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Human Relations; Jul 2006; 59, 7; ABI/INFORM Global
pg. 961

Human Relations
DOI: 10.1177/0018726706067598
Volume 59(7): 961–992
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SAGE Publications
London, Thousand Oaks CA,
New Delhi
www.sagepublications.com

How symbolic remuneration contributes to the legitimacy of the company: An institutional explanation

Mariluz Fernandez-Alles, Gloria Cuevas-Rodríguez and Ramon Valle-Cabrera

ABSTRACT

This research analyzes whether variable compensation is designed as an economically rational incentive to increase organizational performance, or whether it also responds to other factors such as the search for legitimacy. A case study demonstrates how the design of the variable compensation system, at both managerial and lower levels, takes into account the company's adoption of popular management practices that increase its legitimacy but not necessarily its performance. The results show that, in the design of their compensation policies, organizations do not always seek financial objectives, as agency theory maintains, but often have other social objectives such as the search for legitimacy, as institutional theory suggests. The management of incentives not only is used to align the interests of principal and agent, but also has a symbolic character, insofar as it signals that the company belongs to a particular social context.

KEYWORDS agency theory ▪ compensation ▪ institutional theory ▪ legitimacy ▪ performance

1. Introduction

Research on compensation has been carried out for more than 70 years, and more than 300 studies have accumulated; in these, the principal topic

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analyzed is the relationship between the compensation and the performance of the company (see review by Gómez-Mejia & Wiseman [1997]). Within this body of literature, agency theory has become the principal conceptual framework used to explain the design of compensation policies. This economic theory analyzes the relationship that arises between two individuals, principal and agent, when the first delegates to the second the performance of a particular job or responsibility, so that the financial gains or losses of the principal depend on the decisions taken by the agent. According to agency theory, both individuals (principal and agent) act in their own interests and seek to maximize their particular utility functions; this implies that the decisions taken by the agent are not always directed towards increasing the wealth of the principal.

Taking this potential conflict of interests as the point of departure, agency theory characterizes compensation as a mechanism of government by reward that aligns the behavior of the agent with the interests of the principal (Jensen & Meckling, 1976; Fama & Jensen, 1983). Making compensation contingent on the results obtained by the agent implies that, within limits, the higher the salary (and the greater the utility) received by the agent, the better will be the performance of the organization and the greater the financial gain for the principal.

However, as Barkema and Gómez-Mejia (1998) and Miller et al. (2002) state, despite numerous studies there is no consensus of empirical evidence on the relationship between the agent's compensation and organizational performance. Current studies are aimed at identifying the specific conditions in which incentives, and therefore the transfer of risk to the agent, work best. Some authors, such as St-Onge et al. (2001), state that the management of incentives is not used exclusively to reduce the agency problem; rather it is utilized as a symbolic tool, in the sense that it responds to a desire for the company to imitate the practices of others in its sector (even when these practices do not represent greater efficiency for the company), and in this way becomes a signal that the company belongs to a particular identifiable social context. This explains the growing literature on what has come to be called the symbolism of compensation policies (Westphal & Zajac, 1994, 1998; Zajac & Westphal, 1995; Staw & Epstein, 2000).

In fact, there are many important common characteristics in the systems of incentives designed by companies that are not susceptible of explanation by agency theory such as egalitarian salaries motivated by considerations of horizontal equity or length of service, and, in contrast, an absence of salary systems dependent on performance (Kosnik & Bettenhausen, 1992). The challenge facing principal–agent theorists is to

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explain these practices in ways that integrate into the agency model alternative perspectives (psychological, behavioral or human resources management) based on notions such as justice, social responsibility, trust or organization culture.

The principal contribution of this article is to provide empirical evidence, through a case study, of how the design of variable compensation (at both managerial and lower levels) takes into account the company's adoption of popular management practices that increase its legitimacy but not necessarily its performance. The intention of the study is to support the theoretical argument that organizations do not always pursue financial objectives such as the maximization of profit, as agency theory claims, but may also seek legitimacy, as institutional theory suggests. Therefore, it is reasonable to speak of symbolic compensation, since variable compensation is sometimes designed to reward not those particular practices and procedures that rationally should enhance the performance of the company but those that enhance its social standing and reputation in its institutional context. In short, the contribution of this article is to propose a complementarity between the two theories (agency and institutional) to provide a better explanation of how decisions on remuneration are reached and justified in organizations.

