2010; Voulgaris, Stathopoulos and Walker, 2010). The findings of these studies indicate that remuneration consultants provide a mechanism for executives of companies to extract and justify excess pay, but did not study specifically what that mechanism is, and how it works. Neither did they research the usefulness of remuneration guidelines as a means to prevent such opportunism.

Because very little in known of the remuneration consultant-client relationship, an explorative field study approach was chosen (Keating, 1995; Scapens, 1990). The role of consultants has been extracted from corporate governance and executive remuneration research, and the empirical evidence used to explore and understand the influence of consultants rather than to test a particular hypothesis about the relationship between consultants' independence and increasing executive pay. The overarching question addressed in this study is: How do consultants engage with the remuneration design process? More specifically, the aim is to explore the consultant-client relationship, focusing on the "challenges" and "solutions" in the process that the consultants are hired to overcome and negotiate, and through which executive pay materializes.

The essay contributes to remuneration consultant and executive pay literature (e.g. Armstrong et al., 2008; Cadman et al., 2010, Conyon et al., 2009; Murphy and Sandino, 2010) by finding that remuneration consultants are not independent and may serve management regardless of remuneration guidelines. The empirical evidence indicates that consultants may use all elements of pay creatively as a means to bypass guidelines and thereby increase remuneration. The mechanisms of the consultant market also play a significant role in the remuneration design process because the competition between consultancies influences the forms, levels, and structures of remuneration designs, thereby explaining ever-increasing levels of executive pay. In order to survive competition consultants have to create innovative pay structures so that they can please their end customer, the management. In addition, the research questions the independence of CEO directors in remuneration committees because, as CEOs, they are possibly former, current, and future clients of consultants, and therefore not necessarily independent in their decision-making.

This study makes at least two important contributions. First, it helps to make sense of the different views and results of previous research that analyze the consultants' influence on executive pay and the board's monitoring role in the process (e.g. Voulgaris et al., 2010; Murphy and Sandino, 2010), and further enriches our understanding of the consultant-client exchange relation. Second, the study provides important understanding to corporate governance of the ways routine practices can bypass rules as well as a rich analysis of the types of consequence caused by forced change. Furthermore, the findings show that the standardization of remuneration practices can be costly. Therefore, it may be inappropriate for regulators to advise all companies to follow the same set of remuneration guidelines.

Essay 3: The modality as a bridging mechanism

Giddens' theory of structuration (1984) has created a small but distinctive contribution to alternative management accounting research (Baxter and Chua, 2003). Although previous research in management accounting is extensive, it is still limited in its ability to explain the link between action and structure (Coad and Herbert, 2009; Englung and Gerdin, 2008; Macintosh and Scapens, 1990:472). This essay draws on research and thinking in sociology that has yet to be brought into the field of management accounting, and demonstrates, through a combination of structuration (Giddens, 1984) and structural hole theory (Burt, 1995), how action and structure interact.

Through a synthesis of structuration and structural hole theory, the essay aims to demonstrate how structural holes emerge in management accounting systems, how new modalities emerge from the agents' use of structural holes, and how a management accounting system that is supposed to protect against opportunism becomes a source of such opportunities. This is achieved by using structuration theory in a flexible manner (Burns and Scapens, 2000; Coad and Herbert, 2009: 192; Macintosh and Scapens, 1990: 470), focusing on the modalities that mediate structure into action between different systems (Whittington, 1992), and that bridge those systems. Although this essay draws on different data than that utilized in essays 1 and 2, the theory has been influenced by the empirical findings of these two prior studies, particularly with regard to how structural holes are used despite the modalities/controls of corporate governance.

The research contributes to management accounting in four ways. First, it proposes structural hole theory (Burt, 1995) as a valuable extension to structuration theory (Giddens, 1984) in order to understand how accounting systems are constructed, maintained, changed, and used through action that is embedded in social relations. Second, it provides a balanced framework with which to explore the governance mechanisms of overlapping structures that neither under-socialize nor over-socialize human action (Granovetter, 1985). Third, from a methodological perspective, a meso-level analysis (analysis of network ties of agent and organization, e.g. analysis of processes of policy implementation) through the use of structural hole theory, bridges the gap between macro and micro levels of structuration, thereby highlighting ongoing processes of social interaction, structure, and agency, a theme that has been underdeveloped by previous research (Coad and Herbert, 2009; Englund and Gerdin, 2008). Fourth, the research also contributes to a fuller understanding of the origins of structural holes by including the role of modality: specifically, how modality is used in creating and bridging structural holes.

Through the analysis of processes of interaction we are able to answer critical questions that help to construct and reconstruct accounting systems: for example, under what conditions is entrepreneurship more or less likely to occur, when are entrepreneurs likely to emerge, why are some actors more successful than others, and why may control mechanisms not work as expected.

CONCLUSIONS

In looking at the empirical findings of essays 1 and 2 it is evident that the 2006 remuneration reform of Finnish state-owned enterprises (SOEs) has not been an ideal example of effective corporate governance. The purpose of the remuneration reform of 2006 was to exclude stock options from the SOE remuneration packages and to ensure that decisions on remuneration will not lead to exorbitant benefits under any circumstances, highlighting the monitoring role of the board of directors in the process. Essay 1 finds that the political intervention (guidelines) did change remuneration practices (removed the stock options from the compensation mix), for good and bad. The guidelines mediated political values into remuneration and possibly reduced managements' risk-taking, harmonizing remuneration schemes in the process. Along with political intervention came unintended consequences, which were mostly economic in nature. The reform of remuneration guidelines potentially decreased management's motivation to take risk and thus create shareholder value, it put pressure on the board of directors to raise management's fixed salaries and bonuses, transformed the bonus ceilings to a new bonus floor, and legitimized the same bonus levels for all SOEs regardless of the size of their organization. Most importantly, the guidelines also partly replaced the functions of the board of directors and the remuneration committee, and potentially introduced deteriorated rights for minority shareholders in the process, with pay proposals that can be shareholder value destructive.

Based on these findings, it seems that strong political guidelines reduce boards' role and power in remuneration design and weaken boards' role as a means of governance. Whether this weakens independent directors' (board of directors) monitoring interest and strengthened their (management) advising interest in remuneration issues remains beyond the scope of this research. However, the steering impact of the SOE remuneration guidelines was short-term. The findings of essay 2, discussed next, show how remuneration consultants assisted their clients (management) in adjusting to the new "no stock options" situation, and in interpreting the guidelines.

Essay 2 looks at the process of remuneration design from the perspective of the board, the management, and the remuneration consultant. Exploring the remuneration consultant-client relationship, focusing on what consultants and clients actually do under strong political remuneration guidelines, the research finds that remuneration consultants played a significant role in detecting loopholes in remuneration guidelines and in legitimizing them – a practice that led SOEs to bypass stock options with share-based remuneration, and kept the executive remuneration at “fair market level”. Consultants identified their end customer to be the management of the organization. It seems that successful consultants know without executives’ formal influence (e.g. presence in remuneration committee meetings) what executives need and want in terms of remuneration. Furthermore, successful consultants’ seem to have long-term relationships with their customers, in which mutual trust plays an important role. These relationships go beyond those of the remuneration committee and consultant, which are still relatively new partners.

The state-owner, like institutions in general (Fich, 2005), seems to favor nomination of former or current CEOs to the SOE board of directors and remuneration committees. This is understandable; who could monitor CEO better than his/her peers? The current research, however, questions the outside directors’ monitoring ability (e.g. Fahlenbrach et al., 2008; Faleye, 2010). Faleye (2010) finds that CEOs are paid significantly more and their remuneration is less sensitive to firm performance when other CEOs serve on their boards. These results and the findings of essay 2 can be explained by “mutual back-scratching” (Adams et al., 2009:30). All CEOs are most likely former, current, or future (end) clients of remuneration consultants. Therefore, it appears unlikely that CEO directors would “rock the boat” (Adams et al., 2009: 42); after all, they are all in the same boat. CEO directors are poor monitors of executive pay because it is not in their interest to moderate it, all executive pay being bounded to a benchmark, controlled, and legitimized by remuneration consultants. This informal social executive network, controlled by a dominant remuneration consultancy, may reduce a CEO director’s interest from standing against changes to CEO pay.

Why do reforms facilitate the approval of practices that appear to be inefficient and inconsistent with shareholder value premise? This research has provided two answers to this question. Firstly, political reforms provide faith and security to taxpayers and other stakeholders that the "design faults and operator failures" (Giddens, 1990: 151) of remuneration are repaired. However, reform is unable to protect against unintended consequences, and reflexivity of social knowledge: "No matter how well a system is designed and no matter how efficient its operators, the consequences of its introduction and functioning, in the contexts of the operation of other systems and of human activity in general, cannot be wholly predicted. One reason for this is the complexity of systems and actions that make up world society." (Giddens, 1990:153)

Secondly, remuneration guidelines do not only constrain but also enable, providing rules that allow new actions (also agency problems), structural holes (Burt, 1995), and as a result, new structures. (How structural holes emerge, how new modalities emerge from agents' use of structural holes, and how a system that is supposed to protect against opportunism becomes a source of such opportunities, is discussed in essay 3.) This dissertation provides two examples of the use of structural holes (essays 1 and 2) in the remuneration context. Although the politicians used the remuneration reform for collective and private benefit (essay 1), so did those monitored and controlled (executives) by looking for loopholes in guidelines. Some of the holes the remuneration guidelines opened up were captured and closed by consultants, and used to improve their business (essay 2). These holes are the result of unintended consequences of political action. According to Giddens, unintended consequences persist no matter what, because reflexivity of social knowledge affects, in the first instance, the social rather than the natural world. New knowledge spins the social world off in new directions. Agents' values and knowledge are connected (Giddens, 1990:54), but the result and the extent that new knowledge changes values is always unknown beforehand. Therefore, we never really know, in advance, the effects of corporate governance reform.

To conclude, this dissertation highlights the importance of social networks and relationships between overlapping structures, which help to understand agents' motives of action.

Understanding the intentions and motives, in turn, provides insights into the structures that agents pursue relative to structures striven by institutions and/or organizations (e.g. political parties). Corporate governance, in general, promotes the use of generic voluntary codes to enhance remuneration practices. Politicians, however, can drive remuneration reforms and push remuneration policies and codes that go far beyond "best practices", codes that appear inefficient and harmful when analyzed closely with reference to the process of executive remuneration design.

In interfering with the SOE remuneration practices, the politicians failed to understand the power, influence, and interests of the social actors (the target group of the reform), and the social rules that govern remuneration practices. At the meso-level (policy implementation) the remuneration reform failed. What can we learn? Political reforms are never value free and neutral, but are driven by interest group politics. Before reform of design we should analyze how, why and under what conditions a reform might work or fail to work, and seek a greater understanding of the contextual factors, mechanisms, and processes underlying a political governance reform. Even if we cannot control the modality/guidelines we should seek to understand it in-depth in order to hedge against unintended consequences. If we do not wish to do this, then it is better to stick to general guidelines and governance than push guidelines that harm the aims of good corporate governance and political governance.

For future research, the author leaves the following hypothesis:

"The benefits of structural holes are the greatest, and the impact of social norms the weakest when corporate governance regulation is strong".

APPENDICIES

Appendix 1: information of case companies

Type of company	Ownership of state (%)	Industry	Turnover (million €)	One-tier or two-tier	Type of chairman / majority of board members	Remuneration systems
Non-listed	100	printing	100-200	One-tier	exec / exec	sal+bon
Non-listed	100	procurement	less than 10	One-tier	civil serv / civil serv	sal+bon
Non-listed	100	retail sale of alcohol bevereges	500-1.000	Two-tier	indep / indep	sal+bon
Non-listed	100	lottery	1.000-2.000	Two-tier	exec / exec	sal+bon
Non-listed	100	logistics	1.000-2.000	Two-tier	indep / exec	sal+bon
Non-listed	100	railroad traffic	1.000-2.000	Two-tier	exec / exec	sal+bon
Non-listed	100	distilling, rectifying and blending of spirits	200-500	One-tier	indep /exec	sal+bon+share
Non-listed	100	specialised governmental credit institution	100-200	Two-tier	civil serv / civil serv	sal+bon
Non-listed	100	striking of coins	100-200	One-tier	exec / exec	sal+bon
Non-listed	85	maintenence and repair of motor vehicles	100-200	One-tier	exec/ exec	sal+bon+share
Non-listed	73	defence equipment	200-500	Two-tier	exec / exec	sal+bon
Listed	57	air transportation	1.000-2.000	One-tier	exec / exec	sal+bon+share
Listed	51	electric services	2.000-5.000	Two-tier	exec / exec	sal+bon+share
Listed	50	petrolium refining	5.000-10.000	Two-tier	exec / exec	sal+bon+share
Listed	49	chemical products	1.000-2.000	Two-tier	exec / exec	sal+bon+share
Listed	40	steel product manufacturing	5.000-10.000	Two-tier	exec / exec	sal+bon+share
Listed	31	iron and steel mills	5.000-10.000	One-tier	exec / exec	sal+bon+share
Listed	34	real estate investment trust	100-200	One-tier	exec / exec	sal+bon
Listed	30	agricultural chemicals	1.000-2.000	One-tier	exec / exec	sal+bon+share
Non-listed	24	wholesale of liquid and gaseous fuels	500-1.000	One-tier	exec / exec	sal+bon
Listed	14	financial services	5.000-10.000	One-tier	exec / exec	sal+bon+share
Listed	12	paper mills	10.000-20.000	One-tier	exec / exec	sal+bon+share
Listed	11	Industry machinery	2.000-5.000	One-tier	exec / exec	sal+bon+share

Type of chairman / board structure: exec = current or former executive of other company, civil serv = civil servant, indep. = independent (e.g. professor). Compensation systems: sal = salary + fringe benefits, bon = bonus, share = shares (not options).

The list of case companies includes all largest SOEs. All information is based on the situation at the end of 2006.

Appendix 2: list of semi-structured interview questions

General questions to CEOs and Chairmen of the board of directors/remuneration committees, which were prepared in order to start and focus the interview:

1. Could you please describe the process of remuneration design?
2. Who designs CEO's incentives?

3. How much time does the remuneration committee use for remuneration design?
4. Do you use consultant(s) in the process of remuneration design?
5. What kind of services do the consultant(s) offer: Which of these does your company acquire from the consultant(s)?
6. Are the remuneration designs working as expected?
7. Do you benchmark remuneration? How/Why?
8. Are there any weaknesses in your remuneration designs?
9. How do you feel about the remuneration guidelines from the Finnish government?
10. What is the meaning of the guidelines?
11. How do you feel about the transparency in remuneration disclosure?
12. How should remuneration designs be developed in the future?
13. Is there anything that you would like to add/discuss that has not been covered yet?

General questions to the consultants:

1. What kind services do you offer?
2. What is your market share? Does it affect your service portfolio? How?
3. Who are your competitors?
4. Why are you hired for remuneration design?
5. What does the consultant work consist of?
6. What is the consultant’s role in remuneration?
7. Could you please describe the process of remuneration design?
8. What are the roles of the CEO and the chairman of the remuneration committee?
9. With whom do you make the first contact in the company? Who is your client?
10. Who defines CEO’s pay?
11. Why is a remuneration consultant used?
12. How do you feel about the remuneration guidelines from the Finnish government?

13. How have the companies (management and board) reacted to the guidelines?
14. What is the purpose of the guidelines?
15. Are there differences in remuneration designs between SOEs and other (private) companies?
16. Do shareholders and management have differences of opinion in the remuneration issues? If so, what are they and how are they overcome?
17. Do the guidelines affect your work/use of consultants/consultant business?
18. What is the purpose of remuneration?
19. How do you find the "right" remuneration level?
20. What is your biggest challenge in remuneration design?
21. What are the future trends for remuneration?
22. Is there anything that you would like to add?

In addition, probe questions were employed to obtain rich detail to the principal question, for example: Can you give me an example of that? How did that affect the organization/person/committee etc.?

Appendix 3: Finnish corporate governance environment

Corporate governance systems differ at country level. Weimer and Pape (1999) divide countries under four corporate systems: the Anglo-Saxon, the Germanic, the Latin and the Japanese system, and analyze each of these systems under eight characteristics, which are the prevailing concept of the firm, the board system, the stakeholders ability to exert influence on managerial decision-making, the importance of stock markets in the national economy, the presence or absence of an external market for corporate control, the ownership structure, the extent to which executive compensation is dependent on corporate performance and the time horizon of economic relationships.

In Weimer's and Pape's (1999) analysis Finland falls within Germanic countries. Typical for these countries is that they are seen as network-oriented systems of corporate governance, meaning that oligarchic groups can substantially sway managerial decision-making via networks of relatively stable relationships. The national governance systems have, most likely, developed and changed over the last twenty years. The change in Finland is due to Finland's transition from a credit-based to a capital-market-based financial system, the liberalization of foreign ownership in 1993 and of EU membership in 1995 (Piekkola, 2005). For example, the two-tier boards are no longer common in Finland. Instead, the Finnish Corporate Governance Code encourages independent boards which consist of independent members, affecting also the CEO/chairman duality[3]. For an extensive analysis of the institutional setting of Finnish Corporate Governance and the differences between the Scandinavian civil-law and the American common-law see Kaisanlahti (2002). According to his research the differences in the protection level of minority investors between common-law and Scandinavian civil-law are not as significant as portrayed by e.g. La Porta, Lopez-De-Silanez and Shleifer (1998).

Almost half of the shares in Helsinki Stock Exchange are owned by foreigners[4]. Finnish households are also active investors and currently hold 20 percent of the shares on Helsinki Stock Exchange. Other large stakeholders are financial institutions, firms, institutions (e.g. government) and nonprofit organizations. Institutional investors as shareholders are not regulated by Finnish law; nor does the Corporate Governance Code establish any particular duties for institutional investors.

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[3] http://www.cgfinland.fi/

[4] http://www.porssisaatio.fi/info/osakeyhtioiden-omistus

The influence of shareholders is not as institutionalized in Finland as it is, for example, in the U.S. (Weimer and Pape, 1999). Although the creation of shareholder value is understood as the key purpose of the managerial directors and the firm, an active takeover market for corporate control does not exist in Finland in the same sense as in the U.S or in the UK. Also, stock market plays a less important role in the Finnish economy than in the Anglo-Saxon countries. The ownership concentration is higher Finland than in the U.S or in the UK, and institutional investors play an important part in Finnish economic life as significant or noteworthy stakeholders in many companies, including the SOEs.

The use of performance –related pay became popular in Finland in the late 1990s (Piekkola, 2005) and performance-related remuneration is common, also in Finnish SOEs (Ikäheimo, Kontu, Kostiander, Tainio and Uusitalo, 2007). Under the Finnish Companies Act (624/2006) the decision on the remuneration of members of the board of directors is made by the general meeting of shareholders of the company. Decisions on the remuneration of the managing director and other operative management and other executives, on the other hand, are made by the board of directors. Decisions on any management share based incentive schemes are made by the general meeting. The board may also be authorized by the general meeting to decide on share based incentive schemes. In practice, it is often the board of directors who decide on the division of the share based incentives.

Finally, considering the stakeholders' time-horizon Weimer and Pape (1999) find that the Germanic countries employ a longer-term time horizon for economic relationships than the Anglo-Saxon countries. This seems to hold at least in Finnish SOEs as the sizable and stable shareholdings by institutions (especially the government), allow for long-term and stable economic relationships.

Appendix 4: Some central theoretical concepts

Corporate Governance: set of processes, customs, policies, institutions and laws affecting the way a corporation is directed or controlled. In this study includes the relationships of the following stakeholders: shareholders, board of directors, executives and experts (remuneration consultants).

Effective Corporate Governance: governance is effective when it fulfills its purpose; for example, when it improves processes that increase shareholder value.

Structure in structuration theory (macro-level): rules and resources, exists only as memory traces.

Structure in structural hole theory (meso-level): social network ties between individuals or organizations.

Agent: an entrepreneurial individual with free will, operates in social settings.

Institution: a mechanism of social order, governs the behavior of individuals; reproduced rules and resources which are given solidity across time and space (structuration theory).

System: the patterning of social relations across time-base, reproduced relations between actors or collectivities.

Rule: specifies the rights and obligations of agent.

Norm: moral code, shared set of values and ideas: what is regarded as wise and what is to be trivialized.

Culture: man actively shapes the world he lives in at the same time as it shapes him, generated through the agent-structure interplay (structuration theory).

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PART II

THE ESSAYS

The Intended and Unintended Consequences of Remuneration Reform: Evidence from Finnish State-Owned Enterprises

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Abstract

This paper analyses the meaning of remuneration reform in Finnish state-owned enterprises (SOEs) and the outcomes that result from such reform. Drawing on unique data based on interviews conducted in 23 Finnish state-owned enterprises and with politicians and institutional investors, the research finds that political experimenting with remuneration guidelines does not come without costs and leads to inefficient governance. The research shows how, through entrepreneurial action, politicians push their political values into remuneration plans via remuneration guidelines, and how politicians manage to control and maintain the control of the remuneration practices in state-owned enterprises, and in the process, partly replace the remuneration committee and the board of directors with the guidelines. On the other hand, the guidelines allow loopholes that may encourage opportunistic behavior by the firms' management. The unfortunate outcome of the process is that minority shareholder rights suffer if remuneration is guided by political interests rather than shareholder interests, and used for purposes other than for shareholder value creation, motivating opportunism at the same time. The research contributes to corporate governance literature by drawing attention to the corporate governance guidelines and the corporate governance of listed SOEs. It also extends the research linking blockholders' benefits and costs, and control systems with remuneration and voluntary codes.

Keywords: Corporate Governance, reform, remuneration, SOEs, voluntary codes, blockholder, structural holes, structuration theory

Introduction

There has been much discussion of the policy reforms that are required to overcome the failures of executive remuneration observed over the last ten years. Most of this deals with exorbitant rewards that executives receive and concerns about the social fairness of pay. Although remuneration reforms have taken place in many countries it is not clear how effective they have been in altering pay-setting processes (Thompson, 2005) and if the reforms have really changed executive compensation in the desired direction (Jensen, Murphy and Wruck, 2004; Matsumura and Shin, 2005; Bender and Moir, 2006). For example, we are seeing record high levels of executive bonuses in the banking sector only a year after the financial crisis of 2008-2009 that drove many of the banks in the US and in Europe into the hands of taxpayers[5].

The question of whether and to what extent executive remuneration practices are imperfect is important for shareholders and policymakers because defects in pay arrangements can impose substantial costs on shareholders (Bebchuk and Fried, 2004). Corporate governance starts from the premise that remuneration is guided by shareholder interests, and thus increases shareholder value (Jensen, Murphy and Wruck, 2004). It serves as a basis for rules and regulation and is used to justify remuneration decisions to shareholders, policymakers, and other stakeholders.

Understanding the reasons for remuneration reforms and finding consequences in the design of reforms have become important as general codes of corporate governance are questioned, harmonized, and substituted with specific rules[6]. Although much has been written about executive remuneration, less is known about why remuneration reforms are executed and with what kind of consequences. The previous studies upon which this study builds suggest that, from shareholder perspective, compliance with regulation does not ensure ethical remuneration (Bender and Moir, 2006), and reforms will not necessarily resolve the problems and issues as intended (Matsumura and Shin, 2005; Thompson, 2005). Although failing to link executive rewards with performance, Thompson (2005) suggested that reforms have facilitated the role of institutional shareholders in approving remuneration packages. The way

[5] See for example The New Your Times, August 31st 2010: “Bank bonuses, bigger than ever, in the spotlight”.

[6] The Financial Services Authority (FSA): http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_19.shtml.

by which reforms facilitate approval of practices that appear inconsistent with the shareholder value premise provides a starting point for this research.

The lack of studies that address the influence of politicians in remuneration reform processes limits our understanding of effective corporate governance. Research that integrates politics into the question of imperfect remuneration practices is rare due to the difficulties of gaining access to interview board and committee members, CEOs, and politicians. Since the exchange of politicians, executives, and chairmen of boards is embedded in ongoing social practices (Granovetter, 1985) governed by corporate governance and remuneration guidelines, it is essential to focus on the purposes of remuneration reform and the reception it has received, in order to understand the reform and its consequences. Unmasking this knowledge requires a focus on the action of politicians, executives, and chairmen, the rules and routines guiding their action (governance and practice), and the benefits and costs attached to them (motives and risks).

To address these issues in corporate governance, this article takes a qualitative approach and adopts a field study methodology (Hoque, 2006), focusing on richness and depth of detail (Ahrens and Dent, 1998) – following the injunctions of Eisenhardt (1989) and Tosi and Gomez-Meija (1989) – and seeks to find new theory by looking inside the black box of remuneration reform with the aim of exploring and understanding the remuneration reform process and its outcomes. To avoid the undersocialized conception of human action (Granovetter, 1985:483) often associated, for example, with agency theory this study takes a social constructivist approach (Emirbayer and Goodwin, 1994:1431) by proposing that understanding remuneration reform can be increased if it is studied with reference to what is actually done under various settings, going beyond the named role positions of politicians, executives, and chairmen of the boards of directors. Although agents can act within the roles assigned to them they can also modify and abandon those roles, which may lead to unintended consequences of action.

According to Ahrens and Chapman (2005), Granlund (2001), and Eisenhardt (1989), events in the field may best be explained with reference to multiple theories. In this study the economics-based agency theory of incentives research is replaced with social approach as suggested by Granovetter (1985), Merchant, Wim and Liu (2003) and Matsumura and Shin (2005). To capture the social dimensions of concepts of remuneration reforms and for theory building, techniques from Giddens' structuration theory (1984) and from Burt's structural hole theory (1995) are combined and integrated with empirical research (Laughlin 1995, Humphrey and Scapens 1996). Whereas agency theory takes the shareholder-board-management structure as given and treats the social mechanisms of a company as a black box, structuration theory helps us to focus on the social structure and its workings and processes. Structural hole theory is then used to illuminate the action of the individual agents in the social structure and the power of a position within the structures.

The focus of the previous research has been on the outcomes of remuneration reforms (e.g. Matsumura and Shin, 2005) rather than on the process of reform. Therefore, the motivation in conducting this research is to examine the process behind the remuneration reform, to understand the reasons for the reform, and the outcomes that result.
The overarching questions addressed in this study are:

1) What are the processes of and reasons for remuneration reforms in SOEs:

a) How do politicians bring their values to remuneration plans through guidelines?

b) How have CEOs and Chairmen proacted and reacted to this, and how have they understood it?
2) What are the consequences of the design and redesign of compensation reforms:
a) What are the intended consequences of the structural collisions?
b) What are the unintended consequences of the structural collisions?

The study draws on interviews conducted in 23 Finnish state-owned companies of which 11 are listed on OMX Nasdaq Helsinki. In addition, politicians, and two major institutional investors in Finland were interviewed to extend the data. Responses gathered during these 44[7] interviews (CEOs, chairmen, politicians, civil servants and institutional investors) are used to trace the reasons for remuneration reforms in SOEs and the consequences that result from such reforms. The reason for choosing Finnish state owned enterprises (SOEs) as the context for this study is that their remuneration practices are heavily influenced by political guidelines. SOE remuneration practices are reviewed often and "unreasonable" elements are expected to be removed from the pay packages, setting remuneration at a level that politicians regard to be competitive. The way in which SOEs structure their remuneration in order to adapt to this constraint, and what type of behavior it drives is of interest.

This study contributes to corporate governance, executive remuneration, and remuneration reform research, and the current debate of political intervention in remuneration practices. It presents unique data of state-owned enterprises in the field of corporate governance and remuneration that has not been researched previously, and provides two new sociological perspectives, structuration theory (Giddens, 1984) and structural hole theory (Burt, 1995), to the discussion of political intervention in remuneration. The research finds that political

[7] In a few cases the roles of CEO and chairman of the board (in another SOE) overlapped, and both roles were addressed during the interview.

experimenting with remuneration guidelines does not come without costs and may lead to inefficient governance. The research shows how, through entrepreneurial action, politicians push their political values in to remuneration plans via remuneration guidelines, and how politicians manage to control and maintain the control of the remuneration practices in state-owned companies partly replacing – with the guidelines – the independent remuneration committee and the board of directors. Although the guidelines lower politicians' monitoring costs, they also create costs that are difficult to value, such as the cost of inefficient governance borne out of opaque political action. Remuneration guidelines can be used both for entrepreneurial and collective purposes[8] because the benefits can be shared with other political agents with similar objectives. However, these benefits do not come without costs: the guidelines may decrease the motivation of firms' management to take risk and create shareholder value, put pressure on the boards of directors to raise fixed salaries and bonuses, and legitimize the same bonus levels for all SOEs regardless of their size, from which small companies benefit. Furthermore, the guidelines allow loopholes that encourage unethical behaviour by the firms' management. The unfortunate outcome of the process is that minority shareholder rights suffer if remuneration is guided by political interests rather than by shareholder interests, and used for other than the creation of shareholder value.

The paper proceeds as follows. The next section describes the theoretical approaches of this research, followed by the research design. Thereafter, a description of the setting in which the remuneration design takes place as well as the historical background against which the results of this research are set are discussed. This is followed by the presentation of the findings, which are then discussed. The final section offers a conclusion and recommendations for further research.

[8] e.g. political purposes

Theoretical approaches

In tracing the reasons for remuneration reforms in SOEs and in examining the consequences in the design and redesign of remuneration reforms, the central concepts and theory building techniques of two theories have been adopted and integrated with empirical research (Laughlin 1995, Humphrey and Scapens 1996). These theoretical approaches are, structuration theory (Giddens, 1984) and structural hole theory (Burt, 1995). These sociological theories were chosen because the research approach required a less restricted view of the principal-agent relationship than that offered by agency theory, a practice suggested by Merchant et al. (2003) and Matsumura and Shin (2005). Agency theory has contributed greatly to corporate governance and remuneration research, but it provides only a limited view of the control mechanisms and their workings in social structures. It also fails to capture action between different structures. The approach adopted for this research allows analysis from a real world perspective in which behavior and institutions are analyzed in their social context (Granovetter, 1985). Incorporating "virtual" social structures and "visible" social networks into analysis of remuneration reform leads to a more comprehensive view of the behavior and influence of agents involved than is currently available, and a deeper understanding of the benefits and cost of both information and control at the micro (agent) and macro (institutional) level of corporate governance.

Structuration theory helps us to focus on a social structure and its workings, and is ideal when examining development projects (e.g. Granlund, 2001) and processes. It takes us in the black box of remuneration design, thereby highlighting its social mechanisms, and deepens our understanding of reform as a social phenomenon, as well as the change process involved in the virtual social structures. Although structuration theory has gained a firm foothold in management accounting research (e.g. Macintosh and Scapens, 1990; Whittington, 1992; Scapens and Macintosh, 1996; Granlund, 2001), prior research has given no consideration to the implications of structural hole theory on corporate governance issues, such as remuneration reforms. However, the theory offers great potential for understanding agent's behavior and action in the process of designing remuneration reform, especially in the case when two systems interact (Whittington, 1992) – for example political and economic systems. Structural hole theory complements structuration theory by illuminating the action of the individual agents in the social structures, and the power of a position within the structures. Thus, there is considerable scope for a melding of the two approaches. Following the guidance of Ahrens and Chapman (2005, 5), Granlund (2001) and Eisenhardt (1989), and the practice of Main, Jackson, Pymm and Wright (2008) and Bender (2007), that events in the field are explained by reference to multiple theories, structuration theory and structural hole theory together are used to illustrate how political values are mediated to remuneration and with what consequences.

Modalities of structuration

Theoretically, this paper builds on the modalities of structuration introduced by Giddens (1984, 29). The focus is on remuneration guidance, the modality of a structural system, the means by which structures are translated into action (Giddens 1984, Macintosh and Scapens 1990), and on agency, referring to an entrepreneurial (Burt, Jannotta and Mahoney 1998, 74-75; Burt 1995; Yang, 2004; Young and Sundavarajan, 2006, 5) individual with free will (Giddens 1984, 5) operating in social settings. An agent recognizes social structures, uses them as a base of action, and reshapes the structures for his or her advantage (Giddens, 1984). He also understands the great value of the social networks that surround him, and is ready to use the networks for his advantage. Although an agent may be proactive and pursues change he reflexively monitors social settings, his own and others. Like the agents of this study – politicians and managers – they know a great deal about why they act and what they do.

Remuneration guidance incorporates the relationship of agents and institutions: agents draw upon certain structures in their daily action, and as they do so also reproduce those same structures and as a result, legitimate eventually them. Structure can be analytically divided into three dimensions. The first one, the signification structure (Giddens, 1984) comprises the shared rules, concepts and theories which agents draw upon to make sense of the meaning of practices, such as corporate governance. Interpretive schemes that are situated between overlapping worlds may specially challenge interpretation and produce multiple interpretations of interpretive schemes. When making sense of the meaning of the practises agents draw first on the meanings and understandings that are most familiar to them, those that come from their own world (Whittington, 1992). This may lead to conflict and struggle over interpretation of meaning. Conflict is evident if the agents from either or both worlds resist the prevailing structures and pursue change for some reason.

The second dimension of structure, legitimation (Giddens, 1984), is mediated through norms that sanction behavior. The legitimation structure institutionalizes the rights and obligations of agents. It describes what kind of action is approved and what is disapproved, and how agents are rewarded or penalized as a result of action. Legitimation practises structure agent behavior, but agents can also use these practises to achieve social approval for their action. The third dimension of structure, domination, consists of the mobilization of two types of resources: allocative and authoritative (Giddens, 1984, 33). Whereas allocative resources arise from the command over objects and goods, authoritative resources refer to capabilities of social actors to organize and coordinate the activity. These resources support the process of action, but at the same time provide a medium for the exercise of power. They are also unevenly distributed among agents, so command over of human, financial or information resources, for example, can be used in the exercise of power.

Agents differ in their abilities to shape and influence changes in structures. Some agents hold a more powerful position than others. In this paper power is addressed as a means to secure and control productive relationships that overlap[9] political and economic worlds. Power implies domination (Giddens 1984, 15-16; Macintosh and Scapens 1990, 461). As Macintosh and Scapens (1990, 461) put it: "Agency and power are related in that agency entails the ability to act otherwise, to be able to intervene in the world, or to refrain from intervening." The agent makes the choice. Choice is possible, because more than one course of action is acceptable within the social structures. For example, politicians have several ways to influence remuneration issues in SOEs. They can legislate on remuneration[10], they can issue corporate governance guidelines incorporating political values, or they can abstain from intervening and trust the board of directors in undertaking their management-monitoring task. In addition, the managers may choose to avoid conflict in remuneration issues by keeping the remuneration schemes at a "modest" level. Or they can try to legitimize higher remuneration levels with the help of remuneration consultants (Conyon, 2008). Both politicians and managers benefit from the knowledge of other worlds, and their practices[11]. Thus, agents' access to different social worlds and structural rules enable stronger and more powerful agency.

[9] By overlapping worlds I mean the different social worlds that agents engage in. They are divided by a social frontier; anyplace where two social worlds meet, where people or organizations of one kind meet people or organizations of a different kind. See Burt 1995, p.132.

[10] For example in the Act of State Shareholdings, (1368/2007)

[11] Such as economics, politics, patriotism, family, church, hobbies (Whittington, 1992)

Agency and the overlapping worlds

The connection between an agent and a social system is known by various names; for example, a role or a position in a social system. According to Giddens (1984, 84) social position can be regarded as a social identity that carries with it a certain range of prerogatives and obligations that an agent who is accorded that identity may activate or carry out. The agents in which relations intersect are physical and legal entities: a person, a group, an organization. Sometimes social worlds (Whittington, 1992) overlap through common members. Sometimes they are completely distinct with no ties to each other. When social worlds lack ties to each other, the gap between them is a structural hole (Burt, 1995).

Structural holes provide opportunities for agents to bridge networks (Burt, 1995; Mitchell 2003) of social worlds. Networks provide agents with resources (Whittington, 1992, 704) with which to effect change, and create conditions for entrepreneurship (Goddard, 2009). For entrepreneurs structural holes are opportunities for information access, timing, referrals, and control (Burt 1995, 13). According to Burt, information does not spread equally across the social frontier because agents are unevenly connected with one another. Access, the first of the information benefits, refers to receiving a valuable piece of information and knowing who can use it. Timing is also significant with regard to the information received: beyond ensuring that one is informed about important issues, personal contacts can make an individual one of the agents who are informed early (Burt, 1995, 46). Moreover, the same information has greater legitimacy when it comes from someone inside the decision-making process who can speak to one's virtues. Recommendations from trusted contacts (friends or colleagues, for example) or "the referrals" as Burt calls them, can solve the issue of legitimacy of the information, because they ensure that the agent's interests are represented in a positive light (Burt 1995, 47).

Agents do not simply conform to rule-bound environments, they also reshape those environments through their own actions (Giddens, 1984). Opinions and behavior are more homogeneous within than between groups, so agents connected across groups are more familiar with different ways of thinking and behaving (Burt, 2004: 349). As social structures are always both constraining and enabling (Giddens 1984, 25), agents can exploit rules and resources in order to legitimate their conduct (Whittington, 1992, 706). People whose networks bridge the structural holes between groups have an advantage in detecting and developing rewarding opportunities (Burt, 2004: 354). These agents see things early and more broadly, and translate information across groups. According to Burt (2004: 355) agents familiar with activities of two groups are more able than those confined within either group to see how a belief or practice in one group could create value in the other, and to know how to translate the belief or practice into language digestible in the other group.

As agents engage in many different social systems they also face a variety of conflicting rules that are most evident on social frontiers. Agents respond creatively to the opportunities that the social worlds present, and they work to loosen constraints that prevent them from doing what they wish. The structural holes that generate information benefits also generate control benefits, giving some actors an advantage in negotiating their relationships (Burt, 1995: 30). Burt breaks the negotiation into three components: structural, motivational and outcome. The social structure defines opportunities, an agent decides whether to pursue such opportunity – and sometimes succeeds (Burt, 1995: 30). In sociological theory this role or position is called the tertius gaudens (Simmel, 1923), the strategist who benefits from the holes (Burt, 1995: 30). The information benefits are closely associated with control benefits, which help agents to identify the advantages of relationships and to understand the resources and preferences being played against one another. Agents who use structural holes can add value through the information and control benefits that reside in those holes (Burt, 1995).

Thus far, structural holes have been discussed in positive light, but they also bear negative effects. Structural holes can be used for manipulation, opportunism and inefficiency. Tertius gaudens, the one who benefits from the holes, can set two distant contacts against each other; for example by feeding them inaccurate or false information or by controlling their relationship. The person controlling a structural hole can create circumstances of imperfect social competition by placing some agents in advantaged positions and restricting the movement of other people so that their movement becomes difficult (Burt, 1995). Whatever the motivation of an agent, the opportunities created by social structure can be used for good or bad, or not used at all (Mitchell, 2003).

From the above, it can be seen that both structuration theory and structural hole theory capture action between structures, recognizing the role of power in the process of change. For this reason they are useful in detecting tensions, challenges, and conflicts arising from competing political and economic interests in executive remuneration. The forthcoming case shows how agents strategically move, brake into structures, and change them over time, and thereby ultimately create new structures. A change in structures is likely to incorporate a mixture of both intended and unintended consequences (Giddens, 1990; Granlund, 2001; Macintosh and Scapens, 1990), with important lessons.

Research design

The aim of this study is to find explanations for remuneration reforms and processes in SOEs and the intended and unintended consequences that emerge from that action. Specifically, this paper examines how politicians bring their values to remuneration plans through Government Decision-in-Principles (remuneration guidelines), how CEOs and chairmen have proacted and reacted to this, and how have they understood it. The research focuses on the reform process that connects restrictive and enabling remuneration guidelines, board of directors, executives, and the remuneration design practices. To accomplish this, the research takes a qualitative approach (Ahrens and Chapman, 2006), following the lead of Bender (2003, 2007), Bender and Moir (2006), and Main et al. (2008). As a study of process, a field study methodology is adopted (Ahrens and Dent, 1998; Hoque, 2006).

The study of agent resistance to control requires the integration of both interpretive and structural elements (Burns and Scapens, 2000). The interpretive element in this study produces accounts of agents' experiences and beliefs about the types of behavior and action that might be called goal incongruent and entrepreneurial. This analysis examines managers', politicians', and institutional investors understanding of and concerns about such forms of behavior; what managers and politicians do, when they do it, how they make sense of their actions, and how – if at all – they share this symbolic world with others. The object of this kind of study will be to understand the remuneration reform and process through agents – in other words, politicians and managers.

The second element of the study comprises an institutional analysis of the organizational context in which the managerial behavior takes place. Remuneration reform is a continuous process. The agents on both sides of the social frontier are active, new information emerges outside the networks, or key agents (such as politicians) change for some reason. This requires an examination of the historical development of current remuneration guidance practices. Historical analyses deepen the research and understanding (Ahrens and Dent, 1998). According to Kieser (1994: 609) structures and behavior in present organizations reflect culture-specific historical developments, and differences between organizations in different cultures can, therefore, only be explained completely if the historical dimension is included in the comparison. Historical analyses also teach us to interpret existing organizational structures as the result of decisions in past choice opportunities, some of which were made intentionally and others more implicitly (Kieser, 1994: 611). This approach provides readers with an understanding of the context in which political and managerial behavior takes place. It helps to explain the pressures to which the agents are exposed, and the extent to which their behavior is reflexive. The focus moves from agents to structures, which are both the outcome and medium of that agency (Giddens, 1984; Granovetter, 1985; Scapens and Macintosh, 1996: 689).

The primary data were collected through interviews and observations. The goal of the interviews was to see the research topic from the perspective of interviewee, and to understand how and why they come to have this particular perspective (King, 2003: 11). According to Giddens (1984: 3) "to be a human is to be a purposive agent, who has both reasons for his or her activities and is able if asked to elaborate discursively upon those reasons". Interviews were chosen as a data collection method because they are a rich source of data and they allow researchers to discover new relationships or situations not previously conceived. Interviews are also an optimal method in a case where there is only a small population of possible participants, such as in this study where all the relevant agents in the field of ownership policy were reached and interviewed.

The interview archive was built by a research team, of which the author was a member, in the course of a research project funded by the Finnish Ministry of Trade and Industry concerning remuneration issues in state owned companies. This took place from November 2006 to January 2007. Altogether 23 largest Finnish state owned companies were contacted[12], and none declined. Of these firms, 11 are Nasdaq OMX Helsinki listed companies. This

[12] Interviewed organizations: Edita Oyj, Hansel Oy, Alko Oy, Veikkaus Oy, Suomen Posti Oyj, VR-Yhtymä Oy, Altia Oyj, Finnvera Oyj, Rahapaja, Raskone Oy, Patria Oyj, Finnair Oyj, Fortum Oyj, Neste Oil Oyj, Kemira Oyj, Rautaruukki Oyj, Outokumpu Oyj, Sponda Oyj, Kemira GrowHow Oyj, Gasum Oy, Sampo Oyj, StoraEnso Oyj and Metso Oyj

amounted to a total of 40 interviews, consisting of CEOs and chairmen[13]. In addition to this group, former and acting Ministers of Trade and Industry responsible for ownership policy, and two major institutional investors in Finland were interviewed to extend the data. This equates to a total of 44 interviews. The focus of this paper is mainly on the data gathered from the listed companies, because their governance is much more interesting and challenging in the political context than the governance of public companies.

The interview process was flexible although a discussion guide was used. The same basic questions were asked of all CEOs and chairmen, but new ideas and questions were also allowed to emerge. Emphasis was on how the interviewee framed and understood remuneration issues and events – that is, what the interviewee viewed to be important in explaining and understanding events, patterns, and forms of behavior (Bryman and Bell, 2003: 344). Observation took place during the interviews. Secondary data were obtained from documentation and archival records. They were used as an additional source of information in making interpretations. They also offered good background material describing the historical development of ownership policy. Documents consist of the Government Decision-in-Principles on the State's Corporate Ownership Policy and other available government memos, annual reports, organizational charts, media texts, and digital materials, such as web pages.

Figure 1 on the next page illustrates the focus of this research. Data analysis is described in the next section with a brief review of the history of the state ownership in Finland, and continues with the history of the remuneration guidance and reforms. Although the focus of the research is on the change of remuneration policy in 2006, the knowledge of the history is necessary in order to understand the actions of the agents and the reasons behind the reform

[13] Some of the interviewed CEOs were also a Chairman in another SOE, and in that case the both roles were addressed during the interview.

process. The section ends with the presentation and analysis of the interview data. The analysis is reported according to the order of research questions posed in the introduction section of the paper.

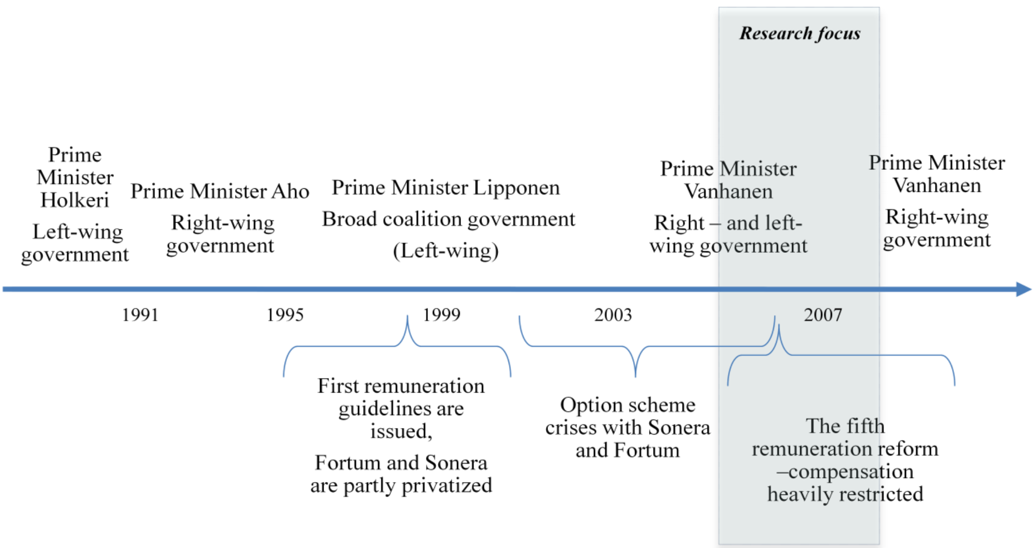

Figure 1. The research focus

Background

Corporate governance is acted on through laws and codes. Codes and principles are often voluntary and largely business driven, and they usually accommodate the circumstances of individual companies; for example, industry and corporate culture. Codes do not normally provide specific rules, but recommend practices to strengthen and enhance internal controls and activities of companies (Boyce, Griffith and King, 2007). Owing to its uniform application, it seems that legislation is most suited to areas where one set of rules can apply fairly to all companies, such as financial reporting standards. If there are justifiable reasons for treating firms differently, codes are seen as a more appropriate method. Therefore, the process of nominating directors to the board (Wong, 2005), transparency, and remuneration, are usually relegated by a code (see e.g. OECD Principles of Corporate Governance, 2004[14]).

Although remuneration codes generally permit flexibility of the choice of remuneration structure, prior research suggests that compliance with codes does not ensure ethical remuneration from a shareholder perspective (Bender and Moir, 2006), and reforms will not necessarily resolve the problems and issues in the way intended (Matsumura and Shin, 2005; Thompson, 2005), thus rising questions of agency conflicts and costs (Jensen, Murphy and Wruck, 2004). Thompson (2005) reviewed the Cadbury reforms and remuneration practices in the UK and suggested that reforms have not been very successful in linking executive rewards with company performance. However, he suggested that reforms have facilitated the role of institutional shareholders in approving remuneration packages. Bender and Moir (2006) examined the effects of corporate governance on remuneration practices in UK listed firms, and found several ways by which following "good practice" might lead to a conflict between shareholders' and managers' interests. Focusing on issues of market benchmark, fairness of pay, use of performance related pay, and executive shareholdings, these authors point out that although transparency is critical in corporate governance, it can lead to unethical behavior and gaming. Because there is no correct number of executive pay, its "fairness" is left for the market to determine, which might not appeal to society. Therefore, conflicts between shareholder, executive, and other stakeholder interests are evident.

[14] *www.oecd.org/daf/corporateaffairs/principles/text*

Taking a US focus, Matsumura and Shin (2005) examined recommendations concerning independent remuneration committees, executive shareholding, and greater disclosure of remuneration practices. They suggested that remuneration reforms do not necessarily resolve problems and issues in the way that is intended. For example, they pointed out that a substantial CEO shareholding may encourage that accounting earnings and gaming be managed with analysts' forecasts of corporate earnings. The findings of previous research reviewed above share a common view; a focus on rules does not specify ethical behavior. Instead, shareholders should evaluate whether a particular behavior is ethical.

Remuneration policy and reforms in Finnish SOEs

The state of Finland addresses remuneration policy in SOEs through two public documents: the Government's Decision-in-Principle (state ownership policy), and the statement by the cabinet committee on economic policy (remuneration guidelines). These documents are directed to the ministries and civil servants in charge of the state's ownership policy (Ministry of Trade and Industry, 2004[15]). Their purpose is to guide the way the state steers ownership, and the related decision-making in all state owned enterprises and the state's associated enterprises. The decision-in-principle is a political statement, and the cabinet committee's statement can be best be described as the behavioral guidance of the political owner – in other words, a recommendation. The documents are not juridical by nature and as such, they should not conduct decision-making in SOEs but, rather, influence it. The government is committed to a four-year program published at the beginning of the each election term. The decision-in-principles and cabinet committee statements can be initiated when necessary.

[15] www.valtionomistus.fi/asiakirjat/en.jsp

The SOE ownership policy is carried out by civil servants and politicians – agents of the public – who have no ownership interests in the enterprises that they monitor. The state is a majority or a major minority block-owner in 54 companies and as the ownership is significant in terms of both the percentage of the enterprise and its value, it cannot sell all its shares overnight without affecting the valuation of a company. From an investors' point of view, the most important elements of state ownership policy are its credibility and predictability over time, and the stable political environment.

Remuneration guidance within the state of Finland dates back to 1994 when the Ministry of Trade and Industry[16] encouraged SOEs to launch stock option loans to boost the privatization plans of the government. SOEs quickly followed the advice, and stock options thereby became a popular method of remuneration. The state's first general ownership policy targets were launched in 1998. Over the last ten years the remuneration guidelines have been updated with increasing speed; with different objectives. As stated in the document, in 1999 remuneration reform was an instrument by which the state owner's specific purposes were enhanced: to increase the level of commitment to incentive schemes' and managements' motivation and to decrease the potentially "unreasonable" elements in remuneration. Politically, the focus was moving from management remuneration to labor issues; in this regard the remuneration of all SOE personnel became just as important as CEO remuneration, thus highlighting the social democratic values of the government. In 2000 the cabinet committee required that in developing remuneration schemes the focus should be in the competitiveness of the systems compared to those in private companies because both the public and private sector competed for the same key personnel. However, the committee stated that the annual bonus of CEOs should not exceed 40 per cent of annual pay.

[16] The Ministry of Trade and Industry was responsible for general ownership policy and general remuneration guidance from 1990 until 2007.

The 2001 option schemes of Sonera[17] (telecommunications) and Fortum (gas and oil), the two "state crown jewels" listed in 1998, aroused stormy public debate and political interest towards the remuneration systems in SOEs, which, with regard to Fortum, continued until spring 2009. National newspapers and other media followed intensively the announcements of listed SOEs concerning the developments of their remuneration policy. Following these episodes, remuneration was again on the government's agenda in 2004. The reform's focus was on the structure of remuneration schemes – inappropriate and excessive schemes should be replaced with moderate and reasonable remuneration packages that would cover all elements of remuneration (e.g. wage, bonus, share-based incentives, retirement benefits), and be based on earnings performance (bonuses and share-based incentives). The maximum bonus level remained at 40 per cent of annual pay. Remuneration schemes had to contain holding periods in order to improve the commitment of the management of SOEs to targets set by the state owner. Share-based remuneration was preferred over stock option schemes. As stated in new guidelines: "short-term gains and possibilities for unanticipated stock option related windfall profits must be ruled out", "the state as an owner does not approve traditional option models because of the short-term windfalls associated with such models and because they fail to encourage management ownership", and "if option schemes are used for specific reasons, part of the options have to be subscribed". Fortum's option schemes were the focus of media attention again in fall 2005:

> Fortum's exorbitant options are without doubt the topic that at the moment infuriates Finns most… I doubt there is a single member of parliament who would not think that Fortum's options are obviously excessive and unreasonable. (Bjarne Kallis, Member of Parliament, Oct. 8 2005)

[17] Sonera was merged a year later with Swedish telecom SOE Telia, currently TeliaSonera.

As a result of the public and political pressure the Ministry of Trade and Industry (MTI) started to prepare yet another remuneration reform in December 2005. The minister had earlier criticized remuneration schemes as being overlapping and excessive. The first draft of guidance initiated by the MTI disapproved the use of all kinds of option schemes. The word “reasonable” was attached to all remuneration – whether dealing with wage, bonus, or share-based remuneration. Share-based incentives and bonuses could amount to no more than annual pay. Long-term remuneration schemes would no longer be available to all SOE staff; instead, the guidelines required that the share-based incentives would be targeted only to the strategic management and key personnel, due to the cost of dilution to the state as a shareholder. The share-based schemes would also have restrictions concerning the sale of the shares, thus encouraging management’s shareholding longer term. The new drafted reform would have meant a considerable cut in remuneration to SOEs’ management, reducing the remuneration level below that of the market average, as indicated by data presented by remuneration consultants and referred by some interviewed chairmen of SOE boards.