The article is structured as follows. First, we discuss the contradictions and complementarities between agency theory and institutional theory, to analyze the contribution of each perspective to the design of the compensation policy. Second, we consider in more depth the concept of symbolic compensation and its relationship to popular management practices, and present several specific research propositions. Next, we describe a case study of a Spanish company belonging to the banking sector. In the final part, we discuss the principal results obtained, limitations and future lines of research.

2. Agency theory and institutional theory: Complementarity or contradiction?

Agency theory, which assumes a separation between the ownership and the management of the company (Jensen & Meckling, 1976), focuses on how to determine the most efficient contract, whether based on results or on behavior, between principal and agent, each of whom has his or her own utility function (Fama, 1980; Eisenhardt, 1988, 1989). In the case of the principal or owner, this function represents maximization of the value of the company; in the case of the agent or manager, the fulfillment of responsibilities at the lowest effort and with the least risk possible. It is impossible

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to specify in the contract all the possible rights and obligations of the parties, current and future; therefore the agent has a degree of freedom to take decisions affecting the assets owned by the principal, decisions that may further the agent's personal objectives (Barkema & Pennings, 1998). The agency relationship is bound to be problematic insofar as there are conflicts of interest between principal and agent, and difficulties (or 'agency costs') for the principal in controlling the behavior and monitoring the results of the agent (Eisenhardt, 1989).

Acknowledging this conflict of interests between principal and agent, agency theory establishes two governing and/or contractual mechanisms for resolving it, based first on monitoring, and second on incentive alignment. The greater the principal's supervision or direct observation of the agent's activities, the fewer the agent's possibilities for opportunistic behavior, and by implication, the more the agent's decision-making should further the interests of the principal (Fama, 1980; Hoskisson et al., 1989). And the greater the use of incentives that make the agent's remuneration depend on performance or results, the more the agent's decision-making should further the interests of the principal reducing the moral hazard problem (Gómez-Mejia et al., 1987; Hambrick & Finkelstein, 1987). Additionally, the use of pay-for-performance systems to attract workers of higher than average ability enables the reduction of adverse selection problems (Lazear, 2000).

According to Eisenhardt (1988), the choice of a compensation system that varies with performance will depend on the following aspects of the agency framework: 1) the capacity for programming the activities to be remunerated, in the sense that the greater the degree of programmability, the more precisely such behavior and work can be defined and therefore the easier it will be to evaluate; 2) the scope of activities to be controlled (in effect, the number of other persons under the control of the agent/manager), in the sense that the smaller the scope of control, the greater will be the principal's capacity to exercise direct supervision by capturing more information on the employees' performance; 3) the degree of uncertainty of the results, insofar as these depend on factors beyond the control of the agent (economic evolution, customer demand, actions of competitors and suppliers, regulation, etc.).

However, reality seems to demonstrate that the design of the compensation system does not always respond to this logic; rather, it responds to other factors, such as the conventions imposed by the sector in which the company operates, or management fashions postulated by the institutional theory, which offer the principal social-psychological explanation (Meyer & Rowan, 1977; Zucker, 1987). This apparent fact, together with the numerous criticisms made of agency theory,[1] explains why studies have

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emerged in the literature offering alternative and complementary explanations for the design of compensation systems.

According to institutional theory, the behavior and survival of organizations tends to be marked by their social context. Organizations adopt the structures and processes that best match the standards, values and beliefs in their 'institutional environment'. Thus the behavior of an organization is not always the result of an economically rational prior choice: more often it responds ad hoc to the search for social acceptance or legitimacy (Pfeffer, 1987; Suchman, 1995).