However, the major Finnish institutional investors were notified of the reform drafted by the MTI. As a result, politicians draw back and redrafted the guidance. The fifth reform was finally introduced in May 2006. The cabinet committee took a firm stance towards options – they were excluded from the remuneration mixture. In addition, there should be no overlapping unreasonable benefits regarding share-based remuneration[18]. The share-based remuneration should not exceed the beneficiary’s annual basic salary, and it must include restrictions on share disposals (two-year shareholding period). The statement also highlighted the role of the board of directors in monitoring the remuneration issues:

[18] “Overlapping” was the term used by Minister of Trade and Industry in his many public speeches concerning options and other share based remuneration. By it he meant that the issue periods should not be overlapping.

> "The board of the directors must ensure that decisions on remuneration will not lead to exorbitant benefits under any circumstances".

The year 2007 was an election year. The Central party Prime Minister formed his second government with a right-wing party, election winner National Coalition Party. New remuneration guidelines emerged again in 2007, but the spirit of the governance remained unchanged. The composition of government in Finland has not affected the remuneration reforms as much as the general public, media, and wider political opinion – politicians seem to have reached a compromise on remuneration issues, and, regardless of their political background, a similar understanding concerning the SOE remuneration.

Fortum's remuneration contracts, however, did not allow the politicians to rest peacefully. The Finnish "pay scandal" continued in 2009 leading to the resignation of both the CEO and the chairman of Fortum. The state appointed a working group[19] to evaluate the government's remuneration guidelines to state-owned companies. The recommendations given in June 2009 were later incorporated into the new guidelines, issued on September 8th 2009[20]. They include for example the clause that "the board of directors is entitled to cancel the rewards or postpone payment if strict application of the incentive system, as a result of changed circumstances and developments beyond the control of the company, would have exceptionally adverse implication[21] for the company". The companies and boards of directors are currently working to interpret the meaning and the practicability of the new guidance.

Over the years the former general recommendations attached to SOE remuneration have become more detailed and restricting (Annual Report of the Ownership Steering Department

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[19] Markku Pohjola, former deputy CEO of Nordea Bank AB, was the chairman of the working group

[20] See all guidelines at www.omistajaohjaus.fi

[21] Can include harm to the company's public image (Matti Pohjola, Helsingin Sanomat (HS.fi) June 15th, 2009.

in the prime Minister's Office[22], 2007-2008: 33-34). The focus of the guidance has moved from general guidance, taking into account the distinctive and various features of SOEs, to detailed and specified control and management of SOE remuneration. The results of this process are discussed next, from the political and economic perspectives. The central agents in the story are the minister responsible for ownership policy (Minister of Trade and Industry), chairmen of SOE boards, and CEOs. These agents have the power and interest to drive change in remuneration practices in SOEs. The story is based on the interviews carried out after the remuneration reform of 2006. The data were addressed through three themes: guidelines in general; restrictions associated with bonuses and share-based remuneration; and attitude towards option schemes. These themes best illuminate the tensions between managers and politicians, and illustrate entrepreneurial action. Together, as symbolic events, they explain the emerging supremacy of political values, and verify political action motivated by the need for change in executive remuneration.

Action and reaction –how a remuneration reform is received, understood, and acted upon

Guidelines in general

The remuneration reform issued by the cabinet committee in 2006 received both criticism and understanding from CEOs and chairmen. Criticism was targeted towards the necessity of reform in general – critics believed the guidelines to be unnecessary –the state should have more confidence in the board of directors, which the state has nominated as a majority owner, and it should rely on boards' expertise with regard to remuneration issues.

[22] www.valtionomistus.fi

> This kind of guidance is not from this world (CEO, listed company)

> I would leave much more room for the board in the decision making. Because us or the board…We all need to work for the shareholders. And if the board has been nominated, it should be trusted as well. And if the members are not trusted they should be replaced. (CEO, listed company)

> The board is responsible for this company. The board hires the CEO and is held responsible at the AGM. It is highly questionable whether we need this kind of [remuneration] recommendations at all. (Chairman, listed company)

The chairmen thought that the guidance was too detailed and did not leave enough room for the board to adjust remuneration according to the needs of the company. The critics argued that common guidelines are not suitable for all SOEs because enterprises operate in different fields, face divergent challenges, and as a result, do not profit from analogous remuneration.

> Companies are operationally in different positions, in different market positions and in different phases. So the needs for remuneration are also very different. (CEO, listed company)

> We [SOEs] compete in different fields. And one on these battlefields is the battle over human resources, key personnel. (CEO, listed company)

In asking the acting and the former Ministers of Trade and Industry what is more important for the state, the competitiveness of executive remuneration or reasonableness of remuneration, they answered:

> They [competitiveness and reasonableness] should not be at variance with each other. That has been our purpose…The competitiveness means of course money but also other good things we can offer to SOE management. (Current Minister of Trade and Industry)

> From the political perspective, reasonableness is more important at the moment, bugger the competitiveness. (Former Minister of Trade and Industry)

These "other good things" that the politicians can offer to CEOs of SOEs, to which the Minister of Trade and Industry made reference in previous quote, did unfold during interviews with CEOs and chairmen as relating to challenging work and peer respect. However, CEOs talked mainly about money and fair compensation, which, from their viewpoint, signals respect for the work they have done.

The remuneration guidelines made some of the chairmen question the state's attitude towards corporate governance in general:

> What is the target of corporate governance? Does the state give these guidelines – or should I say recommendations – to the board of directors? No. I have never received them as a chairman. Is the guidance given to those nominated to the board by the state? If this is true, then I think this is the idea. But then the central idea of corporate governance has been lost. That is, that all board members represent all shareholders. (Chairman, listed company)

Those who showed understanding towards the guidelines thought that the guidance was practical and leaves enough room for variation in remuneration schemes. It also facilitated the role of the board as the decision maker by giving a firm shareholder stance with regard to the will of the state in terms of remuneration issues. One of the chairmen commented:

> Options are excluded from the share-based systems. It is a clear statement from the owner. I do not see that it is problematic. I think we have enough room for the board to make pragmatic decisions. (Chairman, listed company)

Some of the CEOs and chairmen took the guidelines given to be the right of a majority owner:

> We have received the guidelines of the government concerning the wishes of the owner…That is the frame for these share-based remuneration schemes. (CEO, listed company)

Some chairmen sympathized with politicians:

> Politicians feel that they are responsible [for the excessive remuneration] to the public, and they try to set restrictions to these [remuneration schemes], but at the same time they understand that we operate in open markets and actions have to be considered because we also need to motivate these key persons. This is not an easy situation…the board is in a difficult position. We need to take care of the company's competitiveness and see to it that it has competent management, and on the other hand we need balance between the restrictions set by the state. This means active dialogue and following the rules of the game that the state has set. (Chairman, listed company)

The smaller the state's ownership in the enterprise the more critical the interviewees were towards guidelines.

> This state's remuneration policy has been value destructive in our case…I mean what I said. I could have managed better with proper remuneration tools…I understand that these guidelines are useful in unlisted SOEs, but when they are applied to companies where the state is only a minority owner we go over the line in corporate governance… The question is how plausible we are as a company and how this effects shareholder value and other shareholders. (CEO, listed company, State ownership under 30 %)

Nevertheless, the guidelines were also followed in those listed SOEs where the state was only a minority owner. But whether holding a critical or sympathetic view, all interviewees referred to politics as the cause for the remuneration reform; for example:

> I think, I believe that this is more politics than acting in the interest of the companies. But I have had my share [of money], so this will not affect much of my life. (CEO, listed company)

> Especially these famous issues with Fortum have given attention to this matter [remuneration]. With politicians involved and, this is a matter with which to practice politics and criticize others and highlight one's excellence if the person has succeeded in driving change. (Chairman, listed company)

> I do not really know if it [the guidance] is written for the benefit of public or newspaper reporters or such. (CEO, listed company)

Usually the majority shareholder nominates the board of directors and is able to trust the board in its decision-making. The potential for a conflict arises when the government does not trust the board it has nominated. The board's controlling and monitoring power is reduced and the board cannot function in the interest of the shareholders – all shareholders. The remuneration guidelines limit the power of the board and substitute the board of directors and the remuneration committee – or the governance modalities – with regard to remuneration design. When it comes to remuneration issues, the board of directors is overthrown by politicians, ultimately resulting in reform – changes in remuneration and corporate governance.

In asking the Minister of Trade and Industry as well as his predecessor whether the remuneration guidelines could be restored to previous "general" principles, both thought that this would be unlikely:

> Not really, along with sufficient freedom of action come very wrong [remuneration] solutions. (Current Minister of Trade and Industry)

> Not in today's world. Parliament does not easily give up its spurious monitoring power. Parliament requires briefing about SOE remuneration. Without guidelines they [SOEs] would become irresponsible. That is what they [the Parliament] would think, the left-wing particularly. (Former Minister of Trade and Industry)

Restrictions of bonus plans and share-based remuneration

> The need to update the remuneration package came from the company, but the restrictions came from the state. (Chairman, listed company)

Politicians do not think that the political restrictions in remuneration, such as the share-based remuneration being limited to annual pay or the maximum bonus level set to 40 per cent of annual pay, have any negative valuation effects in SOEs[23]. The politicians know that the SOEs have performed well – above expectations – which led to the problem of excessive CEO pay. Politicians do not see it as problematic that remuneration schemes are almost identical in all SOEs or are harmonized – and that the unlisted SOEs apply the same guidelines to remuneration and have similar remuneration systems as listed companies, with the exception of share-based schemes.

CEOs commented on the bonus and share-based remuneration restrictions, for example by stating:

> The top management's 40 % maximum annual bonus level is low. The previous figure was 50 %. The target assessment leads to a situation where annual bonus amounts to approximately a maximum of 25-30 %. We like to keep the targets real. Of course you can start budgeting so that the targets are lowered… That is bad management though. (CEO, listed company)

[23] "Politicians" refer to the members of the cabinet committee and their actions in remuneration (the committee approves the guidelines). Minister of Trade and Industry is a member of the cabinet committee, but is not the sole decision-maker.

> If this goes on, then in the long run, the SOEs will not be competitive in labor markets. (CEO, listed company)

> They [politicians] should not create a solution to the problem associated with Fortum ex post. If they do that, then this will become rocky. Just because of Fortum all others have to do that [follow new guidance]. It is a bit dangerous. (CEO, listed company)

The CEOs were naturally unhappy with the pay cuts. The reduced bonus levels also meant problems for human resource management and recruiting because the bonus was a remuneration method used widely or in some cases throughout the companies – from the top down to the factory floor. And when the CEOs' maximum bonus was set to 40 per cent it naturally resulted in lower bonus levels throughout the organizations.

> It is really difficult to take the lollypop back once you have given it. (CEO, listed company)

> If these bonuses and remuneration systems are cut, it is expected that fixed salaries will then face pressure. (CEO, listed company)

Similar problems were also faced with regard to share-based remunerations systems, where maximum amount of shares was tied to annual pay. Metso's board of directors, for example, took the government's guidance by heart and set a euro ceiling to the firm's share performance[24]. The purpose must have been to make sure that the managements' rewards would not exceed the politically accepted level. Metso is listed on the Nasdaq New York and the State of Finland is a minority owner and blockholder with 11.1 per cent ownership.

[24] "The share ownership plan for 2006 has been specified to cover a total of 61 Metso managers. Based on the 2006 earnings period, by the end of March 2007 a maximum of 100,601 shares will be distributed, or about 0.07 percent of the all company shares. The Metso Executive Team can be rewarded with a maximum of 25,955 shares. If the average value of Metso's share between March 5 and March 16, 2007 exceeds EUR 38, the number of grantable shares for the 2006 plan will be decreased by a corresponding ratio." For more, see www.metso.com.

Moreover, at the same time as management pay cuts, the number of key personnel was readjusted in the companies in order to reduce the number of people to whom the share-based remuneration was targeted. This was carried out in a manner suggested by the Ministry of Trade and Industry and caused further pressure on the salaries of the management and on annual bonuses.

The chairmen were responsible for the decisions made by the boards of directors concerning the design and restrictions of the remuneration schemes, but most nevertheless criticized the new remuneration policy:

> I think that we cannot operate so that we follow this 40 per cent maximum bonus wished by the state. It does not work in countries where we talk about aggressive sales management or managers of big projects or others. (Chairman, listed company)

> And now this owner has issued a principle that the bonus can be only 40 per cent. But it is unclear to me what thinking and philosophy this decision has been based on…This maximum of 40 per cent has been considered incorrectly. But it is evidently based on the thought that managers should not be paid too much. I think differently: you should pay according to performance. (Chairman, listed company)

> If all the [remuneration] tools have both belt and braces performance might suffer. (Chairman, listed company)

> It is clear that management is unsatisfied because the state issued such restrictions. They have seen how colleagues in Fortum have made fortunes, but now there are clippers, and the lottery coupons are no longer valid… (Chairman, listed company)

Consistent with CEOs and most of the chairmen, the pension fund investors thought that the remuneration restrictions were too tight, but understood that the boundaries were the result of the political experiences gained from Fortum's options scandals. They thought that fixed and harmonized remuneration systems were a bad idea because SOEs, just as any other companies, need variation in their remuneration systems. However, the institutional pension fund investors would not publicly confront the state and question its governance because they did not want politicians to lose face. If politicians did not listen, the institutional shareholders would threaten to sell shares and reduce their ownership in the SOEs in the long-term. But in practice the threat is empty, as all the interested parties know, because all the listed SOEs are among the top 20 companies in Finland; and therefore the institutions are "the partners of the state in good and bad" as expressed by an institutional investor:

> We of course favor domestic investments but no one forces us to own badly managed SOEs. We do not want crises or publicity, issues are dealt with quietly.
>
> Politicians should leave loopholes in the remuneration policy to allow variation in remuneration schemes, but that would require political nerves.

Regardless of their criticism towards the remuneration policy, institutional investors stated that it is good that the state owner publishes the ownership policy – otherwise the institutions would have to guess what the politicians are doing, and why.

The political desire to create homogeneity in remuneration schemes by issuing reforms leads back to the general regulation practices; the politicians could not punish Fortum publicly for only violating its remuneration schemes – because Fortum is a listed company. But the state could launch recommendations concerning remuneration that are addressed to all SOEs as guidelines; which in the end offer the desired political outcome – the potential to cutback management pay in all SOEs. This type of practice seems to be common in politics:

> In solving the problem of energy price I could not bring up the issue only with this one company but I called the whole industry. If I had broached the subject with just one company [the company "at fault"] –I cannot do that. Because it [the energy company in question] operates in the same market, the problem was solved that way [collectively]. (Minister of Trade and Industry)

The 2006 reform and the new guidance made politicians feel that they are safe, at least for now – with no new SOE remuneration scandals in sight.

> The guidelines we have now are good, I think. (Minister of Trade and Industry)

Option schemes

The institutional investors interviewed thought that the 2006 remuneration reform was the result of Fortum's excessive option schemes. They thought that it was not the Fortum management who should be blamed for the scandal but the board, who was responsible for the design of the remuneration system. Fortum's share price performed much better than anyone expected so all shareholders including the state should be happy:

> We are always nervous whether the state wants the companies to perform well or just reasonably well; we must then do our investment decisions accordingly. (Institutional investor)

The investors thought that the public option discussion was more of a political problem than an economic concern – they were happy with the rapid development of Fortum's share price. They criticized the state's remuneration guidance for its harmonizing nature – the same remuneration schemes for all companies. The Ministry of Trade and Industry had informed institutional investors and some of the SOEs of the 2006 guidance reform, but this did not provoke "passions" because, as one of the directors responsible for pension fund investment policy stated: "Remuneration does not really affect our investment decisions", and "CEOs of SOEs are top quality even without options". The investors wondered why the state had not dealt with the remuneration problems "in-house" instead of issuing public guidance. They believed that, today, the state is more powerful than the SOE management, so public guidance would not be necessary. Their interpretation was that the guidance worked as a political advertisement for the Minister of Trade and Industry:

> This type of public discussion would never be necessary with any other company than a SOE. The private company CEO would have been simply sacked if the owner was dissatisfied. Why is this discussion taking place then? Because the owner acts in two roles: the one of owner and the other of politician. Will remuneration become the mediator of political action? (Institutional investor)

From a political point of view the remuneration schemes have to be transparent, fair, and comprehensible. Current Minister of Trade and Industry blamed his former colleagues for failing to carry out good remuneration package design because the previous government supported the launch of option plans to the fields of businesses that offered the potential for windfall profits – a mistake that the present minister corrected in 2003 when he took up his role; including responsibility for ownership policy and its development. The 2006 reform features the kind of competitive and reasonable remuneration encouraged by politicians. Politicians[25] do not recognize problems in uniting the two issues; the explanation of the Minister of Trade and Industry was that the remuneration is not just a matter of money – managerial motivation is a sum of different elements including a social position or a role at the top of the economy.

CEOs and the majority of chairmen did not like the exclusion of the option schemes from the remuneration mix. They recognized the previous problems associated with options but thought that all remuneration alternatives should be kept open because share-based remuneration was considered more expensive to shareholders than option schemes. Another

[25] The cabinet committee, represented by the Minister of Trade and Industry in remuneration context.

reason was that the options are still widely used in private companies, and recruitment becomes more challenging if one widely used remuneration instrument is no longer available.

> Option has become a swear word because of Fortum… The honest answer is that we would think about options in this house. But then I should say that the state would not be the owner, and this public discussion would not have taken place. (CEO, listed company)

> Well, I do not like share-based remuneration. I like options. (Chairman, listed company)

> Minister said that he is against options because the Finns are against them. And my answer was that if you go and ask a thousand people walking on the Aleksanterin katu ["The Wall Street of Helsinki"] what option is, maybe only two can tell you. (Chairman, listed company)

Furthermore, many of the new CEOs had been hired with the promise of an option package. One commented:

> I have only been working in capitalistic companies so far. I have not worked in a SOE before. I did not know that this kind of restrictions exists. It did not exist when I was recruited…And then you know that there is a market outside that functions with [private] rules. And I do not understand why we should be different from them. Or there is a choice, we should not be listed. (CEO, listed company)

The CEOs and almost all the chairmen of listed companies as well as the interviewed institutional investors thought that the remuneration guidelines did not pursue competitive remuneration, although this was stated in the policy paper issued by the state. According to the interviewees the reform's political aim – the only aim – was to cut executive remuneration.

As evidenced by the data, political, functional and social pressures can make modalities of structuration, such as remuneration guidelines, susceptible to change. Political pressure can include, for example, remuneration and corporate governance problems, as featured in the previous story. Functional pressures may involve the agents' doubts about whether practices function technically or practically as expected and needed. The CEOs of state-owned enterprises were worried that the extensive cuts in management pay and the limitations set on the numbers of key persons in SOEs were rather demotivating for their management teams. The politicians worried that remuneration, and stock options particularly, was politically risky, and issued guidance to moderate the remuneration schemes. The CEOs and the boards were put in difficult positions because politicians[26] had engaged in operational issues including the design of remuneration schemes. The extensive public discussion around Fortum's option schemes had significant influence on the development and structure of the SOE remuneration schemes. Such social pressures include the loss of consensus around meaning and interpretations, disruptions in historical continuity, changes in societal expectations or laws, and finally, structural changes – as seen with the 2006 remuneration reform.

The analysis of major findings

By breaking into modalities of structuration through interaction using the opportunities created by structural holes all structures – signification, domination and legitimation – can be modified and changed over time and their potentially institutionalized characteristics can be broken down.

[26] through the guidelines

The 2006 remuneration reform process was not perfect, neither from the economic or political perspective. As pointed out in previous studies, the change processes usually involve both intended and unintended consequences (Granlund, 2001). This was also the case with this reform. The remuneration guidance, partly substituting the remuneration committee as a modality in remuneration issues, mediates political values into managerial remuneration. The adjectives “reasonable” and “competitive” attached to remuneration offer possibilities for different interpretations, and, as such, signal political spirit and attitude. The remuneration guidance also allows multiple interpretations concerning its function. The CEOs did not interpret the guidance as fair and competitive because the remuneration systems were harmonized in SOEs. Instead, they interpreted the meaning of the guidance as an intention to cut management pay and as a medium of political penalty. Employing the well-known adage, one of the CEOs interviewed commented on the pay cuts as:

> If you pay peanuts you get monkeys. (CEO, listed company)

The CEOs interviewed understood the remuneration schemes to be mainly symbolic. The remuneration practises are allowed politically because they are a common practise in private companies that operate in open and global markets. It would then not be politically wise to prohibit the use of remuneration systems altogether in SOEs, as previously carried out by a social democratic government in Sweden, for example. But the politicians can and did cut the pay levels signalling that they were interested in public opinion, thus leaving the board of directors to manage the problems associated with the new remuneration guidance.

The remuneration guidance as a signification modality also offers possibilities for multiple ways of interpreting and understanding the nature of the guidelines: was it guidance or just a recommendation?

> In one of their papers [consultants] they call it "Government's remuneration guidance". It shows that this has not been understood. It can be only a recommendation, if even that. (Chairman, listed company)

The policy as a written document had no legislative ground – it was a recommendation. But when it was delivered to the boards and to the companies[27] it was referred to and introduced as guidance, and also understood as such. The voluntary principles had thus changed to statements, restricting the board's and management's ability to influence the remuneration schemes, thus limiting the dialectic of control (Giddens, 1984: 374), or the power of the board of directors more specifically. When going through the remuneration schemes that the boards had developed after the remuneration reform of 2006, the political influence was clear: the new remuneration schemes were almost identical in all the companies. The remuneration committees' work was influenced greatly by the remuneration policy papers issued by government, even though the chairmen and CEOs scowled:

> I do not believe that any company would act against the will of its majority owner…Of course we listen to what the majority owner says. A wise board usually tries to hear what the owners think. Then the board decides which battles are worth winning. (CEO of listed company)

> I was visiting the Minister of Trade and Industry right after the state had decided it does not approve the use of options. As far as I know the reform had not been talked about with any of the SOE boards beforehand. He said he had really studied the matter and used a whole evening to clear this matter and I think that he had also been informed by some professors, and a board member from some company. I said: have you listened to anyone who has met the market? (Chairman, listed company)

[27] Through the compensation committee, chairman of the board, the civil servant on the board of directors, or the ownership entity in the Ministry of Trade and Industry

Multiple interpretations, such as those made from the remuneration guidance, are favourable to politicians because they increase the possibilities for opportunistic behaviour: for example possibilities to use the remuneration guidance and the public debate as a political advertisement. If the stability of the political atmosphere is threatened, for example, by a stock option scandal, the ability to set out remuneration reform is politically comforting – and the threat of reform also works as a means of control over the CEOs and the boards of directors. However, the CEOs can also use the guidance opportunistically, by hunting the holes that permit a remuneration level above what is usual or what the management had in place before the reform:

> This paper [the statement of the cabinet committee on remuneration] helps us to change our long-term remuneration plan upwards where it should be. (CEO of unlisted company)

The contrast, is not politically dreadful as long as it is not public knowledge, because "the holes" in guidance keep the managers busy and happy, providing more alternatives in the remuneration schemes to those entrepreneurs that are motivated enough to look for them – often with the help of consultants.

By following the actions of tertius gaudens (the strategic actor who benefits from structural holes) we can understand and track changes in social and institutional structures. The domination structure was enacted through political power. The Minister of Trade and Industry used the power attached to his position to escort political values into remuneration through the statements of the cabinet committee on economic policy. In doing so he used his superior access to information, the allocative and authoritative resources that are attached to his position. He controlled and coordinated the relationships around him – both CEOs and chairmen – by drawing on his rights as a majority shareholder or blockholder, and he used his social position in the social frontier to advance his personal goals as a politician (tertius gaudens) by engaging in the public discussion and by using remuneration reform as his political advertisement. As a result of his action, a new structure (a new external governance mechanism, political remuneration guidance) emerged, drawing on political values, norms, and legislative traditions, and relying on the governance of human behaviour with rules and regulations that reduce risk-taking behaviour, and partly substituting shareholder monitoring with regulatory agency as a result.

The state can always take remuneration issues to the Annual General Meetings if the matters cannot be settled otherwise. Companies try to avoid public confrontations with politicians because it is usually harmful, as was the case with Fortum's stock option schemes. The major institutional investors in Finland have been rather passive when it comes to remuneration issues and in engaging in public discussions, probably because of their own political "baggage"; an issue referred to by many of the interviewees:

> The boards of directors might have thought that this [current remuneration policy] does not currently harm other shareholders. They [institutions, pension funds] are themselves captured by the political system. If you look at them, there are labor unions[28] and politicians and you know what. That probably ties their hands. (CEO, listed company)

Or it may simply be the case that institutional blockholders do not consider remuneration issues to be as important as do the politicians, because the so called over-payment examples are relatively unimportant for shareholder value in the listed SOEs, compared with, for example, badly conceived acquisitions and investments.

The guidance – or recommendations – is not a regulation by nature. As such, it is not put under the same sort of scrutiny that is typical in the process of drafting a new law. A

[28] The Finnish labour unions often have a representative on mutual companies' board of directors.

regulation reform requires that all significant parties addressed by the law are informed early of the process, and that they have a chance to influence the process as well as the outcome, for example, by engaging in public discussions and demonstrations, or by lobbying. And, ultimately, the law is always conditional on the approval of Parliament. The design of the statement of the cabinet committee on economic policy in remuneration does not involve such a heavy and long formal process. It can be drafted quickly, without public fuss. And what is best: it can be readjusted to meet political needs when necessary (see Figure 2, summary of the guidance reforms). In the end, and as shown by the case, remuneration guidance or recommendations can work just as well as a law as a means of changing the legitimized structure of remuneration. The new structure, in a feedback fashion, legitimizes the future need to update remuneration procedures.

Politicians have the power to issue remuneration reforms, but since the reform is not juridical by nature politicians are not responsible for the outcome it may have/has; for example, on recruitment issues, or SOE valuation in the long-term. Politically, remuneration reform is a good instrument for controlling the executive remuneration processes of the SOEs: the politicians (with the help of bureaucrats) design the systems that the SOE boards are then responsible for under the Company Act. Power without (economic) responsibility enables a politically perfect state of affairs.

As far as the domination structure is concerned, the Minister acting as a majority or a significant blockholder is usually capable of carrying out a politically striven agenda by drawing on her/his ownership rights, previous remuneration guidance, or public opinion – or when previous guidelines or recommendations have lost their legitimacy, as happened with the case of Enron in the United States and with Fortum in Finland.

Just as social identities constrain agents' action, they also enable it: important is that those who are influenced actually acknowledge the legitimacy of these alternative principles (Whittington, 1992: 706), drawn from another – such as political – world. The political guidance is accepted and followed by SOE boards of directors because CEOs and chairmen do not want negative publicity personally or directed at the company they manage. They rather follow the "one-size fits all" guidance, just as their peers do.

> It is not good for any company to be put in a crossfire with society. Of course it worries us. (CEO, listed company)

The boards of directors cannot always agree with the state without losing the board's legitimacy in the minds of other shareholders. The boards are confident that the state cannot replace chairmen or other board members every time political and economic interests collide. Sudden replacements on SOE boards would raise questions about governance problems – and the minister would be required to respond and take responsibility. It could also cause future recruitment problems for the chairmen – a serious problem in a small country like Finland.

> It is politically easier to issue the remuneration reform than to replace a chairman – you may run into the chairman on the street. It can also cause all kinds of problems because people have connections. (CEO, listed company)

> I have already replaced quite a few chairmen of the board of directors. But the idea is not new – it's small world with only a few good candidates. (Minister of Trade and Industry)

The reform also increased pressure on the board of directors to raise the fixed salaries and bonuses of the key personnel, including the CEOs. By increasing the salary the board could improve the overall remuneration package, because the bonus and share-based schemes are also attached to annual pay. Politically, this is less interesting, because the cost is carried by the company in the first instance. Also, managements' salaries (excluding the CEO) are quite opaque to media and politicians.

Finally, the guidance legitimates the same bonus levels to managers of non-listed companies as for those of listed companies. And the managers of unlisted SOEs have used this to their advantage: the maximum bonus level recommended by the state has been fully implemented in their remuneration design, and in some cases it turned out to be the normal annual bonus, resulting in that "the ceiling" becomes "the floor". Even the smaller companies that previously had no or quite mediocre remuneration schemes use the maximum bonus level because it is recommended by the state. At some point one of the companies finds a loophole and starts to pay more, which others follow. So, some companies and managers benefited from the reform although most suffered in financial terms. The politicians, though, seem to have been the ultimate winners so far.

Figure 2 (illustrating the summary of intended and unintended consequences of remuneration guidance reform) shows how the results of political intentions cause a large number of unintended economic consequences. According to Matsumura and Shin (2005) remuneration reforms are generally targeted at improving the ethical environment of executive remuneration. The ethical issues of remuneration did not emerge strongly from this study, at least not from the interpretations of the interviewees. The political objective was to make remuneration more equitable, not necessarily more ethical. The findings of this study support Holmström's (2006) view that experimenting with incentive designs can be problematic because it causes unintended consequences that are not thoroughly understood, and side-effects that are often unfortunate.

Political intentions:	**Unintended political consequences:**
• Mediates political values •Allows power without responsibilty •Works as a populistic advertisement •Reduces managements' risk-taking	• Allows loopholes (multible interpretations) in guidance •Change from recommendations into statements
Economic intentions:	**Unintended economic consequences:**
•Identical remuneration schemes in all SOEs	•Partly replaces the functions of the board of directors and the remuneration committee •Decreases management's motivation to take risk and thus create shareholder value •Puts pressure on the board of directors to raise fixed salaries and bonuses •"One size fits all" approach transforms bonus ceilings to bonus floors •Legitimizes the same bonus levels for all SOEs regardless of their size etc., small companies benefit •Weakens the rights of minority shareholders in all SOEs

Figure 2. Summary of the intended and unintended political and economic consequences of the remuneration guidance reform.

Discussion

The purpose of this research was to understand the meaning of remuneration reform in state-owned enterprises and the consequences of such reform. The focus was on embedded agency (Granovetter, 1985), acknowledging that structure and agency are equally important (Burt, 1995; Giddens, 1984). Applying a novel combination of two perspectives, structuration theory (Giddens, 1984) and structural hole theory (Burt, 1995), as a means to discuss political intervention in remuneration, this research presents unique data of state-owned enterprises in the field of corporate governance and remuneration that has not been researched earlier.

The research finds that political experimentation with remuneration guidelines can be problematic because it causes consequences that are not thoroughly understood by shareholders. The research shows how, through entrepreneurial action, politicians push their political values onto remuneration plans via remuneration guidelines, and how politicians manage to control and maintain the control of the remuneration practices in state-owned companies by partly replacing the independent remuneration committee and the board of directors with the guidelines. Although the guidelines lower agents' monitoring costs, they also create costs that are difficult to value, such as the cost of inefficient governance borne out of opaque political action. Remuneration guidelines can be used both for entrepreneurial and collective purposes[29] because the benefits can be shared with other political agents with similar objectives. However, these benefits do not come without costs: the guidelines may decrease management's motivation to take risk and create shareholder value, put pressure on boards of directors to raise fixed salaries and bonuses, and legitimize the same level of bonus for all SOEs regardless of their size – from which small companies benefit. Moreover, the guidelines allow loopholes that may encourage unethical behaviour by management. The unfortunate outcome of the process is that minority shareholder rights suffer if remuneration is guided by political interests rather than shareholder interests, and used for other than shareholder value creation. These findings extend prior knowledge of remuneration reforms (Bender and Moir, 2006; Matsumura and Shin, 2005 Thompson, 2005) and highlight the importance of human factors in corporate governance reforms. The research's contribution to

[29] e.g. political purposes

corporate governance, particularly to the growing literature on voluntary codes, blockholders, and remuneration is discussed below in more detail.

Remuneration has been a major issue in corporate governance reforms (Matsumura and Shin, 2005; Thompson 2005). Previous research has shown that the presence of blockholders (individuals, corporations, and institutions) seems to have little impact on major corporate decisions such as leverage and acquisitions (Holderness, 2003). However, a blockholder appears to monitor the form and level of managerial remuneration (Holderness, 2003: 60). Holderness (2003) reports that as the ownership of a blockholder increases he has a greater incentive to increase firm value. The results presented here have shown that a politician, acting as a blockholder on behalf of the state has a great interest to not only monitor but also influence the designs of managerial remuneration, regardless of the size of their ownership. This indicates that a blockholder's incentive can also be other than just value maximization, supporting the findings of previous studies (Shleifer and Vishny, 1997: 758) that block ownership is motivated both by the shared and private benefits of control, with both factors typically working at the same time (Holderness 2003, 54). These shared and private benefits are discussed hereunder in the context of blockholder costs.

The ability of shareholders to influence the pay-setting procedures in a listed company has been improved in many countries including Finland by creating remuneration committees that have independent members. The body of the remuneration committee should therefore be able to ensure that remuneration packages are optimal from shareholders' perspective. In this way the shareholders should stay in control of the pay processes without the need to issue guidance with regard to specific forms of remuneration. Instead of trusting the SOE boards of directors and remuneration committees (that the state has nominated as a majority owner) with regard to pay-setting, the Finnish politicians have partly replaced the duties of both governance mechanisms in SOEs by political remuneration guidance. The guidance diminishes the role of the remuneration committee and the board of directors; their responsibility for overall system design and ratifying and monitoring the remuneration systems. In essence, remuneration guidance replaces the functions of generating ideas, selecting the best ones and tailoring them according to the needs of the company. As a result, the board of directors and the remuneration committee become dysfunctional, filling only partly their duties.

What effects do the remuneration guidance then have in terms of board governance of SOEs? Most likely the guidance reduces conflicts between a board and management in remuneration issues because the board cannot be solely blamed for the "one-size fits all" remuneration system. On the other hand, the management of the firms and minority shareholders may put pressure on the board to discard the political guidance, or be faced with accusations that the board does not maximize the wealth of all shareholders (although it transforms majority and block owner's political values into remuneration, and all the way to company performance) with the result that the board thus fails in its duty. The corporate governance codes (or the guidelines in this case), while acting to protect investors, generally do little to enhance the governance process itself (Carver, 2007). In fact, the voluntary codes promoted by a blockholder can hurt the minority shareholders if they are shareholder value destructive. An interesting alley for future research would be to find out more about the extent to which human behaviour can be governed by rules and regulations in the context of management remuneration, focusing on the role of remuneration consultants and remuneration committees in the pay-setting processes.

The political push towards remuneration methods such as fixed pay and bonuses, rewards steadiness and rationality by the firm's management thereby encouraging risk-avoidance. This, in a certain phase of a company's life-cycle, can be value destroying rather than maximizing. Such defected remuneration methods also block the adoption of remuneration contracts that encourage risk-taking and the maximization of shareholder value. The guidance may make the boards become distracted by political pressure and interests that do not only pursue shareholder value. The guidance also protects the boards of directors from having its remuneration practice questioned, and provides legitimacy to a tighter remuneration policy. This supports the findings of Main et al. (2008) reporting that concerns for legitimacy push remuneration committees towards institutional isomorphism in processes and practice because the committee has a tendency to follow the norms and customary practice of others, for example the guidance and their SOE peers. As this case shows, the SOE boards of directors adopted the political remuneration practice legitimized by social and political values and norms, as well as by the media. The guidance's requirements combined with public curiosity (Benz and Frey, 2007) and hostility towards executive pay (Thompson, 2005) can generate large costs for a company – a phenomenon that has been previously witnessed with the disclosure requirements of corporate governance (Ferrarini and Moloney, 2004:15, 2005:12), leading ultimately towards inefficient governance (Bauwhede and Willekens, 2008).

The remuneration guidance for SOEs is not set by professional bodies but by politicians. As such, the guidance lacks transparency because it carries hidden objectives, as is typically the case with political language and texts. Becht, Bolton and Röell (2002: 19) suggest that if the owner of the firm can design and implement any corporate charter in the way he/she likes, he/she tends to write inefficient rules. According to Shleifer and Vishny (1997: 768) the inefficiency of state firms is not surprising. The political remuneration guidance carries both large investor/blockholder benefits and costs. In the process of maximizing his/her own welfare, the large investor redistributes wealth from other shareholders in both efficient and inefficient ways. The inefficient ways include, for example, the pursuit of personal non-profit maximization objectives (Shleifer and Vishny, 1997) that can be economically harmful and politically useful, as has been shown by this study.

We can identify at least three types of blockholder benefits and costs in this case. Firstly, the ability to control the remuneration design can be seen as a private benefit of control (Holderness, 2003: 55), deriving from the ability to control structural holes (Burt, 1995). In this case a blockholder enjoys the benefits (personal political advertisement) that are not shared with minority shareholders, but which most likely indirectly[30] reduce the wealth of minority shareholders. Secondly, the remuneration guidelines partly substitute the SOE board and the remuneration committee as a corporate governance modality. This limits the power of the board and the board's ability to function in the interest of all shareholders. Such a private benefit of control most likely reduces the wealth of minority shareholders. On the other hand, the remuneration guidance reduces the blockholders' monitoring needs and thus lowers the monitoring costs, because the monitoring action is partly replaced with an artifact, a human devised constraint. Thirdly, managers are encouraged to find loopholes in remuneration guidance. These loopholes and the imperfect competition associated with remuneration contracts between the companies, and the subsequent inefficiency of remuneration contracts may also leave room for managerial ex post bargaining, resulting in unintended consequences and further costs – including perhaps for the blockholder – because he/she may need to come up with new management monitoring measures, such as new governance reform. However, it is difficult to estimate, the extent of these blockholder benefits, or the costs to minority shareholders that cannot be removed with a partial privatization. The costs would seem to be an interesting area of future investigations.

[30] The ability to control the remuneration process is not a cost to minority shareholders as such because politicians can choose how to use their power in compensation design. They may even decide to abolish the guidance and trust the boards of directors to do their job. If the political action (the guidance) is shareholder value destructive, blockholder benefits become minority shareholder costs.

According to Morck and Steier (2005: 40) the institutions of corporate governance appear to be hard to change. They also point out that when change or institutional experimentation takes place the outcome is often disastrous to those involved. Morck and Steier (2005) propose that an institutional change seems to require a crisis in existing institutions. In this study we have seen how the politicians, as a result of a crisis associated with stock options, have imported political values into management remuneration schemes in SOEs through structural holes, and changed the virtual structure of remuneration by introducing a new external governance mechanism: a guidance that is not law but understood and acted upon in the same manner as law. Speech and text – the remuneration guidance – do not carry only meanings but also objectives, actions and plans. The political goal to which political values refer is a socially reasonable and acceptable level of management remuneration. The mode of conduct that promoted the political goal was the design of the remuneration reform targeted to end stock options, and returning management remuneration to an acceptable level. Thus, the political guidance played an important role in keeping down executive pay, supporting the earlier findings of Shleifer and Vishny (1997). Further, the reform process was financially unfortunate for the managers but successful to the politicians involved as they found a way to exercise power without legal or economic responsibility. This corresponds with Boycko, Shleifer and Vishny (1996) who found that political intervention in public enterprises is likely because politicians who manipulate SOE operations for political reasons receive all of the benefits of such interventions, but bear little of the costs. In this case, however, remuneration processes are disturbed and the political intervention was extended to partially privatized companies that are stock exchange listed, and as a result, increasing minority shareholders’ exposure to the possible blockholder costs.

Conclusions – placing remuneration guidance back to its historical context

The roots of the Finnish SOE corporate governance problems seem to derive from the historical adaptation of popular Anglo-Saxon corporate governance models (Licht, 2000), such as the use of stock options for remuneration. Owing to their popularity, stock options were adapted in the same manner as the privatization ideology of the 1990s. However, the adaptation was carried out without consideration to the national culture of a social democratic country (Roe, 2003:2). According to Licht (2000) national culture represents societal values (such as equality in pay), which are politically enacted through remuneration guidance in reforms. As the 2006 remuneration reform shows, the adaptation of popular remuneration practises failed because they did not have public, political, or more broadly, societal acceptance at the time of the stock option crisis.

Finland, as a society, is not as tolerant of income inequality as the United States. In this regard, a SOE managers' will to hire and fire according to the mentality of the labour market found in the United States might create governance problems because the Finnish government has listed the creation of employment as its highest goal. Recently,[31] the Minister of Finance representing a right-wing National Coalition Party proposed that all Finnish companies should avoid such remuneration and share option plans in coming years that could increase the feeling of inequality at the place of work. The Central Organization for Finnish Trade Unions, SAK naturally supported the proposition saying that: "It would be right and reasonable if managers and shareholders could restrain their greediness." The Vice President of the Central Chamber of Commerce commented that the minister's proposition was a skilful political act, pleasing, no doubt, the public. Political remuneration guidance sits well

[31] Helsingin Sanomat, 13 January, 2009. "Kataisen optioehdotukselle tukea yritys- ja palkansaajapuolelta"

in this current political and social atmosphere, where even the approach of the rightist party draws on and benefits from the ideology of social democracy.

In conclusion, minority shareholders should keep an eye on blockholders, especially when the blockholder is a state. By recognizing the structures of remuneration and the differences in economic and political structures we are able to see how a majority owner's and blockholder's influence and interests are mediated to companies. Once structures (institutions) face sufficient functional, social and political pressures – due to the political belief that they fail their purpose in shaping behaviour – the structures' legitimacy is questioned by agents. As a result, new designs of modalities (opportunities) emerge as entrepreneurial agents start to seek fresh ways to bridge the networks, navigate around the constraints, reposition themselves in the social network and fill structural holes. When the modality, the broker of the social worlds, is in the process of being replaced the structural holes surface because the two social worlds, structures, are no longer connected. The modality works reflexively: as a broker but also as a buffer – a structural hole between different social worlds. In the case of remuneration, the guidelines as a buffer minimizes the need for interaction in remuneration issues, keeping the remuneration committees, boards of directors, and CEOs under control and thus reducing their power. In time, the most legitimate modality is politically chosen to replace the old one, signifying present values, norms, and power. When the new modality is in place most of the structural holes on the social frontier close because people tend to follow legitimized practices. The modality as a structural hole is not thoroughly closed but kept open to ensure monitoring and control – the private and collectively shared benefits of the holes. Ultimately, the modalities as structural holes provide a path for new social structures, enlightening the duality of structure in practice. However, a modality as a structural hole affects the social structures around the hole. Thus, a reform's result is, to a great extent, unintended, leaving the reformers with a somewhat inefficient outcome.

Agency theory has contributed greatly to corporate governance and remuneration research, but it provides only a limited view of the control mechanisms and their workings in social structures. It also fails to capture the action between different structures. In this study, the middle range theory approach building on the techniques of structuration theory and structural hole theory, integrated with empirical research, has explained the complex process of executive pay setting and its outcomes, such as the partial substitution of the remuneration committee, and its subsequent consequences. The theory illuminates the world of corporate governance outside the economic spectrum and, as such, offers great possibilities for future studies on both corporate governance and on accounting.

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How Consultants Increase Executive Remuneration Despite Remuneration Guidelines: A Process Approach

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ABSTRACT

Manuscript Type: Empirical

Research Question/Issue: This study seeks to explore the remuneration consultant-client relationship, focusing on what consultants and clients actually do under heavy political remuneration guidance.

Research Findings/Insights: A qualitative social constructivist approach was adopted, drawing on interviews with the CEO and independent chairman of the board of 23 Finnish state owned enterprises, and with a leading consultant in four competing consultancies, finding that remuneration consultants are not independent and may serve management regardless of remuneration guidelines. Consultants may use all elements of pay creatively to bypass guidelines and thereby increase remuneration. The mechanisms of the consultant market also play a significant role in the remuneration design process because the competition between consultancies influences the forms, levels, and structures of remuneration designs, thereby explaining ever-increasing levels of executive pay.

Theoretical/Academic Implications: This study makes two important contributions. First, it helps to make sense of the different views and results of previous research, and further enriches our understanding of the consultant-client exchange relation. Second, the study provides important understanding to corporate governance of the ways routine practices can bypass rules as well as rich analysis of the types of consequence caused by forced change.

Practioner/Policy Implications: For policymakers, the findings show that remuneration guidelines can be ineffective if consultants are used in the process of remuneration design. Also, harmonization of remuneration practices can be costly. Therefore, it may be inappropriate for regulators to advise all companies to follow the same set of remuneration guidelines.

INTRODUCTION

The majority of recent corporate governance and executive remuneration research reports that executive pay is generally higher in organizations that are the clients of consulting firms (Armstrong, Ittner and Larcker, 2008; Cadman, Carter and Hillegeist, 2010; Conyon, Peck and Sadler, 2009; Kabir and Minhat, 2010; Murphy and Sandino, 2010; Voulgaris, Stathopoulos and Walker, 2010). They indicated that remuneration consultants provide a mechanism for executives of companies to extract and justify excess pay, but did not study specifically what that mechanism is, and how it works. Neither did they research the usefulness of remuneration guidelines in preventing such opportunism.

The lack of studies that address the influence of consultants in remuneration design processes limits our understanding of effective corporate governance. Research that integrates social relationships into question of imperfect remuneration practices is rare because of the difficulties in gaining access to interview and observe board and committee members, CEOs, and consultants. Since the exchange of consultants and clients is embedded in ongoing social practices (Devinney and Nikolova, 2004; Granovetter, 1985) governed by remuneration guidance, it is essential to focus on what consultants and clients actually do during the process of remuneration design, in order to understand the client-consultant relationship and its consequences. Unmasking this knowledge requires a focus on the relationships of consultants and their clients (action), the rules and routines guiding the relationship (governance and practice), and the benefits and costs attached to them (motives and risks).

To address these issues in corporate governance and executive remuneration research, this article presents an explorative (Keating, 1995; Scapens, 1990) qualitative (Ahrens and Chapman, 2006) study and adopts a field study methodology (Hoque, 2006). While the role of consultants has been extracted from corporate governance and executive remuneration research, the empirical evidence is used to explore and understand the influence of consultants rather than to test a particular hypothesis about the relationship between consultants' independence and increasing executive pay.

The research focuses on the richness and depth of detail (Ahrens and Dent, 1998) following the lead of Bender (2003, 2007, 2010), Bender and Moir (2006), Main et al. (2008), the injunctions of Eisenhardt (1989), and Tosi and Gomez-Meija (1989:185), and seeks to find new theory by looking inside the black box of remuneration design with the aim of exploring and understanding the process that connects restrictive remuneration guidance, the remuneration consultant business, and remuneration design practices. The overarching question addressed in this study is: *How do consultants engage with a remuneration design process?* More specifically, the aim is to explore the consultant-client relationship, focusing on the "challenges" and "solutions" in the process that the consultants are hired to overcome and negotiate, through which the executive pay materializes.

The study draws on 44 interviews conducted in 23 Finnish state-owned enterprises (SOEs) – of which 11 are listed on the OMX Nasdaq Helsinki – and in four leading consultancy companies focusing on executive remuneration design within the same market. Despite strong, political remuneration guidelines, several pay scandals took place in the SOEs during the period 2002-2009. The scandals, and the inefficiency of the guidelines to prevent them, inspired this research.

This study makes two important contributions. First, it helps to make sense of the different views and results of previous research, and further enriches our understanding of the consultant-client exchange relationship. Second, the study provides important understanding for corporate governance of the ways routine practices can bypass rules, as well as rich analysis of the types of consequence caused by forced change. The findings suggest that remuneration consultants are not independent and may serve management regardless of the remuneration guidelines. The consultants use all elements of pay creatively to increase remuneration. The mechanisms of the consultant market also play a significant role in the remuneration design process because the competition between consultancies influences the forms, levels, and structures of remuneration designs, and thereby explains the ever-increasing levels of executive pay.

The paper proceeds as follows. The next section reviews the previous research that pertains to the present study. Thereafter, the research design and methodology are discussed, followed by a presentation of the findings of the study. The findings are then discussed combining evidence from the field with theoretical insights from the corporate governance and general consultant-client literature, and the final section concludes by considering the intended and unintended consequences for corporate governance theory and practice.

REMUNERATION PROCESS AND CONSULTANTS

While one of the main tasks of the consultant is to generate benchmark data (Bizjak, Lemmon and Naveen, 2008), consultants may also provide a variety of services to remuneration committees and the management of organizations. These additional services include, for example, evaluating the CEO and other executives, providing corporate governance advice on executive and board pay, assisting with tax, accounting and listing-related issues within remuneration design, and pension benefits. Services to management and the company may also include advice relating to mergers and acquisitions, private banking, and after sales of shares (owned by managements) received from share-based long-term incentive schemes. Although consultants are expected to offer independent and legitimate advice (Bender, 2010), the services provided to management in other sectors raise potential conflicts of interests. According to critics (e.g. Bebchuk and Fried, 2004) the CEOs of companies with weak governance use compensation consultants, who are reliant on the organization for current and future business, to design and justify excessive pay packages.

The potential conflicts of interest relating to remuneration consultants have generated, to date, a handful of studies which report varying views. Armstrong et al. (2008), found that CEO pay is generally higher in most firms that use remuneration consultants, but like Cadman et al., (2010) they did not find support for claims that CEO pay is higher with "conflicted" consultants that also offer non-remuneration related services and have cross-selling interests. Murphy and Sandino (2010) found mixed US and stronger Canadian evidence that executive pay is higher in companies where the consulting firm also provides other services. Conyon et al. (2009) report that the equity used in the remuneration package is greater in firms that use a consultant, but found no evidence that potential conflicts of interest lead to greater CEO pay.

The link between cross-selling conflicts and independent consultants originates from the Waxman Report (2007). However, a wide range of services can be sold under the label of executive and director compensation, hiding the cross-selling of specialized (Waxman, 2007:2) consultants and the potential conflicts of interests of those services. In addition to compensation reviews, incentive designs and compensation committee advisory services many specialized (according to their web pages) consultants, such as Frederic W. Cook and Pearl Meyer, offer advice on areas of compliance, transactions and corporate governance ranging from tax and accounting analysis, IPO advice, to board of directors' compensation. Who is the consultant's client in board and committee compensation? What about in tax, accounting and securities law analysis? Many of these additional services are "technical" but linked to the executive remuneration design, and paid by the company. Are all the remuneration design related services not only negotiated but also executed in practice by independent board of directors or independent committees? Or is the consultant's client in these services the firm's management?

Voulgaris et al. (2010) investigated the effect of remuneration consultants on the levels and structure of CEO pay in the UK. They found that the use of a consultant has an increasing effect on the level of total CEO remuneration and that the consultants' influence on pay levels mainly stems from an increase in equity based compensation. Based on the findings they concluded that consultants' influence is positive because they influence firms to choose a form of CEO pay that incentivizes CEOs to act in the shareholders' interests. For this reason, consultants are not part of the agency problem but can be part of the solution by designing an optimal pay contract (Voulgaris et al., 2010:32).

Murphy and Sandino (2009:25) found an interesting anomaly in interpreting their US results of consultant's repeat-business and board independence. Their results showed that firms using consultants working exclusively for the boards are likely to pay more rather than less to their CEOs than other firms using consultants. This is set against the assumption that an independent board reduces remuneration consultants' conflict of interest relating to repeat business with the firm (Murphy and Sandino, 2010:17) and the general assumption that independent boards are effective governance mechanisms in decreasing agency problems (Bebchuk and Weisback, 2009:7). As Faulkender and Yang (2010:269) have shown with the remuneration peer groups, executive pay-setting process may be theoretically transparent in the U.S., but in practice susceptible to camouflage.

Most of the recent studies of executive pay and consultant's influence are based on public information variously available in different countries due to different disclosure requirements and measures that can be biased (e.g. Armstrong et al., 2008:27). By looking at the results closely it is evident that considerable care should be taken when interpreting them. For example, Voulgaris et al. (2010:32) have high trust in governance institutions and make an implicit assumption in their interpretations that executive, consultant and remuneration committee behavior is so constrained by market and corporate governance that is allows little impact of social relations on remuneration design. Under such circumstances all parties in the remuneration process have perfect information (Granovetter, 1985:484), people and systems function as expected, and the behavior of actors' results from their named role positions and becomes automatic, disembedded from social relations. However, the market is not perfect because information is scarce and opaque. To avoid the undersocialized conception of human action (Granovetter, 1985:483) this study takes a social constructivist approach (Emirbayer and Goodwin, 1994:1431) by proposing that understanding consultants' influence in the design process of executive remuneration can be increased if it is studied with reference to what consultants and clients actually do under various settings, going beyond the named role positions of consultants (e.g. consultants as experts; Bender, 2010). The different views and results of previous quantitative research may make sense when social dimensions of remuneration design are included in the analysis of consultant's influence on executive pay, capturing interaction of individuals and institutions (guidelines).

RESEARCH DESIGN

Company selection

For this qualitative research, the author chose to study, through field-based research (Hoque, 2006; Ahrens and Dent, 1998), Finnish state owned enterprises representing a wide range of industries, and four consultant companies that focus on the executive remuneration design in the same market. The reason for choosing the SOEs for the context for this study is that this group was hit by several pay scandals during 2001-2009 despite a tightening of political remuneration guidance. The SOEs have independent boards and remuneration committees, predicting strong internal (Fama and Jensen, 1983) and external control mechanisms. SOE remuneration practices are reviewed often by the State and "unreasonable" elements are expected to be removed from pay packages, setting remuneration at level regarded to be competitive by politicians. The ways in which SOEs structure their remuneration to adapt to this constraint and what type of behavior it drives in the remuneration design process is of interest because it offers insights into the ways routine practices can bypass rules as well as rich analysis of the types of consequence caused by forced change. Interestingly, despite the guidelines, excessive pay continues to hit the headlines.