> The main social-psychological explanation for the phenomenon of directors' remuneration is institutional theory, which considers the isomorphic pressures that influence companies to act in similar ways [. . .] Linked closely to institutional theory are theories of legitimacy. Legitimacy relates to the way in which organizations seek to accord with society's expectations in order to gain acceptance.
>
> (Bender, 2003: 207)

As Suchman (1995: 580) states, 'organizations can also garner moral legitimacy by embracing socially-accepted techniques and procedures, when sound practices may serve to demonstrate that the organization is making a goodfaith effort to achieve valued, albeit invisible, ends'. Therefore, according to institutional theory, one can predict practices within an organization from cultural perceptions of legitimate behavior, traditions in the industry sector, the history of the company or popular management practices (Eisenhardt, 1988). For example, society's perception of the remuneration practices of a company can affect the status of that company in the environment or context from which it obtains financial and human resources. Gómez-Mejia and Wiseman (1997) suggest that, if a company rewards its managers with excessive generosity, its reputation can be adversely affected and it may lose social support. Using consultants in the design of compensation schemes can be considered a mechanism for gaining legitimacy, insofar as the recommendations of such professionals external to the organization are presumed to be independent (Barkema & Gómez-Mejia, 1998).

According to institutional theory, when organizations that share the same environment or niche adopt the structures and behaviors that are accepted in their particular environment, a phenomenon of isomorphism takes place (DiMaggio & Powell, 1983): 1) coercive isomorphism (generated by the regulatory framework); 2) mimetic isomorphism (derived from imitation of 'best practices'); and/or 3) normative isomorphism (as a response to the pressures of professionals and consultants).

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Therefore, institutional theory may explain the homogeneity among companies in certain management practices, including those related to the design of compensation systems. Finkelstein and Hambrick (1989) suggest that companies belonging to different sectors of industry present different salary patterns and structures that could be explained by the influence exerted by consultants. Shaw et al. (2002) explain the power of the compensation system and salary dispersion as elements that favor the implementation of the company's strategy, combining classic economic perspectives with institutional theory and organizational justice theory. St-Onge et al. (2001) provide empirical evidence that the management of incentives (share option plans for managers) is not used exclusively to align the interests of principal and agent but also serves in a symbolic way to signal that the company is imitating practices observed in other companies of its sector (even when these practices do not represent more efficiency for the company). Then, pay-for-performance systems are not only a way to reduce agency problems (adverse selection/moral hazard) (Lazear, 2000) but also a mechanism for the firm to provide a specific image, for example, attracting particular types of people (Bender, 2004). In this way, the compensation system becomes another sign or announcement that the company considers that it belongs to a particular social context. From this interpretation there have developed increasing numbers of studies on what has come to be called the symbolism of compensation policies (Westphal & Zajac, 1994, 1998; Zajac & Westphal, 1995).

In short, agency theory and institutional theory are differentiated by what factors each holds to determine the design of the compensation system. Agency theory holds that contingent compensation will be used regarding the uncertainty of the results, the control scope, and the programmability of the work evaluated; institutional theory holds that compensation practices depend mainly on the tradition of the company's industry sector, social beliefs and policies, and relevant legislation (i.e. the social context of the company in general) (Eisenhardt, 1988) (see Table 1).

Management choices (for example, in respect of compensation) that are explainable by institutional theory do not necessarily have to be classed as irrational. In fact, the adoption of structures or procedures legitimated by the company's environment can be evidence that management is acting responsibly, by complying with the requirements of powerful external institutions or by avoiding claims for negligence in case particular aspects of its activities go wrong (Meyer & Rowan, 1977, 1991). Thus, certain behaviors cannot be understood from agency perspective but from institutional perspective, and vice versa. Rational behavior is a common feature in both agency and institutional theories, but it serves different objectives: maximum efficiency versus social legitimacy (Scott, 1995; Paauwe & Boselie, 2005). In

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Table 1 An analytical comparison between agency theory and the institutional approach