A two-pronged approach was used that primarily consisted of on-site interviews and observations at all the firms, as well as a review of relevant internal documentation when available, online information, and published material from outside sources including Government Decision-in-Principles on the State's Corporate Ownership Policy, and annual reports of SOEs. The first part of the data (SOE interviews) was collected by a research team of four that the author conducted in the course of a research project funded by Finnish Ministry of Trade and Industry concerning compensation issues in SOEs. This took place between November 2006 and January 2007. Altogether 23 of the largest Finnish state-owned companies were contacted, and none declined. Of these firms, 11 were Nasdaq OMX Helsinki listed companies. This amounted to a total of 40 interviews, consisting of CEOs and independent chairmen of the boards who also acted as remuneration committee chairs. Most of the interviews were conducted with a two (researchers) to one (interviewee) approach.

During the SOE interviews it became apparent that all SOEs in this study used remuneration consultants, and their role was significant in remuneration design. To gain a better understanding of consultant's influence and to capture and detect differences in perceptions, practices, and interpretations of all parties of the remuneration design process, data collection was extended to consultants. In the second phase, the five leading remuneration consultant firms operating in Finland were contacted and four agreed to participate in the study. The interviews were conducted during April-May 2009 by the author and a co-interviewer from the first phase research group. External factors, such as the executive pay scandal that took place that spring and the new remuneration guidelines that were being drafted as a result, most likely assisted in gaining access to consultants.

The interviewed consultants hold a key position in their firms as a partner, co-founder or CEO, operate actively in remuneration design and develop new business opportunities. All of these firms had/have customer relationships with SOEs and were/are regularly offering services. Company A, is a market leader in remuneration design, which, in practice, holds a virtual monopoly ("specialized" consultant; Waxman, 2007). Company B focuses on its long-term customers and essentially offers remuneration design as an additional service ("conflicted consultant"). Company C is one of the leading international consultant companies with a small branch in Finland ("conflicted" consultant). Company D is the smallest of the interviewed players in the business ("specialized" consultant), focusing on remuneration. Because the consultant business is based on trust and the SOEs are not required to publish the identity and the nature of the assignment of remuneration consultants, the consultants are treated anonymously.

Research methodology

In conducting the interviews, discussion guides were used that moved from company specific to market specific issues. The guides addressed three main areas extracted from corporate governance and executive remuneration research. The focus was on the consultant-client relationship, the tensions and challenges, and how the participants dealt with each of them. The first set of questions focused on the remuneration design process and the roles of different parties. The second set addressed the market of remuneration design and thoughts on SOE remuneration guidelines. The third set of questions elicited information about the future and trends in remuneration. Emphasis in all of these questions was on how the interviewee framed and understood remuneration practices and process – that is, what the interviewee viewed as important in explaining and understanding events, patterns, and forms of behavior.

Due to the exploratory nature of the study, the interviews were semi-structured. The interview protocol was used for eliciting responses rather than following systematically. Basic topics were covered, but the order of questions and their wording were ad hoc. The interviewee was allowed to take the lead, to dictate the direction and length of discussion of particular questions. New ideas and questions were allowed to emerge, to gain further insight about a statement made by the interviewee. New issues were raised, for example, the role of consultants and consultancy market in increasing executive pay –emerged from the interviewees' expanded commentary on specific questions. A total of 44 interviews were collected. The duration of interviews varied between one and four hours. All interviews were taped and later transcribed.

Analysis of interview data was commenced as soon as the early interviews of first round were completed. It was soon noted that similar issues started to appear. During the consultant interviews special attention was given to issues relating to consultants' relationships with clients, their form of influence and the interpretation of remuneration guidelines. Within this coding process certain themes begun to reappear that were confirmed by the critical, repeated and careful reading and analysis of the transcripts, and through discussions with the other member of the research team. In the analysis, focus was on tensions evidenced by the data (Ahrens and Dent, 1998).

FINDINGS: HOW CONSULTANTS ENGAGE WITH REMUNERATION DESIGN

Based on this extensive research process, three main themes were identified that structure understanding of the consultant's influence in the process of remuneration design. The first theme focuses on the relationship between the key players (remuneration committee members, CEOs and consultants); the roles and activity in remuneration design and the reasons why consultants are hired. The second theme focuses on the challenges relating to remuneration design, including remuneration guidance and restrictions, and the market of remuneration design. The third theme, functionality of the remuneration design, focuses on actions that consultants took to overcome remuneration problems, and shows how the remuneration design has risen to meet the challenges described in earlier sections.

The Remuneration Consultant-Client Relationship

The interviewed consultants saw themselves as initiators in building the relationship with clients. The consultants felt that the chairmen were less enthusiastic than the managers to update the incentives, because it would increase the costs in the company.

> They [executives] would be happy to work even overtime with incentives, and they have a huge motive as beneficiaries to structure them, whereas the board manages the issue without as serious opposite interest. The chairman of the board does not necessarily have the pressure to update the incentives again. We need to wake them up. (Consultant A)

Consultants acknowledged that the strongest player in remuneration, in terms of motivation, is the management because the remuneration process is about negotiating executive pay and managements play for the highest stakes. The consultants felt that their output is in the fairness of compensation of which managements benefit:

> The most important element in executive remuneration is that it is competitive, market-based and comparable. Although the outcomes may vary greatly the possibilities should be in line with others. This is what is important for them [CEOs] – fair compensation. And that is the value-added we can offer. (Consultant A)

Most of the chairmen were annoyed by the consultants' active approach to secure repeat and new business. The following quote represents the thoughts of most chairmen, indicating that the consultants' activism potentially compromised their independency:

> Consultants have invaded the business of remuneration design. They are very active. Sometimes I wonder whom they represent: the management or shareholders. (Chairman of the board, listed company)

CEOs, chairmen and consultants gave different reasons why consultants were hired. The CEOs motives were clear: they expected to be paid fairly and in line with their peer group.

Consultants contributed to the relationship by keeping the CEOs informed of the current trends of remuneration and the benchmark. The CEOs of listed companies thought that the consultants' main contribution, along with the benchmark, was the technical expertise they provided to the firm. By "technical" they meant the mechanisms of equity-based designs, which the boards and firms had, little experience. One of the chairmen was particularly negative towards the use of consultants, but acknowledged the value of their expertise in equity-based designs:

> They [consultants] do technical background work for us. Their greatest contribution is that they can tell us what the general systems are like: what is the normal [remuneration] level, the length of earnings period, the lock-up period. (Chairman of the board, listed company)

The consultants also identified other reasons, including their role as mediator in smoothing the tensions between the board and management. One consultant expressed that they were used to provide expertise for reasons that were not communicated, and the benchmark was often the solution to the problems of such clients.

> We are used to provide outside expertise for reasons that are not communicated. For example, an inter-company power game. The board might have different views concerning remuneration or they admit that they have no experience of designing. And often they want benchmark data. (Consultant D)

Consultants understood their mediating position between the committee and management, and the power attached to it. The following quote highlights the consultant's position and the tensions that come with that position:

> We have lots to lose, like reputation, and we like to be everybody's friend. But we should not be yes-men to CEOs. What is important is that the chairman makes sure that we eat out of his (*sic*) hand. He gives me the mandate. (Consultant A)

In asking with whom the consultants make the first contact in the company the answer varied between the human resource manager, chairman of the board and the CEO.

> Usually we contact the chairman but in some cases, based on personal chemistry, we contact the CEO because he overpowers the chairman. How do we know that? We know these people. Faces go around. The kick-off maybe initiated by the CEO but the chairman of the board understands (the need) to join the project. (Consultant A)

The remuneration committee often chose the consultant, but the major part of the work was carried out by the team of consultants and managers:

> The process starts within a company. The remuneration committee acknowledges that the current schemes are terminating and it is time to renew them. The HR manager presents the potential advisors and is authorized to put out a tender. We pitch to the committee or often to the HR manager. The advisor is chosen by the chairman of the board and remuneration committee. But from thereafter the situation is such that we work with the management and report to the committee when it meets. (Consultant B)

Although the chairmen are satisfied with the committee work, the remuneration consultants feel that the role of the remuneration committee is problematic because the committee members do not have enough resources to carry out the given tasks. They referred to resources as prerequisites for control and influence whereas the scarcity of resources, such as time and knowledge, implies weak remuneration committee control. The committees often rely on information collected and presented by consultants and managers.

> The role of the remuneration committee is problematic considering the resources they have for the job. They are members of the board of directors; a good member is a CEO in another company, or if he is a board professional he holds 4-5 other board seats. His number one job is board membership. The remuneration committee is a small side business for him, consisting of key employee recruitments, salary policy of the company, different bonus schemes, other than

> financial compensation and share-based schemes. It is an extensive gamut of issues. If the committee has on average four meetings per year and the meetings last a couple of hours at a time and if we consider the design of a large company's share based scheme - it is easily a half-year project that takes hundreds of hours of work. (Consultant B)

> They [the committee] can look at benchmark data but they rest on [the information] what is presented. There are not many of those in Finland who get the remuneration design in front of them, having 15 minutes for decision making, and even if they had received it a week earlier not many can say whether it is good or not. (Consultant D)

Generally, the consultants carry out the major part of the work and the remuneration committees are left with the question of what it is the committee wants from the management and who are the key people that participate in the program. The following quote describes the process followed by the majority of the SOEs:

> We have developed a concept in which the client does not have to bunch together experts from different fields because if they use us we have the lawyers and all. We prepare the design background with the remuneration committee or with the chairman. We start with the goals focusing on the questions of "what do you want to reward" and "what do you want to measure". In the second phase of the work we propose our view of the suitable design including the levels with examples and costs. Then we can compare stock options with share-based incentives. The earnings potential is more relevant than the method. In the third phase we get comments that "we [committee] do not want stock options". Well, in that case we design a funny system that is based on the share price. After a couple of rounds of discussion the design is taken to the board of directors by the committee. Enforcement follows the board's decision. We also give advice regarding disclosure. With share-based schemes we state what is usually disclosed and what is not. In the best case we round up the beneficiaries and give them an inspiring speech that this is the strategy and through these you are paid if you fulfill the expectations of the board. (Consultant A)

The management and consultants pressure the committee to review the remuneration practices, whereas the State as owner expects the committee to control and put a damper on the increase in executive pay. These pressures very often materialize as redesigned remuneration schemes. Because the remuneration committees do not have sufficient resources (time and knowledge) to take up the task of remuneration design, the consultants control the process, working for the committee with the management. The consultant's role is to mediate between the board and executives, and to negotiate a compromise that appeals to both parties.

The remuneration committees are not oblivious of the surroundings. They know who the consultant's end customer is.

> For consultants it means more business, when management is the customer. And the management keeps buying in order to get more, I would think. It [use of consultants] hikes up pay levels! (Chairman of the board, listed company)

> Over the years we have seen that the remuneration committees are becoming more and more active but so far, at least within our client firms, the customer is the management. Not so often the CEO but the HR director, who reports to the compensation committee. Of course the CEO knows what goes on, but does not necessarily openly or visibly instruct the HR director. (Consultant B)

Even if the consultants are hired by the committee they work with the management. The design of the executive remuneration scheme is only a small part of the services their sell. Usually the SOEs also use the consultants' expertise for technical issues that are not a duty of the board but the management. This additional work, often attached to executive remuneration design, means additional and repeat business for consultants but also conflicts of interests because the consultant is reliant on the management for securing repeat and new business. The following two quotes represent the views of conflicted consultants. While the first is from a consultancy with the cross-selling interest, the latter represents a view of a specialized consultant.

> We have long-term relationships with clients and serve the whole organization, so the earnings potential is located elsewhere [not within executive remuneration design]. I would see that we have kept them [management] happy with salaries. (Consultant C)

> We do everything relating to compensation excluding benefits. When a share based reward or stock option has been designed there is administrative work for two years –from sending letters to writing IFRS-reports. To lubricate this process we started to help with the after sale of shares as well. [Company x] saw that this generates asset management clients if they [executives, clients] make money and it will also generate brokerage business through the sale of options or shares. And because we did the same business for different reasons we had no difficulty in putting the businesses together and learning from each other. (Consultant A)

Summing up, the consultants have significant influence on executive pay design. The influence emerges from the consultant-client relationship, wherein the consultant and management are often the most powerful parties measured by knowledge and motives. The consultants' influence is not only positive but also negative as the consultants' future business is dependent on their past and current relationships with clients, indentified by the consultants as management.

Challenges in Remuneration

Guidelines and Restrictions. The remuneration guidelines of the State authorities, which were targeted at cutting excessive executive pay from 2006, were the major reason that restricted the chairmen's enthusiasm to improve the SOEs remuneration systems. The political guidelines also put the board in a difficult position:

> The need to update the remuneration package came from the company, but the restrictions came from the State. (Chairman of the board, listed company)

> Politicians feel that they are responsible [for the excessive remuneration] to the public, and they try to set restrictions to these [remuneration schemes] but at the same time they understand that we operate in open markets and actions have to be considered because we also need to motivate these key persons. This is not an easy situation…The board is in a difficult position. We need to take care of the company's competitiveness and see to it that it has competent management, and on the other hand we need to balance this with the restrictions set by the state. (Chairman of the board, listed company)

Most chairmen of the board of directors thought that the State's remuneration guidance was too detailed and did not leave enough room for the remuneration committee to adjust remuneration according to the needs of the company. The critics argued that the same guidelines could not be suitable for all SOEs because the companies operate in different fields, face divergent challenges, and as a result do not profit from analogous remuneration. All CEOs of listed companies were critical towards the guidelines.

> This kind of guidance is not from this world. (CEO, listed company)

The chairmen who showed understanding towards the guidelines thought that the guidance was practical and left sufficient room for variation in remuneration schemes. It also facilitated the role of the board as the decision-maker by giving a clear shareholder stance. One chairman commented:

> Options are excluded from the share-based systems. It is clear statement from the owner. I do not see that it is problematic. I think we have enough room for the board to make pragmatic decisions. (Chairman of the board, listed company)

The guidelines considerably restrict executive remuneration. Share based compensation is limited to the level of annual pay and the maximum bonus level is set at 40 % of annual pay. All CEOs of listed companies thought that both levels were too low compared to the previous levels the companies had applied (50-60 %) and to benchmark private companies. The low bonus levels caused problems for human resource management and recruiting because the bonus was based on a compensation method used widely and in most cases throughout the company –from the top to the factory floor. If CEO's maximum bonus was set to 40 % it naturally resulted in lower levels throughout the organization. Similar problems were faced with share-based systems, where the maximum amount of shares was tied to annual pay. For example, Metso's board of directors, SOE listed in Nasdaq New York, set a euro ceiling to the firm's share performance in 2006.

> It is clear that management is unsatisfied because the State issued such restrictions. They have seen how colleagues in Fortum have made fortunes, but now there are clippers and the lottery coupons are no longer valid. (Chairman of the board, listed company)

> It is difficult to take the lollypop back once you have given it. (CEO, listed company)

> I know someone who works in a private company. The owner had told him that he does not have to look over the fence and check if the grass is greener on the other side. If he feels that his pay is too low he should go by the register and ask for more. That is the best system. It puts the executive's morals and ethics at stake and he does not have to think [about money]. That is best. (CEO, listed company)

All CEOs, and the majority of the chairmen of the boards of listed companies did not like the exclusion of the option schemes from the compensation mix. They recognized the problems associated with options, but thought that all compensation alternatives should be kept open. In addition, many of the new CEOs had been hired with the promise of an option package. One commented:

> I have been working only in capitalist companies so far. I have not worked in a SOE before. I did not know that this kind of restrictions exists. It did not exist when I was recruited. (Chairman of the board, listed company)

The consultants thought that the guidelines pursuing “reasonable” and “competitive” remuneration did not encourage competitive remuneration. The bonus level, for one, was too low when benchmarked. A market-based level would be closer to 60-70 % in the listed SOEs.

> If we compare SOE with other SOEs they have all a 40 % maximum bonus. It is competitive. If we compare SOEs with private companies most likely the SOEs’ bonuses are significantly lower. (Consultant B)

The guidelines created tensions between the CEOs pursuing competitive remuneration and the board of directors restricting it. The consultants defended the executives, drawing on benchmark which was understood as a legitimate solution in evaluating the levels of pay. The consultants’ challenges become, keeping the executive pay in line with benchmark while following at the same time the guidelines of the State.

Concentrated Remuneration Design Supply. In Finland, the remuneration design market is concentrated around a small number of service providers. The same type of clustering effect is also found in other countries, including the UK and the United States (Conyon et al., 2009). The CEOs and chairmen of the boards of directors who were interviewed identified three consultant companies that they worked with (all three are included in the consultant companies interviewed for this study); although one company was seen to dominate the market, with an estimated market share of over 50 %. The company’s dominant position is, according to customers, competitors and the company itself, based on its singular resources and on its superior relationships with customers and stakeholders, including managements, boards of directors, politicians, media, and academics. The singular resources they hold include, for example, extensive benchmark data relating to executive and board remuneration in the major Finnish companies, both listed and unlisted.

> We get the most positive feedback from designing competitive and comparable [share based schemes]. Government's guidelines also state that it has to be comparable, competitive and market-based. If you want to compare stock options and shares for example. Share-based schemes are more opaque than stock options. Or information that is not public. We have information what is the outcome and how tight the criteria have been. Then the companies will avoid bad sizing flaws. We have designed 500 systems over the last 20 years in almost 200 companies. We have learned from mistakes and seen it all. (Consultant A)

The dominant consultant company (A) has been in the remuneration design market longer than all the other players, and they were the first to introduce share options in Finland. Initially they provided advice on corporate finance and transactions but later expanded to remuneration, specifically long-term incentives and benchmarking. The company has a long relationship with SOEs because it had structured stock options for the first four listed SOEs over 20 years previously. Today the company offers full service in remuneration, including tax and legal advice, administrative services, private banking and after sales of shares the managements received from share-based long-term incentive schemes.

> I guess it [the market share] helps. If I was a customer, doing a public thing like this, I would want to be sure that this sizing is legitimate, realistic and comparable. That my managers would not feel underpaid because I am happy with them. (Consultant A)

> Now that I know them [the dominant consultant firm] why would I choose someone else? They are strong professionals with powerful know-how. The know-how also on IFRS-issues, and they help our financial management with it. (CEO, unlisted company)

Although all CEOs were contented clients, some chairmen of the boards criticized the dominant company's practices. They thought that this service provider copied the remuneration schemes from one company to another, leading to a situation whereby every client had a similar remuneration structure, including methods and measures, and as a result, the competitiveness of their clients in the executive market was weakened.

> Currently, if you send an invitation to submit a tender in remuneration design, it is €50.000-200.000 per round and in practice it is a three-night secretary's copy process when you change names and take it from a company to another for a review. (Chairman of the Board, listed company)

The dominant consultant company considered clients as its worst competitors because those companies learned during the process of remuneration design, and sometimes decided to take on the task of updating old documents themselves. This issue was considered in the pricing of the services, and it probably also played a role in the service provided. Mass was preferred over a selected niche, and a harmonized remuneration design served this purpose, keeping the design price low. In this regard, benchmarking kept many executives happy because the majority of the SOEs in the study used the services of the dominant consultancy firm.

The competitor consultancy firms shared the chairmen's thoughts regarding the "copy machine" practice. They claimed that the dominant design practice was so influential that they had no choice but to follow it in their long-term design. Such a decision did not leave much room for variation in remuneration schemes across the whole market. The following quote highlights this issue:

> We face hard pressure to follow the practice of [dominant consultant company] and if we want to deviate from it we have to use performance share with EPS and another return on capital based measures. If our market peer group uses a copy machine model we have quite a lot of work to do, including the company's management, to convince the committee and the board of the company that they should obtain a different model. (Consultant B)

The dominant practice is hard to resist, because the State's guidelines motivate companies to follow similar practice by stating that remuneration should be comparable, market-based and competitive, emphasizing that, in remuneration design, there is a need to benchmark against the peer group. One of the consultants commented that the State's ownership steering unit encourages the use of existing solutions in executive remuneration design. The competitors had identified the close relationship between the dominant remuneration consultant and the State's ownership unit, hinting that the dominant consultant company might have influence on the content of the State's guidelines.

> From our point of view it seems that they [the ownership unit] socialize only with one consultant company [the names of the consultants]. (Consultant D)

> We have discussed these [guidelines] since 1994…But they [the State's ownership unit] have kept us and we have kept them informed what happens in the world. They have known what is going on…Although there are a few weird bugs these are very smart guidelines. (Consultant A)

The benchmark data that the dominant consultant company holds is a unique resource in a sense that it is something the other service providers do not possess. The competitors criticized the use of benchmark data because they sold a different remuneration approach, one that was derived, from scratch, from the company's own strategy. The competitors thought that benchmarking is an easy way to make decisions because it is based on numbers that are simple to understand. The dominant consultant company offers safe service because they use an old, approved remuneration structure that is also less expensive than a new design, developed for each client from scratch. Benchmarking, however, does not necessarily reflect the company-specific strategy or the type of control needed. The competitors also claimed that the benchmarking that the dominant player sold leads to increase in executive pay.

> Very smart consultants update benchmark yearly and present it in public. Those below the median hire the consultant to update their schemes. It is a very effective pay lift. (Consultant D)

The consultants also reproached the competitor for being too friendly with customers in order to generate add-on business and claimed that the competitor's earnings model was based on building up mass from remuneration design and generating profit from other services, such as private banking. According to the competitors, the dominant consultant's practice places questions on the ethics of remuneration design.

> I know that our competitor has tried to attach a success fee to stock option returns and we have used it also in situations where the reward's tail has been connected to what the remuneration schemes have delivered to beneficiaries. They are long-term contracts; they were signed before remuneration committees existed. (Consultant B)

The dominant design is so deep-rooted in the social system that those who tried to sell a different approach had to follow a path of unique design with considerable risks, or be content with a client base consisting of smaller unlisted companies and focus on bonus design or other areas of human resource management that were not found in the core areas of the dominant player's service portfolio. The smallest of the interviewed consultancy companies, which tried to remain independent relative to client companies and followed the remuneration guidelines word for word, had difficulties in securing business and finding new clients:

> It just came to my mind that when we were designing a revenue model for a SOE and strictly followed the guidelines and then we were replaced [with the dominant consultant] –it was because of that? We do not search [for loopholes in the guidance]. What I mean is that we followed tightly the rules; bonus was 40 % of annual pay. We built a model in which it was the maximum and then we were replaced… I have not seen the model since. (Consultant D)

The fact that one consultancy dominated the market biased the supply of remuneration design making other consultancies dependent on the action of the dominant consultancy. This further increased the power and influence of the dominant consultancy firm and led to standardized remuneration schemes and increasing executive pay engineered by benchmark. The only way to successfully compete in this environment is to identify the needs of the clients and fulfill them. The next section reviews these “solutions”.

Functionality of the Remuneration Design - How the Design Has Risen to the Challenges

> We can lean about benchmark in structuring the remuneration package. It is rather wide so companies can find an allocation point that they like. There is more freedom of choice than with a salary benchmark. (Consultant A)

Play Safe and Use Benchmark Data in Design. According to the consultants a smart way to increase one’s pay is to be concerned for the pay of subordinates. Once the CEO has managed to increase his management team’s total remuneration package he can be quite confident that his own pay package will be improved as well with the inclusion of a market-based multiplier. That is how benchmarking works at a company level. But the real value of benchmarking comes from unpublished peer group data, the more international the better because the executive pay packages are generally lower in Finland than in other western countries. It is particularly the wide benchmarking of long-term incentives that gives a lot of freedom to package sizing, helping to make up for poor annual bonus levels.

> The benchmark is quite wide [in share based incentives], unlike in fixed salaries, we show that you should give 30.000 -50.000 stock options to this person according to this benchmark. We have considerable responsibility for the benchmark; it is difficult to see through it. We can show, if needed, that this information is right but the benchmark of share based incentives and analysis is based on non-disclosed information when we need to blot out the names of the companies. This is a business of trust. (Consultant A)

Benchmarking is a powerful legitimating tool in executive remuneration that can be used creatively. For executives it is a way to secure a growth trend in their remuneration during turbulent circumstances which require changes to remuneration structures. The committee can legitimize most of its remuneration decisions with benchmark data and be confident that the decisions are market-based and customary. A benchmark also helps the committee to control the CEO's financial ambitions as it sets standards for "normal" pay packages. However, the benchmark data also restricts the committee's freedom of decision because it provides a frame for decision-making and puts firm pressure on the committee to employ the frame once it has been communicated to the executives; the latter is frequently actioned by the consultants. Consultants hardly ever recommend CEO pay at below market.

Even the State, as owner, benefits from the benchmark, although as a trade-off it has to approve a "market-based" upward trend in remuneration. Benefits to the State come in the form of harmonized remuneration practices. Harmonization is expected to reduce the principal's monitoring costs and help prevent unreasonable rewards. The obverse of harmonization leads to a situation whereby a company loses its competitiveness in remuneration because all systems are equal. The benchmark data thus works as both an enabling and restricting remuneration tool. The consultant company holding such a powerful intellectual market-based asset can use it in securing a dominant market position.

> I could say that if the management is unhappy with the remuneration system it has not been designed based on our benchmark. Because if the company follows our proposal of the size of the remuneration package, as they almost always do, I can say to the manager that you have no reason to be dissatisfied. (Consultant A)

Take a Risk, Hire (Another) Consultant and Look for Loopholes in Guidance.

> If the guidance gives any room for imagination then of course a consultant is needed to present the possibilities to the board of directors in such a light that the board does not understand what it is about. (Consultant D)

> The more difficult the regulation is the more the motivation to find loopholes. Everything originates from the situation that we have to treat the owner and management the same way. This state of mind cannot be changed by any regulation. They [board and owner] still want them [remuneration schemes] and our job is to design [rewards] in a more difficult jungle. (Consultant A)

There are several ways by which the CEOs of SOEs can keep up with the private sector pay benchmark regardless of the remuneration restrictions imposed by the State. Consultants thought that the easiest way was to use slack criteria. According to one interviewee, the board of directors feels that they have filled the duty if the bonus outcome is set at a maximum of 40 %. If the outcome is close to 40 % nobody is caught because the guidelines are followed. The steering element is of course lost in such practice if the bonus hits the ceiling early during the financial year. A low bonus level can be also compensated by long-term incentives so the total remuneration level (salary +bonus+ long-term incentives) remains competitive.

> One way to find a consensus in these is to let the State keep its face and put in slack criteria so that 35 % of annual pay is paid according to the same performance that would be employed for a [bonus] maximum of 60 %. (Consultant A)

> It [the bonus level of 40 %] is low but it can be compensated with slack criteria. The outcome was 38 % in 2007 which was a good year. This fits into that. But the fact that we do soft systems so that this 40 % materializes at least every other year is little foolish. (Consultant A)

Because stock options are excluded from the remuneration mix, the companies use their shares for long-term remuneration. Share-based incentive programs are less transparent than stock options because they are approved by the board of directors outside the annual general meeting. The objectives for each share earning period are set by the board of directors, but the objectives and the measures are not disclosed. So, it is difficult for shareholders to discover what that particular program is designed to reward. Even if the measures are disclosed their definitions remain unclear: for example, what EPS, what ROCE and what TRS (total shareholder return).

The negative political and social attitude towards the use of stock options and the pressure to ensure that compensation is performance focused has led to innovative long-term designs. In most SOEs, the equity-based designs resemble stock option plans, which have been disapproved of by the State as shareholder since 2003. For example, in one case a consultant (B) designed an annual performance share unit program, with a three-year earning period and a three-year lock-in period. The reward was paid out in cash at delivery. The guidelines of 2003-2006 could not keep up with the innovative practices and did not state specifically the type of the model SOEs should use, but it was firmly indicated that executives' interests should be aligned with shareholders, and therefore remuneration designs should lead to executive ownership and executives were expected to hold on to the shares received through their stock awards. Without understanding all the ways in which a performance share program can be structured, laymen would think that the rewards are paid in shares and they are held in individual accounts for the lockup period.

The lockup period for the performance share program was lengthy, three years. If the guidelines had been interpreted as the State believed they should, the share rewards should have been deposited into executives' accounts with tax deducted after each earning period. In this way the executives would have been exposed to the same risks as the shareholders. However, the board of directors decided –guided by a consultant - that the three-year holding period was too risky for the executives, and in order to keep the incentives as a motivating factor they decided to delay delivery and taxation and pay rewards in cash. The cash element reduced the executives' downside risk considerably, which combined with free share units follows the consultants' idea of a perfect remuneration plan. Such a practice also kept the value of the possible rewards fairly constant as the number of share rights granted appears to reflect the grant price, keeping the annual reward level fairly stable, bonus-like. The consultants' designs that are applied with the aim to optimize the rewards are without question favorable to executives, but may increase the costs to the company (e.g. in the form of tax or hedge contracts) and appear questionable considering the spirit of the remuneration guidance issued by the State. The Minister of Economic Affairs, who had in 2006 pushed through the guidelines, commented the outcome as:

> We tried to find a more workable solution, and what we came up with in 2006 is good, I think. It is clear that this was not in the State's intentions. (Minister of Economic Affairs, Kauppalehti, March 3th, 2009)

As presented above, stock option restrictions can be bypassed through the use of share based remuneration programs, combining elements from stock option programs and bonus schemes. The share based schemes are complex and offer the potential for much variation. For example, changes to control rules may deliver shares regardless of the restrictions and measures encouraging managers to deal-break whether in the interest of the board of directors or not. Also voluntary and involuntary termination, retirement and misconduct issues can be included in agreements.

> It [the stock option restriction] could be bypassed perfectly by doing share based incentives using the total shareholder return for share allocation. The yield curve matches the stock options, but it is not a stock option. We do not give managers a chance to buy the shares but rather give them for free. It makes no economic sense, it probably makes sense politically. (Consultant A)

The consultants, chairmen of the boards and the CEOs all agreed that guidelines and restrictions eventually lead to a situation whereby, all other elements being fixed, the salary remains the only competitive element. They saw that such a trend would lower the companies' risk-taking and dividends because they endanger the payment of salary. Such a course, would clearly not be in the interest of a normal shareholder, but politically it might make sense because politicians are more risk averse than other investors. This latter view is supported by what has been seen in the financial crisis of 2008-2009.

DISCUSSION – THE INTENDED AND UNINTENDED CONSEQUENCES

Independent or Conflicted Consultants?

The remuneration consultants in this study work with their clients much like consultants in general. To make themselves necessary the consultants have to understand the needs of their clients. Through formal and informal engagements with their clients the consultants build specific worldviews, learn, share and interpret meanings (Devinney and Nikolova, 2004:10). A well trained consultant is able to make sense of her/his clients' needs and fears intuitively by "listening with the third ear" (Kets De Vries, 2009). In asking how the consultant knows that CEOs are happy with the remuneration designs one of the interviewed consultant stated: "He just sits by the chairman and nods. He does not have to speak". The comment indicates a mutual understanding and shared language between the consultant and client, which according to Devinney and Nikolova (2004:13) is a precondition for the creation of a long-term relationship.

The consultant and client need each other if they want to remain successful (Devinney and Nikolova, 2004). Devinney and Nikolova (2004) propose that as consultants and clients work together for a long time their worldviews start to blur and their interpretations become more homogenous (2004:15). This might be negative for the reflective knowledge creation, but a source of other benefits for both parties. The length of the remuneration consultant-client relationship might partly explain why executive remuneration continues to increase despite the guidelines. Two of the consultants said that their relationships with CEOs went back ten to twenty years. During that time the rewards where still designed by or with the management. The remuneration committees and guidelines are much younger that the relationships of consultants and executives. Those consultants who have internalized the executives' worldviews over the years of the relationships know what the clients need without formal interaction. Thus, the executives do not have to be active participants in the process of remuneration design to profit from it.

The remuneration consultants are not neutral bystanders in the process of remuneration design, like consultants in general (Kets De Vries, 2009:5). The consultants, including the dominant consultant, had cross-selling and repeat business interests, and identified the management as their end-client. The assumption in previous research has largely been that if the consultant sells only remuneration related services (Waxman, 2007:3) and works for the independent committee/board the consultant is independent (Cadman et al.2010; Murphy and Sandino, 2010:25). The findings of this study suggest that consultants that are labeled or described as "independent" are not indeed independent. In this light, the results of previous research – finding no evidence of greater pay in the clients of conflicted consultants (Armstrong et al. 2008; Cadman et al. 2010, Conyon et al. 2009; Murphy and Sandino, 2010) – are understandable: there is no evidence because they compare two of a kind. That is to say, conflicted consultants.

Concentration of the Remuneration Design Market

The benchmark connects the key beneficiaries, the executives, over company borders. It works as an invisible bridge between anonymous individuals who profit from the shared knowledge (legitimate, market-based, increasing pay), but who also bear the costs of the network, the loss of truly competitive remuneration schemes. The visible network, consisting of consultant-client relationships, supports the invisible network by generating mass to the benchmark which further improves the legitimacy of the data. At the same time, the benchmark generates new consultant business because there is always someone under the "market medium" (Conyon et al., 2009) in need of a more competitive remuneration design. In line with the strategic network view (Pillai, 2006) networks not only provide access to resources but also the ability to exploit such resources. The dominant consultant company has created a network around itself whereby strategic information accumulates providing a competitive advantage because the resources that, in theory, are accessible to all consultant companies are, in reality, obtained by only one company.

As the size of the consultant company's network increases and expands so does the company's influence and control in remuneration issues, improving competitive advantage and profits. Once the power of the consultant company is great it cannot be overlooked by the political regulator, which might explain the close relationship, indicated by the data, between the ownership steering unit and the dominant consultant company. Prior research calls this "status accumulation", which refers to a firms' ability to enhance its social standing by forming cooperative relationships with prominent network partners (Podolny, 2001). The achievement of status, in turn, helps to enhance performance (Shipilov, 2008). The consultant company benefits from the size of its network just as the customers benefit from the benchmark, but the costs of network maintenance are left to be paid for by others. These costs include, for example, the loss of the company's competitiveness in terms of remuneration and costs to shareholders in the form of inefficient remuneration schemes. These findings are in line with Main et al. (2008) who state that following legitimized remuneration practices might not be in the best interest of companies.

Using Benchmark and Loopholes in Guidance to Increase Pay

The remuneration designs that consultants offer to SOEs are globally used, market-based solutions that, at best, provide much variation in size, measures, terms, and conditions, taking into account the firm-specific needs. As the data show the remuneration guidelines do not stop market-based remuneration developed through benchmarking, or the riskier schemes. Remuneration designs may appear ethical and motivate executives, although they harm shareholders. As Bender and Moir (2006) find, the best practices of corporate governance do not necessarily encourage “good” executive behavior. The knowledgeable, motivated and networking players always try to optimize their benefits (Burt, 1995), both within and beyond the restrictions set by institutions. Benchmark practices, for example, generate constant increases in executive pay. This happened by always placing the CEO a little further up the benchmark charts than his peers.

Because remuneration is treated as an entity all of its elements allow possibilities. Conyon et al. (2009), Kabir and Minhat (2010), and Voulgaris et al. (2010) found that the use of equity was greater in clients of consultants, which Voulgaris et al. (2010) interpreted as a positive influence: aligning pay with performance. However, the findings of this study indicate a different interpretation, in which equity is one of the means used to increase executive pay, thereby also explaining the method’s popularity. If the annual bonus level is restricted consultants can compensate for this with share rights, or lower the bonus targets and the slope of the earnings curve of performance shares, or use loose criteria in bonus and equity schemes. Or they can increase the CEO's salary if that is the only element left to compensate the difference between market benchmark and politically approved levels of remuneration. In SOEs the use of equity was creative as it was used to compensate for the terminated option schemes. Such schemes are not decided at the AGM by the shareholders as option schemes previously. It is the independent board that establishes the terms of equity with consultants. What is interesting in considering the independent boards is that the members are current or former CEOs and executives, and therefore, current, former or future clients of remuneration consultants. Consultant may contribute to the optimal remuneration contract (Voulgaris et al., 2010), but the optimal contract, negotiated by the consultant between the "independent" committee and CEO may not be in the shareholders interest.

The Effects of Market Mechanisms on Increasing Executive Pay

The guidelines and remuneration restrictions challenge consultants to look for loopholes that, when found and applied, offer a competitive advantage with regard to remuneration, restricted (e.g. by methods) and enabled (e.g. legitimated) by benchmark data. The use of remuneration loopholes is more risky than legitimate benchmark practices, but offer greater benefits than those received by peers, with the potential to be handsomely rewarded. For a consultant, the loophole offers a way to break into the market of remuneration design that is dominated by a competitor who has unique resources and relationships that are hard, if not impossible, for the consultancy to develop for themselves. The competition of consultants, therefore, seems to explain part of the increase in executive remuneration.

Their unique resources and relationships both restrict and enable the dominant consultant's action because the consultancy business is based on knowledge, relationships, trust and reputation. Reputation is something consultants need to consider with regard to the independent advice they are expected to provide (Cadman et al., 2010; Murphy and Sandino, 2010). Trust is present in the relationship that the consultant and clients benefit from. It is also present in benchmark data that is partly based on unpublished information that is not available for the wider community to judge. If trust or reputation fractures, the consultant's business suffers as the benefits of a network (economic gains, mutual learning, sharing of risks, entry barriers to a market, chances to surmount regulation and guidelines, and legitimation) deteriorate. Trust is also closely associated with information (Granovetter, 1985): consultants with whom clients have a continuing relationship have an economic motive to be trustworthy in order to encourage future transactions (Callon, 1986). Likewise, continuing economic relationships often become overlaid with social content that carry strong expectations of trust (Granovetter, 1985). Benchmarking and relationships, on which competitive advantages within the consultant business are built, are both dependent on trust and reputation. Therefore, the risk of losing one or the other restricts the dominant consultant company's action in their search of loopholes. After all in awarding the business to the consultancy the State requires them to harmonize remuneration practices, use peer benchmarking and market-based solutions. As a result, the loophole remuneration design market, with its risks of excessive executive pay and shareholder and taxpayer outrage, remains mainly in the hands of niche players, although the dominant player may also occasionally test the waters with new designs.

Reasons for Choosing a Specific Consultant

As this study shows, the consultants have both the interest and power to influence executive remuneration. Their influence and power generate from the process, in which the roles of participants, the nature of problems, and solutions are negotiated (Callon, 1986). Somewhat surprisingly, the dominant consultant company was not chosen because of a low price and/or higher quality; the clients' choice was based on the capacity to understand the client, trust and reputation, and on their superior resources and services. Therefore, CEOs do not necessarily have to go opinion shopping to increase their pay (Kabir and Minhat, 2010); long-term relationship with one trusted consultancy is enough and may go unnoticed. As the consultant holds, and is hired for, the kind of superior knowledge that executives' need that consultant controls the process, provides a benchmark, and guides the decision-making of the remuneration committee that seldom makes a complex decision without considering the legitimate justification provided by the consultant (Bender, 2010). Consultants with power can find ways to resist existing rules (guidelines) by reasserting routine practices through a benchmark.

The choice of a consultant is also based on the benefits and risks that companies are ready to take with regard to remuneration design. The dominant consultant company offers safe, simple and legitimate services in which benchmarking provides a route for improved benefits in all elements of remuneration. The companies that were satisfied with the dominant practice were, however, exposed to its darker side. The use of a benchmark and the "copy machine" designs led to a situation in which the companies' remuneration designs are harmonized, thus providing limited competitive advantage in this field. The choice of a niche consultant and the practice of loophole searching gave the case company a chance to stand out from its SOE peers as they strive for competitive remuneration. Through this practice the executives have, over the years, clearly benefited, compared to their peers in other SOE organizations.

An efficient way for a minority consultancy house to gain a foothold in this type of the market is to design a solution that proposes above the benchmark medium, thus a recommendation that is truly competitive and unique compared to peers. The dark side is that these schemes occasionally lead to socially condemnable “excessive” outcomes, which to the relief of consultants are left for the remuneration committee and the board of directors to resolve. Such excessive schemes (no matter what the outcome of action by the remuneration committee) do not change the relationship between consultant and executives because consensual interests are tied together and legitimized by institutionalized market forces and mechanisms. In the final reckoning, it is the CEO who decides the level of appropriate pay package, comparing the benefits and risks involved –the rest of the remuneration design process is a negotiation weighting up the pros and cons of rewarding and penalizing.

CONCLUSION

Based on the existing corporate governance and executive remuneration literature, and integrating insights from an empirical field study, this research contributes a more differentiated picture of remuneration consultants. The study approaches the remuneration design as a process, exploring the embedded social relations of consultant, CEO, and independent chairman of the board/remuneration committee. The findings suggest that remuneration consultants are not independent, due to the fact that their end-client is the management. Consultants can use all elements of pay creatively to bypass guidelines and thereby increase remuneration. The mechanisms of the consultant market may also play a significant role in the remuneration design process because the competition between consultant companies influences the forms, levels and structures of remuneration designs, and thereby explaining ever-increasing levels of executive pay.

Although this study’s purpose is not to generalize, the findings provide an important general understanding of corporate governance with regard to the ways that routine practices can bypass rules, as well as rich analysis of the consequences that forced change can cause. These include the diffusion of remuneration practices and use of consultants, which can both benefit and harm organizations and shareholders. A focus on what remuneration consultants and clients actually do under various settings helps to make sense of the different views and results of previous research, and further enrich our understanding of the consultant-client exchange relationship. Furthermore, the findings show that the standardization of remuneration practices can be costly. Therefore, it may be inappropriate for regulators to advise all companies to follow the same set of remuneration guidelines.

This exploratory qualitative study may lay the groundwork for follow-up research along several dimensions. For example; the remuneration design market is not only concentrated in Finland but also found in the UK and in the US (Cadman et al., 2010; Conyon et al., 2009). Does competition between consultancies explain the increasing executive remuneration in these markets, niche players being most aggressive? What about the length of the consultant-client relationship? Do institutional investors prefer certain consultancies? If so, why? How should corporate governance address the issue that consultants, guidelines, and independent boards can all be part of the agency problem? Qualitative research with the network perspective adopted in this research has been shown to be a powerful methodology for generating new insights into the remuneration consultant-client relationship. It could be a fruitful way to approach the governance problems that are, above all, social by nature, taking their complexity into consideration rather than trying to atomize it. Future research would also benefit from exploring the link between culture and the remuneration consultant-client relationship, because culture, like action, is embedded in social relations (Erirbayer and Goodwin, 1994). Finally, the findings suggest that remuneration consultants behave like management consultants, therefore, the research on remuneration consultants could benefit from the extensive management consultant-client literature, an avenue not yet considered by previous research.

APPENDIX: LIST OF SEMI-STRUCTURED INTERVIEW QUESTIONS

General questions to CEOs and Chairmen of the board of directors/remuneration committees, which were prepared to start and focus the interview:

14. Could you please describe the process of remuneration design?
15. Who designs CEO's incentives?
16. How much time does the remuneration committee use for remuneration design?
17. Do you use consultant(s) in the process of remuneration design?
18. What kind of services do the consultant(s) offer: Which of these does your company acquire from the consultant(s)?
19. Are the remuneration designs working as expected?
20. Do you benchmark remuneration? How/Why?
21. Are there any weaknesses in your remuneration designs?
22. How do you feel about the remuneration guidelines from the Finnish government?
23. What is the meaning of the guidelines?
24. How do you feel about the transparency in remuneration disclosure?
25. How should remuneration designs be developed in the future?
26. Is there anything that you would like to add/discuss that has not been covered yet?

General questions to the consultants:

23. What kind services do you offer?
24. What is your market share? Does it affect your service portfolio? How?
25. Who are your competitors?
26. Why are you hired for remuneration design?
27. What does the consultant work consist of?
28. What is the consultant's role in remuneration?

29. Could you please describe the process of remuneration design?
30. What are the roles of the CEO and the chairman of the remuneration committee?
31. With whom do you make the first contact in the company? Who is your client?
32. Who defines CEO's pay?
33. Why is a remuneration consultant used?
34. How do you feel about the remuneration guidelines from the Finnish government?
35. How have the companies (management and board) reacted to the guidelines?
36. What is the purpose of the guidelines?
37. Are there differences in remuneration designs between SOEs and other (private) companies?
38. Do shareholders and management have differences of opinion in the remuneration issues? If so, what are they and how are they overcome?
39. Do the guidelines affect your work/use of consultants/consultant business?
40. What is the purpose of remuneration?
41. How do you find the "right" remuneration level?
42. What is your biggest challenge in remuneration design?
43. What are the future trends for remuneration?
44. Is there anything that you would like to add?

Also, probe questions were employed to obtain rich detail to the principal question, like: Can you give me an example of that? How did that affect the organization/person/committee etc.?

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Modality as a Bridging Mechanism

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Abstract

This paper draws on research and thinking in sociology that has yet to be brought into the field of management accounting and demonstrates, through a synthesis of structuration and structural hole theory, how structural holes emerge in management accounting systems, how new modalities emerge from agents' use of structural holes, and how a management accounting system that is supposed to protect against opportunism becomes a source of such opportunities. The research proposes structural hole theory (Burt, 1995) to be a valuable extension to structuration theory (Giddens, 1984) in understanding how accounting systems are constructed, maintained, changed, and used through action that is embedded in social relations. From a methodological perspective, meso-level analysis through structural hole theory bridges the gap between macro and micro levels of structuration, highlighting ongoing processes of social interaction, structure, and agency, that has been underdeveloped by previous research. The research also contributes to a fuller understanding of the origins of structural holes by including the role of modality: specifically, how the modality is used in creating and bridging structural holes.

Keywords: structuration theory, structural hole theory, modality, network analysis, management accounting

Introduction

Giddens' theory of structuration (1984) has created a small but distinctive contribution to alternative management accounting research (Baxter and Chua, 2003). Most research has applied the theory as a valuable point of departure when studying management accounting in its social context (Macintosh and Scapens, 1990; Scapens and Macintosh, 1996), drawing specifically upon the idea of duality of structure (Ahrens and Chapman, 2002; Collier, 2001; Conrad, 2005; Granlund, 2001; Scapens and Robert, 1993; Seal et al., 2004; Soin et al. 2002). It has also encouraged research on management accounting change, with a focus on how rules and routines structure organizational activity over time (Barley and Tolbert, 1997; Burns and Scapens, 2000), and provided a framework for other change studies (Granlund and Modell, 2005) such as relationships between different forms of trust (Busco, Riccaboni and Scapens, 2006). Furthermore, the use of structuration theory has generated research on theoretical and methodological issues (Coad and Herbert, 2009; Englund and Gerdin, 2008; Stones, 2005).

Although previous research in management accounting is extensive, it is still limited in its ability to explain the link between action and structure (Coad and Herbert, 2009; Englund and Gerdin, 2008; Macintosh and Scapens, 1990:472). Coad and Herbert (2009) examined the potential of Stone's (2005) "ontology-in-situ" framework for management accounting and found that although the framework focuses attention on the strategic conduct of agents and the importance of power in social interaction, it provides few insights into the process of reproduction and change in management accounting. They suggested that this limitation could be overcome by using structuration theory in a flexible manner and by drawing inspiration from other theoretical perspectives.

In their well-known study of "Structuration Theory in Management Accounting" Scapens and Macintosh (1990) focused on the institutional aspects of structuration theory, made reference to a longitudinal field study, but the potential of network analysis was not discussed in their paper although they used data that was originally collected through social network analysis (Covaleski and Dirsmith, 1988a:8). However, it is probable that the data collection method influenced the quality of the data and ultimately the interpretations that both the original authors (Covaleski and Dirsmith, 1988a) and Scapens and Macintosh (1990) made from it. Had Scapens and Macintosh (1990) connected the use of structuration theory framework with network analysis twenty years ago, might the position of structuration theory be much stronger in management accounting research today. Social network analysis focuses on understanding the nature and consequences of ties between individuals or groups and its power lies in its ability to help explain important development, social and economic outcomes for particular individuals and groups. The combination of structuration theory and network analysis would have helped other researchers to make the most of the potential that structuration theory offers; that is a balanced framework with which to analyze both structure and action, including the non-situated modalities that enable and constrain action and situated practices of individuals (Englund and Gerdin, 2008).

To address the structuration theory's limitation to provide insights of processes (Coad and Herbert, 2009) and situated doings of human agents (Englund and Gerdin, 2008), drawing inspiration mainly from structural hole theory (Burt, 1995) this article presents a synthetic perspective intertwining network relationships into Giddens' meta-theory (1984). The power of this framework lies in its ability to focus on embedded agency (Granovetter, 1985), acknowledging that structure and agency are equally important (Giddens, 1984; Burt, 1995), and that networks not only link together actors and institutions but also interpretative schemes, norms, and facilities. Using insights from network analysis to understand the process of structuration takes the researcher inside the black box of process, through which many social, economic, and political phenomena can be explained (e.g. Burns and Scapens, 2000). In examining the patterns of relations among agents and institutions over time the process becomes more concrete and understandable, creating links between causal mechanisms and unique histories (Erirbayer and Goodwin, 1994:1418) that structuration theory alone is incapable of providing (Macintosh and Scapens, 1990:472) because it does not incorporate historical time (Archer, 1995:65).

The main contribution of this study is to demonstrate through a synthesis of structuration and structural hole theory how structural holes emerge in management accounting systems, how new modalities emerge from the agents' use of structural holes, and how a management accounting system that is supposed to protect against opportunism becomes a source of such opportunities. This is achieved by using structuration theory in a flexible manner (Burns and Scapens, 2000; Coad and Herbert, 2009: 192; Macintosh and Scapens, 1990: 470), focusing on the modalities that mediate structure into action between different systems (Whittington, 1992) and that bridge those systems. The research contributes to management accounting in four ways. First, it proposes structural hole theory (Burt, 1995) as a valuable extension to structuration theory (Giddens, 1984) for understanding how accounting systems are constructed, maintained, changed, and used through action that is embedded in social relations. Second, it provides a balanced framework with which to explore the governance mechanisms of overlapping structures that neither under-socialize nor over-socialize human action (Granovetter, 1985). Third, from a methodological perspective, a meso-level analysis through the use of structural hole theory bridges the gap between macro and micro levels of structuration, thereby highlighting ongoing processes of social interaction, structure, and agency, that has been underdeveloped by previous research (Coad and Herbert, 2009; Englund and Gerdin, 2008). Fourth, the research also contributes to a fuller understanding of the origins of structural holes by including the role of modality: specifically, how modality is used in creating and bridging structural holes.

The article is structured as follows: first, an overview of structuration theory and structural hole theory is provided, followed by a synthesis describing the actor-structure relationship. This is followed by an illustration of the synthesis using Covaleski and Dirsmith's (1988a and 1988b) field study of the University of Wisconsin budgeting system, enriched with archival records. Thereafter, the findings are discussed in the context of higher education funding, a current topic in many countries including the US, UK, and Finland. The article concludes by discussing how management accounting research could benefit from a synthesis perspective that reflects the mutually constitutive nature of agent and structure.

Networking Agent and Structural Holes –Theoretical Framework

The Nature of Agent and Action

In this paper, an agent refers to an individual operating in social settings. The agent has free will, and is able to intervene in a way that social structures are sometimes changed or significantly altered (Giddens 1984: 5). Agents recognize social structures, use them as a base of action, and reshape the structures to their advantage. Agents can and do make choices in social settings, are purposive (Giddens 1984: 3) and have entrepreneurial qualities because they can pursue opportunities when they acknowledge them. Agents are the authors of their own world. They have reasons for their activities, and are able to elaborate – if asked – those reasons (Macintosh and Scapens, 1990: 458). Entrepreneurialism occurs when an agent, acting alone or perhaps with the help of others, identifies a possibility to change an existing structure, or way of doing something, and seeks to change it by creating a new function to carry out their objectives (Young and Sundavarajan, 2006: 5). Although agents may be proactive and pursue change they recognize the social structures that surround them and the ontological security (Giddens, 1984) that the routines of the social structures' offer. Agents also understand the great value of the social networks that surround them, and are ready to use the networks for their advantage.

Agents reflexively monitor social settings, their own and others. Agents know a great deal about why they act and what they do. They also know how to act and interpret the actions of others. Giddens' called this ability to actively search and use information a notion of "knowledgeability" (1984, 3), arising from past experiences and shared pools of knowledge, such as culture (Sewell, 1992:7). However, agent's knowledgeability is bounded. Human action produces consequences that are intended, but also consequences that are unintended. The unintended consequences may also form unacknowledged conditions of action in a feedback fashion (Giddens, 1984: 27).

The Process of Structuration

A social system can be understood by its structure, modality, and interaction (Giddens, 1984; figure 1). Structure is constituted by rules and resources governing and available to agents. Social structure that controls agent's behavior and action exists only as memory traces (Giddens, 1984). By calling structure a virtual order of transformative relations Giddens (1984: 17) means that social systems as reproduced social practices do not have structures but rather exhibit structural properties. Structures exist in knowledge and in our action. Structure exists as time – space presence, only in its instantiations in such practices and as memory traces orienting the conduct of knowledgeable human agents. Theoretically, this paper builds on the modalities of structuration introduced by Giddens (1984: 29). The modality of a structural system is the means by which structures are translated into action, and through which agents can acquire and share knowledge. It is a concrete instantiation of the abstract structure. Interaction is the activity instantiated by the agent acting within the social system (Giddens, 1984). An interaction can be both formal and informal, supplementing each other (Groat, 1997); informal referring to networking that is not officially recognized or mandated by organizations and in which the content of the exchange can be work-related, personal, or social.