	Agency theory	*Institutional theory*
Key idea	The organizational practices emerge from efficient management of information and transmission of risks	The organizational practices emerge from mimetic forces and from the tradition of the sector
Basis of the organization	Efficiency	Legitimacy
Vision of the individuals	Self-interest and rationality	Search for legitimacy
Role of the environment	Fit between organizational practices and the environment	Source of practices that organizations must accept
Role of technology	Fit between practices and technology	Technology moderates the impact of the institutional factors
Problem	Control	Organizational practices
Independent variables	Uncertainty, control and programmability	Tradition of the sector, legislation, social beliefs and policies, founding conditions
Assumptions	Self-interest Rationality Aversion to risk	Acceptance of external pressures

Source: Eisenhardt (1988: 491).

addition, it does not imply that both objectives are always contradictory but rather they can converge. Given information asymmetry about the likely effectiveness of certain practices, managers could adopt those practices which are widely well accepted to safeguard their personal reputation (institutional premise) as a personal utility among stakeholders, reflecting this fact the risk-adverse managers' behaviors (agency premise) (Staw & Epstein, 2000).

Then, some studies have used both perspectives in a complementary way to analyze the processes of performance assessment (Erbes-Sequin, 1981; DiMaggio, 1988; Young et al., 2000) or to examine the choice of designs for the compensation system (Eisenhardt, 1988; Westphal & Zajac, 2001). The tendency is toward joint studies facilitating a more realistic analysis of organizational practices. As Beckert indicates (1999: 779), 'under market conditions, institutional rules and intentional rational agency can be

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conceptualized as antagonistic mechanisms that contradict each other but, nevertheless, remain interdependent'. This author argues that uncertainty represents a crucial variable for understanding the interdependence between institutional and agency theories. In situations of high complexity, decisions based on strategies of optimization are impossible. Consequently, decisions are feasible only through the institutionalization of rules that allow people to predict what others will do. Bender (2003: 208) maintains the complementarity of the two theories in stating that 'none of the theories on its own provides sufficient explanation of the phenomenon, but together they might begin to explain how remuneration committees determine the pay of their executive directors'.

With the object of studying in greater depth the design of the variable component of compensation, in the following sections we develop the arguments of both perspectives – agency and institutional – in order to define our research propositions.

3. Popular management practices and symbolic compensation

The term 'symbolic compensation' (Zajac & Westpahl, 1995) was coined to define a type of compensation that does not pursue maximization of organizational efficiency but results from institutional pressures. A company's adoption of the type of compensation system used by the majority of the companies in its sector signals that the company belongs to this social context:

> institutional theory can be relied on to predict that environmental and mimetic pressures induce firms to adopt similar practices over time, irrespective of their relative merits or efficiency [. . .]. Hence, if the use of stock option plans (SOPs) is widespread and diffused, a firm must include them in its executive compensation packages because it is an acceptable practice.
>
> (St-Onge et al., 2001: 261)

That is, although it is possible that companies design their compensation systems to reward better organizational performance, the process may be simpler: companies follow the fashion or social convention within their industry or activity sector (Meyer & Rowan, 1983; DiMaggio, 1991). Authors such as Staw and Esptein (2000) provide empirical evidence that companies adopt remuneration packages linked to particular popular

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management practices. Abrahamson (1996) defines these practices (such as Management by Objectives, Zero-based Budgets, T-groups or Total Quality Management) as techniques that follow patterns or cycles of fashion. Authors like Davis (1991), Palmer et al. (1993) and Haunschild and Miner (1997) state that social networks among companies promote the diffusion of such practices from one company to another.

According to institutional theory, these management practices are popular because they are considered modern techniques. By adopting them, the company enhances its image as modern and innovative, and gains legitimacy in its business environment via its reputation[2] (Wagner & Gooding, 1987; Barley & Kunda, 1992).

The idea that an organization that pursues legitimacy is less efficient or rational than another that focuses on financial objectives appears to be implicit in institutional theory (Meyer & Rowan, 1977). However, Scott (1995) believes that the search for legitimacy does not necessarily imply negative economic consequences. Securing more legitimacy could materially benefit an organization – for example, by facilitating access to certain valuable resources (Elsbach & Sutton, 1992). Before analyzing how popular management practices are remunerated in organizations (i.e. symbolic compensation), it is necessary to demonstrate our first research proposition (P1), that the proposal or implementation of these popular practices confers legitimacy on the company:

> *P1*: A company will enhance its legitimacy when it establishes popular management practices, independently of the impact that these practices may have on the organizational performance.