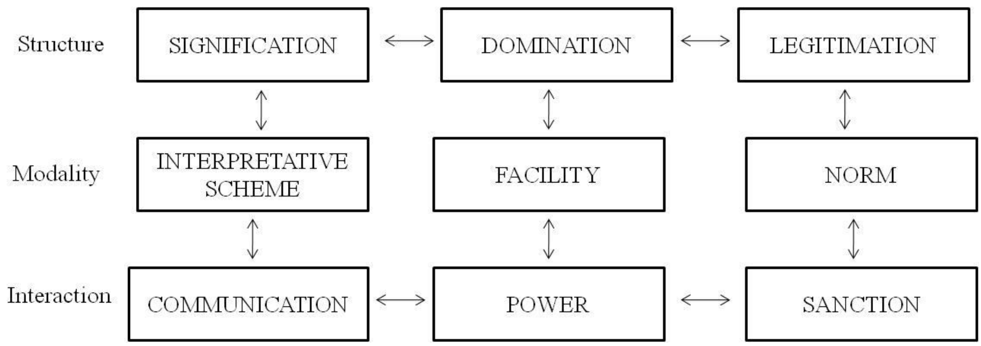

Figure 1. Giddens' dimensions of structure (1984:29)

The duality of structure (Giddens 1984: 25; Scapens and Macintosh 1996: 680) incorporates the relationship of agents and institutions: agents draw upon certain structures in their daily action and as they do so, they also reproduce those same structures and as a result, eventually legitimate them. The signification structure comprises the shared rules, concepts, and theories that agents draw upon to make sense of the meaning of practices, for example, in the context of this paper, management accounting or corporate governance. Interpretive schemes that are situated between overlapping worlds, such as the economic and the political, may especially challenge interpretation and produce multiple interpretations of interpretive schemes. When making sense of the meaning of practises agents draw first upon the meanings and understandings that are most familiar to them, those that come from their own world. Conflict is evident if agents from either or both worlds resist the prevailing structures and pursue change for some reason.

The domination structure consists of the mobilization of two types of resources: allocative and authoritative (Giddens, 1984: 33). Resources are anything that can serve as a source of power in social interaction (Sewell, 1992: 9). Whereas allocative (nonhuman) resources arise from the command over objects and goods, authoritative resources refer to the capability to organize and coordinate the activity of social agents. Allocative resources can be naturally occurring or manufactured, and are used to enhance and maintain power. Authoritative (human) resources are, for example, knowledge, physical strength, and emotional commitments, that can be used to increase and maintain power, including knowledge of the means of gaining and controlling human and nonhuman resources (Sewell, 1992: 9), and access to relations with other agents. These resources support the process of action, but at the same time provide a medium for the exercise of power. They are also unevenly distributed among agents (Giddens, 1990: 44), therefore command over of human, financial, or information resources, for example, can be used in the exercise of power.

The legitimation structure is mediated through norms that sanction behaviour. These modalities or norms contain "the values and ideas of what is to be regarded as virtue and what is to be regarded as vice; what is to count as important and what is to be trivialized; what ought to happen and what ought not to happen" (Macintosh and Scapens, 1990: 460). The legitimation structure institutionalizes the rights and obligations of agents. It tells us what kind of action is approved and what is disapproved, and how we are awarded or penalized as a result of our action. Awards signify trust and access to benefits such as additional knowledge, whereas sanctions signify distrust and control, and restrict access to resources. Because structures are produced and reproduced by individual and collective agents, structures are never objective but rather are interest-related and value-laden. Legitimation practises structure agent behavior, but agents can also use these practises to achieve social approval for their action. This is the duality of structure at work (Giddens 1984: 25): the structural properties of social systems are both the medium and outcome of the practices they organize.

Engaging Trust, Risk and Power with Agency

Trust is a central element in structuration (Giddens, 1984, 1990). In his theory of modernity (1990:83) Giddens states that "the nature of modern institutions is deeply bound up with the mechanisms of trust in abstract systems, especially expert systems". Expert systems provide security (Giddens, 1990: 113), which comes in the form of the routines that institutions offer. Giddens (1990:34) defines trust as "confidence in the reliability of a person or system, regarding a given set of outcomes or events, where that confidence expresses a faith in the probity or love of another, or in the correctness of abstract principles (technical knowledge)". Trust exists in the context that human activity is socially created. Without trust, there would be no activity; trust drives action. Trust and risk intertwine; trust serving to reduce and minimize risks subject to activity. The points of connection between individuals and the representatives of expert systems are called access points. Access points are places of vulnerability in abstract systems, but are also junctions at which trust can be maintained or built up (Giddens, 1990:88): in other words, sources of active agency, opportunities, and risks.

Trust is closely associated with risk because it presupposes awareness of circumstances of risk, and refers to expectations that can be frustrated (Giddens, 1990:31). In discussing the difficulties of controlling the modern societies, Giddens lists four risk factors (1990: 151). These are, design faults, operator failures, unintended consequences, and reflexivity of social knowledge. The first factor relates to reasons why systems go wrong. The second refers to mistakes made by system operators. As long as humans are involved, so there are risks of failure. Although both of these factors are important, Giddens (1990:153) stresses the significance of unintended consequences and reflexivity of knowledge: "No matter how well a system is designed and no matter how efficient its operators, the consequences of its introduction and functioning, in the contexts of the operation of other systems and of human activity in general, cannot be wholly predicted. One reason for this is the complexity of systems and actions that make up world society". According to Giddens, unintended consequences persist no matter what, because reflexivity of social knowledge affects, in the first instance, the social rather than the natural world. New knowledge spins the social world off in new directions. Agents' values and knowledge are connected (Giddens, 1990:54), but the result and the extent that new knowledge changes values is always unknown beforehand. Because of this, social life cannot be completely controlled. There is always homogeneity of interests and motives driving change (Covaleski and Dirsmith, 1988a), which brings us to the importance of power.

Most social relationships are based on a mixture of trust and power, mechanisms of social control (Bachmann, 2001:351). Power can be defined in terms of intent or the will to achieve intended outcomes (Giddens, 1984: 15). Power plays an important factor in defining the extent that the rules and resources drawn from other social worlds can be exercised in other circumstances. In order to generate change in social structures an agent needs to acquire distance from constraining rules and focus on enabling elements. Agents who control resources including information are more powerful than others. The appropriation of knowledge is not a homogenous process, but is differentially available to individuals in power positions (Giddens, 1990:44). The power of any agent can grow or diminish over time. Power – as a form of rules – holds agents accountable for their actions, communicates a set of values about what is approved and what is disapproved, and what rewards and penalties can be utilized. Power, in the broad sense, is the ability to get things done and to make a difference in the world (Macintosh and Scapens 1990: 461).

Agents differ in their abilities to shape and influence changes in social structures. In this regard, some agents hold a more powerful position than others. They are proactive, represent a strategically important organization, are members of an elite or are perhaps just intelligent network players with excellent social abilities. In this paper power is addressed as a means to secure and control the productive relationships that overlap[32] different social structures. Power implies domination. As Macintosh and Scapens (1990: 461) put it: “Agency and power are related in that agency entails the ability to act otherwise, to be able to intervene in the world, or to refrain from intervening.” The agent makes a choice. Choice is possible, because more than one course of action is acceptable within the social structures. Thus, agents’ access to different social structures and structural rules enable a stronger and more powerful agency.

Social relations involve autonomy and power, tensions and contradictions, trust and control, cooperation and competition (Sydow and Windeler, 1998: 280). Whether agents are politicians, managers, academics, or factory workers, they are resourceful. Even the most humble agents have resources that they can use to influence their superiors. This two-way

[32] By overlapping structures I mean the different social structures that agents engage in. They are divided by a social frontier, anyplace where two social worlds meet, where people or an organization of one kind, meet people or an organization of a different kind. See Burt 1995, p.132. At the meso level the social structure refers to network ties between individuals or organizations.

exercise of power is called the dialectic of control (Giddens 1984: 16), sifting focus from individual agency to networks of two or more individuals and collective agents, and to opportunities and risks that these networks of relationships offer entrepreneurial agents.

Agency and the Benefits of Overlapping Systems

The connection between an agent and a social system is known by various names, for example a role or a position in a social system. According to Giddens (1984: 84) social position can be regarded as a social identity that carries with it a certain range of prerogatives and obligations that an agent who is accorded that identity may activate or carry out. They "are constituted structurally as specific intersections of signification, domination and legitimation (Giddens, 1984: 83). The agents in which relations intersect are physical and legal entities: a person (manager), a group (board of directors), an organization (firm). Sometimes the overlying social structures overlap through common members. Sometimes they are completely distinct with no ties to each other. When they are distinct and lack ties to each other, the gap between them is a structural hole (Burt, 1995).

A structural hole is a role or position in the social structure (Burt 1995), consisting of "relatively unconnected sets of understandings, practices, rules and organizations" (Yang, 2004). The less contact the agent's network members have with each other the more structural holes the network contains. The structural hole provides an opportunity for an agent to establish contact with each of the two networks, bridging the structural hole and providing information and control advantages and the freedom to behave entrepreneurially (Burt, 1995). For example, as a result of the hole between them, the two otherwise distant contacts bridged by an agent provide network benefits that generate value, control, or both, to the agent if he or she chooses to use the hole to their advantage. Thus, structural holes are an opportunity to broker the flow of information between people, and control the projects that bring together people from opposite sides of the hole (Burt, 2000: 9).

Whittington's framework (1992: 705, figure 2) of social systems and the structural bases for action serves as an example of opportunities and brokering of structural holes. In his study of social systems and managerial agency, organizations were divided according to their activity system and their typical social structural rules and resources. According to his framework firms, as economic organizations, rely on capitalist structures, apply capital ownership as basic resources, and focus on profit maximization. Political systems, such as the state, rely on legitimate coercion and patriotism as they represent legislative and juridical organizations. In order to maintain agency in these social systems (as is the case in any social system) agents need to know how to get on, know the rules, and how to play according to these rules. Managers and politicians, for example, are full members of society and operate in a diversity of social systems. They are therefore able to draw upon, and respond to, a multiplicity of rules and resources (Giddens, 1984:85; Whittington, 1992: 705). With values and interests drawn from other systems, CEOs need not to always apply their resources simply to maximize profit (Whittington 1992: 706), or politicians need not be dependent on capitalist social structures. Thus, the agents' access to different social structural rules and social systems (the creation of knowledge from the application of information bridged from different systems) enables stronger, although sometimes also weaker, agency. In this way, networking agents exploit opportunities arising from past experiences and knowledge that in turn motivate and enable agents to recreate past network positions as future beneficial ones, paralleling Giddens' (1984, 1990) conceptions of the duality of structure, as well as reflexivity (reflexive monitoring of action).

Activity system	*Communal*	*Economic*	*Domestic*	*Political*	*Intellectual*
Dominant structures	Ethnic and religious	Capitalist	Familial	State	Professional and academic
Basic resources	Networks	Capital ownership	Partiarchal authority	Legitimate coercion	Expertice and legitimacy
Basic rules	Solidarity	Profit maximazation	Paternalism	Patriotism	Professional codes
Organizations	Clubs, churches	Firms	Households	Executive, legislative and juridical	Professional bodies and universities

Figure 2. Social systems and structural bases for action (Whittington, 1992:705)

Whittington's separation of organizations into the economic and the political domains is analytical in the sense that in the modern world an agent is engaged in many overlapping social systems. Individual agents bridge different social systems and are able to draw upon and respond to a multiplicity of rules and resources. Whittington calls this type of action a second form of agency, in which the issue is "no longer one of choosing which is the appropriate rule in particular circumstance, but potentially of defying immediate system logics altogether" (1992: 704). As agents engage in many different social systems they also face a variety of conflicting rules that are most evident at the social frontier. According to Burt (1995), the social frontier divides social worlds. Structural holes generate opportunity, and create inequality between people and organizations because opportunities are not distributed equally. Agents with networks rich in structural holes – agents with networks that provide high structural autonomy and low monitoring – know about, may take part in, and can exercise control over, more rewarding opportunities (Burt, 1995: 2).

Modalities of structuration (Giddens, 1984), the access points to connections between individuals or collectivities and representatives of abstract systems (institutions), create entrepreneurial opportunities for certain actors by offering various bridging mechanisms across structural holes. Modalities, the rules and resources, are under constant change and therefore vulnerable, because rules that restrict agency can be manipulated by the use of resources. Modalities are not only constraining but also enabling, providing rules that allow new actions, structural holes, and as a result, new structures. Structural holes are thus the result of the interplay of rules and resources, the duality of action, and a source of possible new structures.

Figure 3 illustrates the interplay of structural holes, using academic and political structures as an example. If the structures are separate, a structural hole exists between them. However, academic and political structures overlap, for example with regard to funding issues and government budget. Both are dependent on the other: an academic structure's stability depends on political funding, whereas political stability depends on the future social and economic prosperity of a knowledge-economy, protected by academic science and research. The academic and political structures share a modality through which they interact. This modality can, for example, be the committee through which university funding is negotiated. For the modality to work, network trust is needed. It is embedded in the relationship of actors and the broker who controls the modality, perhaps the committee chair or the Secretary of State for Education. If the negotiating actors trust each other that trust can be extended to a much wider group of people through referrals (Burt, 1995:47). However, if the trust between frequently socializing agents deteriorates it hampers the information flow not only between them, but also between the structures they represent, thereby questioning the modality's functionality because some of the actors/broker do not behave in the expected/uniform way.

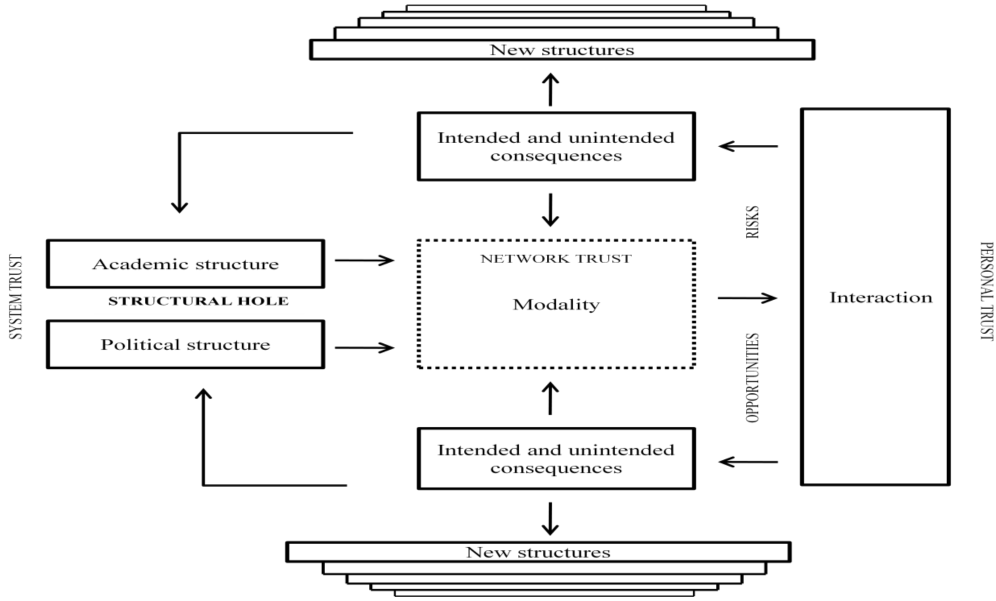

Figure 3. Interplay between structural holes and structures

When the modality is questioned and information does not flow, a structural hole appears between the structures. Opportunism arises as agents try to find new ways to bridge the structures and control the information exchange. To this end, agents can use both formal and informal networks, which as is the case for all human behavior, has both intended and unintended consequences (Giddens, 1990). The structures could remain separate, but that would mean significant changes to both structures. The academic structure would need to find new ways to fund its activity and to justify its existence. The political structure would take the risk that the power to govern the future would be placed in the hands of others, for example, an economic structure and large corporations, because the academic structure would need their support to survive, meaning that the research interests might change from those of democratically elected politicians.

In order to rebuild the bridge between the worlds the agents and the broker need a new shared language. After such a shared language is recreated, a compromise negotiated, and the trust built into the process, the broker bridges the structures with new modality and the structural hole disappears. Throughout this process the agents of both worlds and the broker learn from each other and from other structures. As knowledgeable human beings they are able to use that knowledge in their future exchange relations – either within these overlapping systems or in other settings.

The Beneficiaries of Structural Holes

Trusted agents have better positions with which to control and bridge structural holes (Burt, 1995:47) than agents who are distrusted. Information (with opportunities and risks) does not flow in the network if the bridge (e.g. modality, expert system, or agent) is not trusted. Therefore distrust can motivate agents to break the legitimacy of the modality and create structural holes by blocking network members from information, and motivate agents to find new ways to bridge the emerging structural holes.

Although agents respond creatively to the opportunities that the social systems present, and they work to loosen constraints that prevent them from doing what they wish, they are not equally likely to pursue the benefits of structural holes (Burt, Jannotta and Mahoney, 1998). Agents who pursue the benefits of structural holes – entrepreneurs – are more likely to be the authors of their own social world. According to Burt et al. (1998: 74) people in the networks who are richest in structural holes see themselves as agents responsible for coordination and change. These authors also argue that the personality items most often claimed by the least constrained agents are their desire for a chance to be in a position of authority and their belief that success will come because of their ability to create. These agents are independent people, who enjoy convincing others, have sales abilities, and are extroverts (Burt et al., 1998: 75).

Agents can be pushed to be entrepreneurs by psychological need or cultural background (Burt, 1995: 35). For example, widely taught and excepted agency theory can be one of the driving factors. Certain types of agent behavior (e.g. shareholder value maximization) are expected from agents such as CEOs. This is even taught at business and law schools. Agents can also be pulled towards an entrepreneurial act by the promise of success (Burt, 1995: 35). A person committed to entrepreneurial behavior is more likely to create opportunities, find and use structural holes, and profit from success, than a person whose values rule out entrepreneurial behavior (Burt, 1995: 36).

The Opportunities, Benefits and Costs of Structural Holes

For entrepreneurs structural holes are opportunities for information access, timing, referrals, and control (Burt, 1995: 13). The information benefits of a network define who knows about opportunities, when they know, and who gets to participate in them. Agents with a social network that is optimally structured to provide these benefits enjoy high returns for their "network investments", because such agents know about, and have a hand in, more rewarding opportunities: information, money, prestige, professional opportunities etc. Knowledge synthesized from these opportunities and the associated risks encompass power: the potential to change current circumstances and build new structures, intentionally and unintentionally.

According to Macintosh and Scapens (1990: 460) a legitimation structure (as introduced by Giddens) mediated through norms and moral codes which sanction behavior, institutionalizes the rights and obligations of social agents. Macintosh and Scapens use, as an example, management accounting systems, which legitimate the rights of some people to hold others accountable in financial terms. In order to gain legitimacy for their action, agents need to look for opportunities that can earn them credits of legitimacy, which in turn helps them gain access to future opportunities and protect them at difficult times (Yang, 2004). Agents seeking to enact change must gain the support of others and develop trusting relationships with people that are equally committed to their objective. Trust and knowledge of past actions and networks enable agents to turn past network positions into future beneficial ones.

Information does not spread equally (across the social frontier) because agents are unevenly connected with one another (Burt, 1995: 13). Access, the first of the information benefits, refers to receiving a valuable piece of information and knowing who can use it. Information and knowledge, however, are not distributed equally in social systems, but are engaged with power (Giddens, 1990: 44): "the appropriation of knowledge does not happen in a homogenous fashion, but is often differentially available to those in power positions, who are able to place it in the service of sectional interests". Yet timing is significant considering the information received: beyond making sure that you are informed about important issues, personal contacts can make you one of the agents who are informed at an early stage. That early warning is an opportunity to act on the information and benefit from it (Burt, 1995: 46). In addition, the same information has more legitimacy when it comes from someone inside the decision-making process who can speak to your virtues. Recommendations from trusted contacts, gossip (friends or colleagues, for example), or "the referrals" as Burt calls them, can solve the issue of the legitimacy of the information, because they get the agent's interests represented in a positive light (Burt, 1995: 47). Consistent with Giddens (1990), action presupposes trust and power, in other words mechanisms of social control.

Opinions and behavior are more homogeneous within than between groups, so agents connected across groups are more familiar with different ways of thinking and behaving

(Burt, 2004: 349). Because social structures are always both constraining and enabling (Giddens, 1984: 25), agents can exploit rules and resources to legitimate their conduct (Whittington, 1992: 706). People whose networks bridge the structural holes between groups have an advantage in detecting and developing rewarding opportunities (Burt, 2004: 354). These agents see things early and more broadly, and translate information across groups. According to Burt (2004: 355) agents familiar with activities of two groups are more able than people confined within either group to see how a belief or practice in one group could create value in the other and to know how to translate the belief or practice into language that is digestible in the other group. In order to activate this ability agents require trust. However, trust is not the only way to coordinate relations of organizations. Another mechanism of control is power (Bachmann, 2001:352). Both of these mechanisms are usually attached to modalities of structuration such as expert roles and designs of control, which legitimate rules in social systems and which bring us to the second type of benefits of structural holes, those of control.

The structural holes that generate information benefits also generate control benefits, giving some actors an advantage when negotiating their relationships (Burt, 1995: 30). Burt breaks negotiation into three components: structural, motivational and outcome. The social structure defines opportunities (duality of action, Giddens, 1984), an agent decides whether to pursue opportunity – and sometimes succeeds (Burt, 1995: 30). In sociological theory this role or position is know as the tertius gaudens (Simmel, 1923), the strategist who benefits from the holes (Burt, 1995: 30). According to Burt a control benefit arises when two persons compete for the same relationship or when two agents are played against one another when they make conflicting demands on the same (third) individual in a separate relationship. For example, a professor with two simultaneous offers from competing institutions may play the universities against each other and gain personal profit as a result, such as higher salary and permanent position. Information benefits are closely associated with control benefits and help agents to identify the advantages of relationships and to understand the resources and preferences being played against each another. Agents who use structural holes can add value through the information and control benefits that reside in the holes (Burt, 1995).

Sometimes agents do not simply conform to rule-bound environments, but reshape those environments through their own actions (Giddens, 1984). They try to avoid crises, but at the same time seek opportunities bounded by rules under constant reconstruction. In his study of entrepreneurship and institutions in transition economies Yang (2004) claims that institutions are more than a set of rules that entrepreneurs have little choice but to follow. He defines institutions as the rules of the game in a society, or the human devised constraints that shape human interaction (p.374).

As institutions are designed to shape social relations, they can also structure incentives in human exchange; for example political, social, or economic action. Structural holes, meeting grounds of connection between individuals or collectivities and the operators of abstract systems (such as legal and economic system), in other words “access points of abstract systems” (Giddens, 1990: 83), explain why entrepreneurial agency can play an active role in structural changes by shedding light on the potential opportunities and constraints embedded in social structures. To take full advantage of structural holes, an agent must find, build up, and maintain multiple connections by not only innovatively dealing with institutional rules but also watching out for opportunities and risks in the structure (Yang, 2004: 383). Agents may influence how the institutional framework evolves; they comply with cultural values, norms, and rules – or not, if there are no penalties, action goes undetected, or the risk of being socially disapproved are worth taking.

Bachmann (2001:352) states that in social systems based on a low level of institutional regulation, power is more often chosen as the dominant mechanism with which to co-ordinate expectations and to control social relationships between individuals and organizations. In circumstances of a strong and rational institutional framework, where trust is produced on an institutional basis (in the form of system trust) and the risk of betrayal can be deemed relatively low by someone considering either power or trust in a specific relationship, individual power resources will have a relatively low value and will often remain unused. Under these conditions system trust is likely to be the prevailing social control mechanism. However, neither is power absent in this case. Rather, it appears as system power in the form of law, powerful business associations, inflexible governance practices, technical standardization, or structures of hierarchy. System power is often opaque to lay people, because it is institutionalized and embedded in modalities designed by experts. The influences of these "hidden" powers in processes of social interaction become explicit and transparent only through knowledge of such processes.

So far, structural holes have here been discussed in a positive light, but they also bear negative effects. Structural holes can be used for manipulation, opportunism and inefficiency. Tertius gaudens, the one who benefits from the holes, can set two distant contacts against each other, for example by feeding them inaccurate or false information or by controlling their relationship. The person controlling a structural hole can create circumstances of imperfect social competition by placing some agents in advantaged positions and restricting the movement of other people so that their movement becomes difficult. As such, structural holes reveal the power of position within social structures (Burt, 1995). Whatever the motivation of an agent, the opportunities created by social structure can be used for good or bad, or not used at all. The intended and unintended consequences resulting from entrepreneurial action can change social structures and create new structures, because the social world is never stable in terms of new knowledge about the way it functions (Giddens, 1990:153).

Case Illustration: The University of Wisconsin Budgeting System

The purpose of this study is to demonstrate through a synthesis of structuration and structural hole theory how structural holes emerge in management accounting systems, how new modalities emerge from agents' use of structural holes, and how a management accounting system that is supposed to protect against opportunism becomes a source of such opportunities. In order to illustrate the role of structural holes in structuration process and the use of modalities as a bridging strategy it is necessary to examine a field of study. The selected study is the rich description of the University of Wisconsin budgeting system provided by Covaleski and Dirsmith (1988a and 1988b), also applied by Macintosh and Scapens (1990) to illustrate how structuration theory can be used to make sense of the social processes of accounting from the institutional perspective.

Although the case was not originally written from the structuration theory or structural hole perspective, it describes social processes that can be understood in terms of these chosen theoretical perspectives. An existing case study was chosen because its later adoption (Macintosh and Scapens, 1990) provides a good illustration of structuration. It therefore gives a familiar platform (also discussed by Boland, 1996 and Scapens and Macintosh, 1996) for further analysis where the focus is on action, interaction, and the emergence of new structures through the bridging of structural holes. The focus of the illustration is on the network positions of actors, on the appearance and disappearance of structural holes that the network provides, and on the modality (the budget process) that bridges the two worlds (academic and political) thereby enabling and restricting action.

This illustration does not rely solely on the research of Covaleski and Dirsmith (1988a and 1988b); the data is supplemented and enriched by archival records. These records consist of online information from the Wisconsin Historical Society, newspaper articles, and books relating to local politics and history.

The Origin of the Budgeting Relationship between the State and the University

This case illustration is built around the budgeting system used in the State of Wisconsin, particularly at the University of Wisconsin. It describes the tensions that arose in 1980s between politicians and university administrators as a result of reductions in funding and the consequences that followed. The budgeting system that the state used developed mainly from the philosophical base of progressiveness (Covaleski and Dirsmith, 1988b: 569), emphasizing rationality, science, and expert decision-making in administration. The roots of the philosophy go back nearly 100 years. The strongest advocate of this progressive movement[33] was Robert La Follette (1855-1925), a Republican governor and later senator, and a graduate from University of Wisconsin-Madison. He created an atmosphere of close cooperation between the state government and University of Wisconsin in the development of progressive policy. This concept later became known as the Wisconsin Idea, originating from University of Wisconsin President Charles Van Hise (1904), a former classmate at the university, and a friend of Governor La Follette.

However, from the beginning, "The Wisconsin Idea" (McCarthy, 1912) contained competing interpretations, arising from the role identifications of the state and the university (Mitchell,

[33] Progressive Republicans believed that the business of government was to serve the people. They sought to restrict the power of corporations when it interfered with the needs of individual citizens. The Progressive Movement appealed to citizens who wanted honest government and moderate economic reforms that would expand democracy and improve public morality (Wisconsin historical society, www.wisconsinhistory.org).

2006:5). The Wisconsin Idea was, at first, a philosophy embraced by the University of Wisconsin, which holds that the "boundaries of the university" should be the "boundaries of the state", meaning that research conducted at the University of Wisconsin should be applied to solve problems and improve health, quality of life, the environment, and agriculture for all citizens of the state. The Wisconsin Idea adapted to politics by Governor La Follette, stated that efficient government required control of institutions by the voters rather than special interests lobbied by large corporations, and that the involvement of (academic) specialists in law, economics, and social and natural sciences would produce the most effective government. The idea was to engage the university with the state so that authority, cooperation, and control would foster efficiency. Both the university's president and the governor sought to keep the center of power in their own hands, which meant that the potential for conflict was present from the very beginning of the close relationship.

According to Covaleski and Dirsmith (1988a), both the academic and political worlds profited from this "rational administration" culture by which difficult issues could be solved with simple reference to experts. State politicians, aided by academics sought reform by removing issues from the realms of politics and open debate, backed up by scientific methods and technical solutions, which satisfied both academics and politicians because politically difficult issues, such as funding, could be resolved with reference to experts and scientific methods. Academics developed knowledge pools gaining professional recognition and autonomy in turn. During the early part of the 20th century, faculty experts consulted with legislators to help draft many influential laws, including the nation's first workers' compensation legislation, tax reforms, and the public regulation of utilities. The philosophy of this positivistic movement (Covaleski and Dirsmith, 1988b) retained an assumption that academics were ideologically neutral with no vested interest or aspirations; therefore they would be objective in their administrative duties. Overall, the academics of University of

Wisconsin played a significant part in progressive reform efforts, helping legislators draft laws, and serving as experts on governmental commissions.

In terms of structural hole theory, "the Wisconsin Idea" was created to bridge the academic and political worlds. The creation of this worldview was built through a process of formal and informal interaction (e.g. friendship between the governor and the president of the UW), in which shared meanings and understandings formed (Macintosh and Scapens, 1990: 464). The shared philosophy helped to align the interests of academics and politicians' and to define and construct problems and solutions in a mutually beneficial way. The Wisconsin Idea was not only important in knowledge transfer but also played a part in creating a long-term relationship and network between academics and politicians.

Budgeting as a bridging modality in social interaction

The governor's role, in general, was central in the university's budgeting process (Covaleski and Dirsmith, 1988b:567), and he controlled it as a broker. In 1982, in line with the traditional process, the University of Wisconsin submitted budget requests to the governor via his supporting budget agency, the Department of Administration (DOA). The DOA's duty was to analyze the requests and develop alternatives for the governor to consider, and to arrange budget discussions involving the governor and each state agency. On behalf of the governor the DOA then presented the Budget Bill to the legislature, Legislative Fiscal Bureau (LFB). Once LFB agrees the terms of the budget the governor signs it.

As part of the traditional budgeting process the university and the governor's office had developed an "enrollment formula" which served as a legitimate base for resource (funding) allocation and control for the governors, and secured the university's autonomy in allocating those resources according its own preferences. It involved such measures as "cost per student credit hour", to determine the resources required to maintain equality among different universities (Covaleski and Dirsmith, 1988b:570). The formula bridged the two worlds and it passed information between them. The modality offered several benefits for "rational" policy makers (Covaleski and Dirsmith, 1988a: 11): "Firstly, changes in program scale or nature were highlighted; secondly, changed in workload were presented according to generally accepted qualified standards: thirdly, the enrollment funding formula provided a methodology for assessing the long term effects of enrollment declines; fourthly, in an area where policy makers have traditionally assigned a great deal of discretion to the Regents in the allocation of funding, it was possible to avoid involvement with the detail of instructional funding decisions; and finally, the number and variety of individual program decisions brought to policy makers was minimized."

It is evident that both the university and the politicians benefitted from the legitimacy that the modality (formula) provided. The political funding decisions were scientifically supported and depersonalized general standards, embedded in technical designs of experts, which would serve as a basis of trust for lay people. The budgeting relationship between the governor and the university was based on a mutual trust that was strengthened by the benefits of control and autonomy that the enrollment formula provided. Because the budget process was both a means of control and a means of autonomy, and the agents acknowledged this, the risks of this relationship and the potential for conflicts were present (Giddens, 1984:193; Macintosh and Scapens, 1990:463). The governor did not traditionally interfere with the university's autonomy concerning the funding allocation inside the organization. Nevertheless, he controlled the agency (DOA) that administrated the budgeting process. As long as the university acted rationally, or at least in a symbolic manner, it was entrusted with autonomy. The economic problems of the State of Wisconsin and worsening budget deficits of the late

1970s brought tensions to this academic and political relationship, finally leading to conflict. The issue of university funding was both academically and politically highly sensitive.

In terms of structural hole theory, the separation of budgeting roles caused more structural holes than would have been the case with fewer roles (13 universities, two state agencies and the governor; Covaleski and Dirsmith, 1988b:567). As a result, the budgeting network was surrounded with more diverse information than would be the case for a less separate network. As the agencies, DOA and LFB (department of administration and legislative fiscal bureau) chose what information was mediated and in which form, they controlled the information exchange across institutions on behalf of the governor and state. The use of enrollment formula enlightened that action.

Exploitation of modality erodes trust between the university and the state

At the beginning of 1980s the state of Wisconsin battled against double-digit interest rates, high inflation, and increasing unemployment, which called for tax rises. The acting governor (1979-1983) at that time was Lee Dreyfus, former chancellor of Stevens Point, which is part of the University of Wisconsin System[34]. Unlike most of the governors dating back to the times of La Follette, Dreyfus was not a lawyer, he had degree in communications from the University of Wisconsin-Madison, and he had never served in the legislature[35]. He had campaigned to give back the state surplus to taxpayers rather than save it for a rainy day or to pay off debt. But when a recession later hit and the state desperately needed money, Dreyfus's administration was in trouble. In Dreyfus' final year in office, 1982, the state had a budget deficit of nearly $1 billion and a 12 percent unemployment rate.

[34] UWS system comprised originally of 13 universities and 14 colleges. www.wisconsin.edu/about/history.htm

[35] JSOnline, A Wisconsin Maverick, Jan. 4th, 2008. http://www.jsonline.com/news/opinion/29416149.html

According to Covaleski and Dirsmith (1988a), two sources of tensions occurred within the budget crisis. The University of Wisconsin System was a result of a merger (in 1972) of two state university systems, those of the Wisconsin State University system (WSU) and the University of Wisconsin in Madison. Madison faculty and administrators had opposed the merger, fearing it would weaken their position. In contrast, WSU faculty and administrators favoured merger, believing it would add prestige to their institutions and level the playing field for state funding. Over the following years the fears of Madison faculty materialized as the State reduced support to the University of Wisconsin System. The university handled the funding problems by internal allocation of resources, which shifted funds from Madison to its siblings, and made Madison concerned about maintaining its "flagship" status.

Two independent studies had documented funding reductions since 1973 and showed that the University of Wisconsin System's budgets were severely underfunded compared to other public universities (Covaleski and Dirsmith, 1988b:571). Several issues influenced the emerging conflict. In the wake of the 1973 oil crisis and the 1979 energy crisis, stagflation began to afflict the United States economy. By 1980, inflation soared to 13.5 per cent. During Ronald Reagan's first years of presidency the US economy was in severe recession (from 1981 to 1982), which hit the industrial state of Wisconsin hard. Although Reagan encouraged the reduction of government spending and spurred economic growth through tax cuts, the fiscal problems lasted in Wisconsin for several years after the recession ended. For higher education, the state's problems meant shrinking state support; calls to focus on efficiency and increase productivity. The means included uniting all universities under a single budget system. Governor Dreyfus was the right person for the job: in his position as President of University of Wisconsin-Stevens Point, he had supported the controversial merger of the

Wisconsin State University system and the University of Wisconsin in Madison in 1971[36]. In 1972, after the merger, he became the Chancellor of the University of Wisconsin–Stevens Point. Madison, the largest unit and a research university, which had opposed the merger, was forced to subsidize its siblings, including Stevens Point.

The State of Wisconsin reduced support to higher education systematically, and used the enrollment funding formula (Covaleski and Dirsmith, 1988b: 571), which bridged the academic and political structures, to legitimize the reductions – thus, from the academic perspective, misinterpreting its meaning. The basic unit of measurement that came under political scrutiny in the budget process was the cost per student credit hour (Covaleski and Dirsmith, 1988b:570). This permits several possibilities for funding reduction because professional salaries, support salaries, operating expenses, and equipment charges are all allocated to such a method[37]. Without considering or understanding the ultimate change a reduction in the measurement would cause, it would be simple to adjust the number downwards and reduce funding. That would mean a significant change to the academic structure because the university would need to restructure its activities or find substitutive funding. Several questions would emerge, for example: should we decrease doctoral level enrollment because the student credit hour is more costly than at master's level? Should we decrease specialized instruction that requires more specialized personnel and equipment that contribute to higher costs per student credit hour? Should we simply use more low-cost teaching personnel and offer lower number of scientific programs?

As the state of affairs became clear to Madison campus the academics begun to question the legitimacy of the modality. They did not lack resources, but used media to challenge the

[36] Reaching a milestone. The University of Wisconsin System, 18(1), 2001. http://www.wisconsin.edu/wisconsinideas/

[37] Albright, B. 1975. An Analysis of Instructional Costs Per Student Credit Hour Fall Quarter 1973 For Public Higher Education Institutions in Tennessee. A Report of the Tennessee Higher Education Commission. http://www.eric.ed.gov

existing budgeting procedure (Covaleski and Dirsmith, 1988a:14) and lobbied elected representatives (Covaleski and Dirsmith, 1988a:15). Thus both the academic and political worlds had resources they could use against each other to legitimate their action.

A significant change in this political–academic relationship took place in the middle of the biennial budget process: Dreyfus did not seek a second term as governor. Anthony Earl, a Democrat, succeeded Dreyfus in early 1983. For the first time the governor was not a graduate from University of Wisconsin-Madison or one of it siblings. Earl had received a law degree from University of Chicago, thus he had less strong ties to the University of Wisconsin System than his predecessors[38]. Furthermore, knowledge of the legislature replaced knowledge of a skillful orator. A new agent brought new dimensions to arising conflict over legitimate modality.

The relationship between academic and political structure was not stable with fixed network positions. New information and new actors brought new perspectives, preferences, and understandings to the frame of relationships, the budgeting process, thereby exposing it to change.

Consequences for the modality

The enrollment funding formula traditionally benefitted both the state and university. As a result of exposed "misinterpretation" of the enrolment funding formula by several governors

[38] For example, Governor Dreyfus was a graduate from Madison, who had engaged in the university's resource allocation for the first time in early 1979 when he had signed into law the establishment of the University of Wisconsin-Madison School of Veterinary Medicine. In 1982 he had warned that the University of Wisconsin System would have to close some of its campuses due to economic pressures, if it wanted to remain one of the nation's top universities, thus highlighting the pre-eminent role of Madison faculty as the backbone of the State's academic system.

and legislators, the academics considered the formula more harmful than beneficial, and questioned its legitimacy (Covaleski and Dirsmith, 1988b: 573). The practice was clearly in conflict with the philosophy of The Wisconsin Idea that the University Of Wisconsin System embraced. Trust of the traditional budgeting system and politicians decreased as the university's autonomy and institutional independence had declined due to underfunded budgets. The university was not able to carry out the objectives it had set as it was forced to accept all qualified students (Covaleski and Dirsmith, 1988b: 572). As a counter reaction to what they perceived as political malpractice the university abandoned the traditional enrollment funding formula and proposed a new modality for the budget discourse. The quantitative formula was replaced by a more qualitative approach, accompanied also by historical data and peer references that revealed the severe underfunding, in order to legitimate the university president's action.

The new budget approach became known as "Decision Item Narratives" (DINs). The narratives emphasized output orientated activities to be undertaken by the university rather than mechanically emphasizing the resources needed to get the job done. The university hoped that the state would be less willing to reduce productivity than to reduce funding, because the cuts in services and programs Governor Dreyfus had been forced to carry out due to recession were at odds with Wisconsin's progressive tradition, as was the brokerage of the enrollment funding formula that the governor had used to his political benefit to hide funding cuts (as had his predecessors). As such, the university tried to restrict the governor's action politically and benefit from the control of new "qualitative" modality by abandoning the old modality and adopting a new one. The benefit would have been regained autonomy. It would have also brought decision-making closer to voters because the governor would have been forced to give his face to the abstract expert system, the budgeting process, and the use of the enrollment funding formula, thereby moving the focus of trust from system trust towards personal trust. In this process the trust the governor enjoyed as a politician would have been tested, since his campaign had promised support for higher education, a promise he was clearly violating.

American progressives who emphasized the need for efficiency typically argued that trained independent experts could make better decisions than the local politicians (Covaleski and Dirsmith, 1988b: 569). Between 1973-1982 however, the power was gradually taken out of the hands of professional administrators (academics) and placed in the hands of elected officials, thus reducing the voice of academics in budget relationship (Covaleski and Dirsmith, 1988b: 573). This increased political power and intervention, and the potential for the governor to benefit politically from his central network position, the access point between the state and the university.

To legitimate the new budget approach, in 1982 the university (Madison in a central role) drew on the philosophy of The Wisconsin Idea, engaging the university's funding in ways by which it could help in the state's economic recovery. Although the academics received the sympathy of the public (Covaleski and Dirsmith, 1988a:14) problems emerged with the university's new budgetary approach. The governor did not like the behavior of the university in that it had abandoned the traditional way of legitimizing fund allocation. The narrative based qualitative budget would enforce the governor to become directly involved with funding allocation, a process that politicians had long been trying to avoid, because educational issues – especially budget cuts – are politically sensitive and thus risky. The expert systems, such as the enrollment formula, had provided safety to those in power, because they could act more opaquely, hiding behind a legitimate system. With the advent of a new qualitative budgeting approach that safety was being divested from the governor.

Governor Earl refused to play by the rules proposed by academics. Instead of applying the qualitative budget categories the governor's budget policy agency (DOA) pooled budgetary requests into one item titled "Improving University Education". The title was in line with the new governor's campaign promises and signaled his support for the university, which he needed to show for political reasons. As a state budgetary analyst commented: "It was our title, Improving University Education. This provides a coherent structure that (1) the governor can defend to the legislature and (2) the university can endorse" (cited in Covaleski and Dirsmith, 1988a: 17). Rather than negotiating the conflict personally with the university the governor approached it through his budget policy agency, which acted as a bridge (modality) between the conflicted parties. However, the modality was controlled by the governor, just as was the case for the traditional enrollment funding formula. An observer at the Legislative Fiscal Bureau commented: "The Governor did not accept the Benchmark model as a basis for funding. Therefore, the governor came to a judgment as to lump sum funding to invest in the university. This would signify an investment in the university to offset previous budget reductions … At the same time it was not a commitment to any of the arguments the university made" (cited in Covaleski and Dirsmith, 1988a: 18). By applying knowledge, and the power and resources (Macintosh and Scapens, 1990: 466) attached to his position, the governor turned the qualitative modality of budgeting to his political benefit.

When engaging in political games the academics did not understand the relationships of budgetary process beyond their own network contact, which in this case was the governor's budget policy agency. The qualitative budget process antagonized the Legislative Fiscal Bureau (Covaleski and Dirsmith, 1988b: 578), which was subordinate to the legislature and monitored proposed state budgets submitted by the governor. Behind this reaction was the fear that abandonment of the enrollment formula would have far-reaching consequences. "The bulk of state monies are allocated to all other agencies on a formula basis. So there is pressure on the university to do this. They need a (quantitative, formula driven) mechanism that has a life of its own." (Covaleski and Dirsmith, 1988b: 577) In the end, the question was not about the absolute amount of fund allocation, it was about legitimizing it with mechanisms that benefitted politicians and legislators. The response of the Legislative Fiscal Bureau to qualitative budgeting was harsh; it threatened to become directly involved with campus or department levels of fund allocation if the traditional policy was abandoned. By abandoning the traditional rules through a unilateral decision, the academics engaged in political game. That changed their position. They could no longer be regarded ideologically neutral with no vested interest; it became questionable if they were objective in administrative duties.

Governor Earl's budget agency recommended funding $20.5 million of the requested $24.6 million for "Improving University Education". The bill recognized the underfunding built into the enrollment funding formula, demonstrating to the public that the governor kept his campaign promise. The governor also included in the budget a one million dollar category "Star Faculty Fund" to highlight his commitment to higher education, which generated high media appeal. The university was content with the result. However, the process left the state with a budget (modality) that could not be scientifically legitimized. Furthermore, in the process, the university had broken the rules and embarrassed the governor(s) and his agency. The university's victory was short-lived. The compensation plan was traditionally handled separately to the budget. The university submitted the plan according to the traditional process and requested an 18 per cent increase in compensation. However, what was approved by the legislature was Zero per cent for the first budget year and a three per cent increase for the second year. The university appealed to the Legislative Join Committee on Employment Relations (LJCER), another legislative modality of the governor, for an additional one million dollars. The committee approved the plan, but the governor vetoed it. The governor rationalized his decision with the objective of maintaining equity among all state employers. (Covaleski and Dirsmith, 1988b: 579-580)

The political betrayal of trust hampered information exchange between the academic and political world. To decrease the political opportunism the academics made the budget discourse public. The academics tried to bridge the structural hole with the new modality by manipulating information to achieve power, trying to make the state dependent on the university's knowhow by making the state commit to the philosophy of "The Wisconsin Idea". During the process of redefining the budget practices, the control of the bridge alternated between the parties, showing that the network was not static. New information and a new actor disrupted the old practice and changed the previously shared worldview. The budget process belonged to and coordinated activities in two worlds, so it could not be fully controlled by the governor, the broker.

The changes the academics introduced to the budgeting process made the interaction between the worlds more difficult for both parties, because the academics did not understand politics. The governor turned the process to his advantage by use of political discourse, and punished the university by blocking the academics from the compensation discussion. An informal budget mechanism, the "Decision Narrative Items", could not directly replace the formal mechanism, the enrollment funding formula, because the governor held his ground. However, the brokering influenced network members as the members influenced the broker, with all agents learning from the process. How the learning influenced shared meanings in both groups had an effect on the way the budget was interpreted thereafter, considering the restricting and enabling elements it offered.

Discussion

The purpose of the illustration was to extend the analysis of Macintosh and Scapens (1990) within the same field study and to show the potential of the synthesis of structuration and structural hole theories for process studies in management accounting. For example, analysis based on structuration theory does not allow causal explanations between action and structure (1990:472), because it does not incorporate historical time: "We cannot say for certain whether or not the university administrators, in deciding to change the budget ritual acted in an unfettered, existentialistic way; or whether the merely followed the dictates of the prevailing social structures." However, analyzing the change as a process (to which Macintosh and Scapens also refer, e.g. 1990:475) instead of an outcome (Burns and Scapens, 2000:4) and intertwining structuration theory with network perspective, we are able to draw more profound conclusions of the balanced (Granovetter, 1985:501) relationship of agency and structure, which neither under-socializes or over-socializes accounts of action. The reason why Macintosh and Scapens (1990) were successful in demonstrating the potential of structuration theory through the Covaleski and Dirsmith (1988a) case is that the original authors used network analysis to describe the domain. Although Scapens and Macintosh made reference to a longitudinal field study, the potential of network analysis was not discussed in their paper.

By employing the lens of structural hole theory the process by which the frame of budgeting is renegotiated becomes less opaque. First, examination of the relations of the budgeting process revealed the key players and their roles, and the original source of conflict – the shared philosophy. Second, the governor's position was central in the network, and it enabled him to bridge the structural hole between the university and the state. Third, the governor's main bridging method was the budgeting process, through which he influenced and controlled the university, acting as a knowledge broker between the two worlds. The budget/modality created entrepreneurial opportunities for both parties because it was both enabling and restricting; both drew upon it and pulled it into action. Both parties used the potential the budget offered in a variety of ways as a means to gain control of the bridge that the budgeting modality represented. The position of the broker was attractive because it offered both personal and group benefits.

Higher education was facing the same challenges in the 1980s as it is facing today; in other words, decreasing government support. Academics understood that at some point quantitative change (shortage of money) yields to qualitative change (change in rules and practices), affecting the attraction of highly talented people to the academic profession. The freedom to conduct meaningful research was undermined by pressures to teach more students and longer hours in order to increase productivity. The search for funding changed the social role of universities, because they were forced to become increasingly entrepreneurial. As the state's funding decreased other sources were needed to cover the deficit. This was against the philosophy of "The Wisconsin idea". Progressives, such as Governor La Follette, had sought to liberate human energies from the restrictions imposed by industrial capitalism. The new policy was about to change that.

A shared worldview and language are preconditions for a successful overlapping modality, such as the single budgeting system of universities. The merger, however, had affected the relationship of academic and political worlds by leaving a gap in the trust between the academics of Madison and other twelve universities within the system, and Madison and Governor Dreyfus (and the state). The lack of trust pushed academic entrepreneurialism further, and led the president of Madison to question the legitimacy of the budget with regard to resource allocation. As a result, the bridge between the two worlds was broken and a structural hole emerged. To replace the modality, a new, shared language was needed.

During the time period of the case, the relationship of academics and politicians was harmonious until the merger of the universities in 1972. The US economy was not stable in the period 1910-1970, but suffered from several downturns. This indicates that a skillful broker can avoid conflicts by balancing the control and autonomy of overlapping structures through tactful modalities that are fairly opaque. If the broker over exercises power transparently, the power is taken away as trust deteriorates. Thus, opportunism is a onetime situation unless it can be covered up such that the behavior is unlikely to be discovered. Modality, the enrollment funding formula, provided the necessary opaqueness. Although the formula was recognized as a possible “Frankenstein monster” (Covaleski and Dirsmith, 1988b:571), it took the University of Madison years to unionize with its siblings and react.

Governor Dreyfus was a former professor of speech; he did not have experience of legislation or politics. The academics, likewise, were short of political skills. The budget reform process undertaken by academics suffered from two setbacks. The first was the surprise that Dreyfus did not seek a second term as governor; he was succeeded by Earl in the middle of the budgeting process. Secondly, governors were traditionally graduates from Madison or one of its siblings, and had strong ties with the institution. Governor Earl lacked these ties because he came from Michigan and had received a law degree from the University of Chicago. The chances that academics would be successful in creating a shared language and worldview in a network of hampered trust and information flow, drawing on political discourse and resources that they did not master, were low.

Modality can generate new structure through a structural hole, but the broker controls the modality. In the end, the new governor blocked the academics from the compensation negotiations and intended to change the research focus of the universities from long-term to short-term, and towards applied research (Covaleski and Dirsmith, 1988b:578), using the modality for his political benefit. In order to survive, the actors could not stay neutral in the sense of “The Wisconsin Idea”. Thus, both academics and politicians contributed to the end of the progressive movement.

Conclusion

The purpose of this study was to demonstrate through a synthesis of structuration and structural hole theory how structural holes emerge in management accounting systems, how new modalities emerge from agents’ use of structural holes, and how a management accounting system that is supposed to protect against opportunism becomes a source of such opportunities. The research contributes to management accounting in four ways. First, it answers the call of Coad and Herbert (2009) to use structuration theory in a flexible manner and to draw insights from other perspectives to provide more rigorous insights into the processes of change proposing structural hole theory as a valuable extension to structuration theory as a means to understand how accounting systems are constructed, maintained, changed, and used through action that is embedded in social relations. Second, it provides a balanced framework to explore the governance mechanisms of overlapping structures that neither under-socialize nor over-socialize human action (Granovetter, 1985). Third, from a methodological perspective, a meso-level analysis by use of structural hole theory bridges the gap between macro and micro levels of structuration, thereby highlighting ongoing processes of social interaction, structure, and agency, a theme that has been underdeveloped by previous research (Coad and Herbert, 2009; Englund and Gerdin, 2008). Fourth, the research also contributes to a fuller understanding of the origins of structural holes by including the role of modality: specifically, how modality is used to create and bridge structural holes. To author’s knowledge, this research is the first attempt to explain the emergence of structural holes with the concepts of structuration theory. In summary, the framework that accounts for the appearance and disappearance of structural holes and the bridging power of modality over time provides us with a better understanding of how collective action is organized in management accounting.

The research highlights the importance of social networks and relationships between overlapping structures, which help understand agents' motives of action. Understanding the intentions and motives, in turn, provides insights of the structures that agents pursue relative to structures striven by organizations. With analysis of processes of interaction we are able to answer critical questions that help to construct and reconstruct accounting systems: for example, under what conditions entrepreneurship is more or less likely to occur, when entrepreneurs are likely to emerge, why some actors are more successful than others, and why control mechanisms may not work as expected. Even if we cannot control the modality we should seek to understand it in depth in order to hedge against unintended consequences.

The synthesis that has been outlined thus far should be seen as preliminary groundwork. The framework could be further elaborated and refined, for example, by integrating Cohen's (1989) and Stones' (2005) views on position-practices into questions of meso-level research ontology (ontology-in-situ; Stones, 2005:7) in order to improve the applicability of the theory to empirical research and to produce more sound ontological arguments than might be permitted by Giddens' ontology-in-general (Stones, 2005:7). From an empirical perspective, future research would benefit from the knowledge of how to govern the academic world of universities. This question is important because such governance has an impact on academic research, its direction, and content. With decreasing governmental and political support universities are required to turn to private funding, often channeled by large corporations with diverse interests. How does such funding structure affect research and its "independence"?

Based on the framework of the current study, future research could also take up the issues of governance mechanisms in other overlapping structures, because the same type of phenomena discussed in this research can be found in healthcare, church, family, cooperatives, state owned enterprises, and in the defence industry, where owners may also draw on more than one set of values. This research would, in turn, further develop the theoretical perspective and framework.

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