Since the company's reputation reflects the image it projects in its chosen environment, appearances are often more important than the 'mere' reality. Oliver (1991: 155) states that 'the appearance rather than the fact of conformity is often presumed to be sufficient for the attainment of legitimacy'. This suggests that the company could enhance its reputation by linking its image to certain popular management practices, even if these practices have not been really implemented as our first proposition assumes. As Pfeffer (1987) and Westpahl and Zajac (1998) have argued, a company's managers may be able to manipulate its institutional environment. And as others have argued (Zbaracki, 1998; Cole, 1999; Pfeffer & Sutton, 1999), it may be a lot easier for managers to announce their intention of adopting popular management practices than actually to implement such practices effectively. With this literature as our point of departure, we define our next research proposition:

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P2: A company will enhance its legitimacy when it is associated informally with particular popular management practices, independently of their effective implementation.

In principle, it would be logical to think that if particular practices in a sector are considered to reflect good corporate management, the adoption of these practices should affect the design of the compensation system. However, the two theories differ significantly on this point. From the agency perspective, when firms adopt particular management practices, and their implementation really does increase organizational performance, it would then be reasonable to increase the compensation received by the employees who participate in these management practices (as the means of aligning the respective interests of principal and agent) (Jensen & Meckling, 1976). On the other hand, from an institutional perspective, the proposal/implementation of popular management practices can improve the organization's legitimacy (Staw & Epstein, 2000) and would thus in itself explain the increased compensation of employees who implemented them (or appeared to do so), independently of the organizational performance (see Figure 1).

Westphal and Zajac (1998) obtained empirical evidence that the mere public announcement of the adoption of popular management practices influences the assessment that board members make of the performance of managers and how they should be remunerated. We extend these arguments to other hierarchical levels different to the managerial ones, defining two further research questions: the first (P3a) responding to agency theory, and the second (P3b) taking the view of institutional theory:

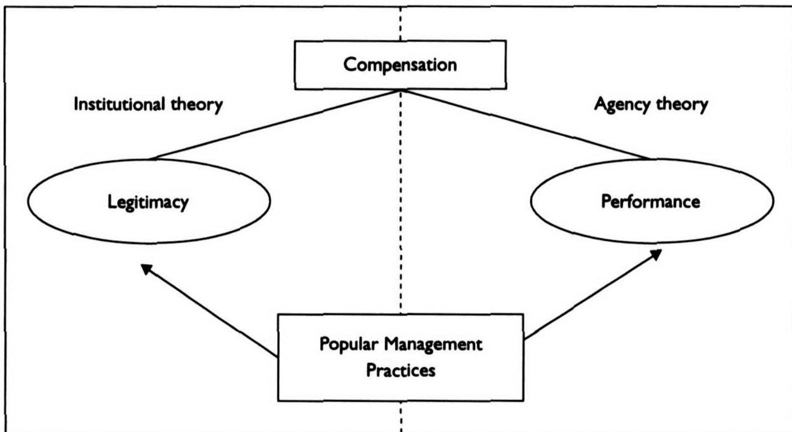

Figure 1 Institutional theory, compensation and organizational performance

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P3(a): Employees will receive higher compensation when the proposed and actual implementation of popular management practices is related positively to improvements in organizational performance.

P3(b): Employees will receive higher compensation as a consequence of the enhanced legitimacy achieved due to the proposed and/or actual implementation of popular management practices, independently of their impact on organizational performance.

4. Methodology and measurement of variables

Whereas the study of compensation has been focused traditionally on quantitative analysis of data using agency theory, in this study not only do we bring the institutional perspective into our analysis but also we use a qualitative research method, the case study. The nature of our research question (how variable compensation is designed in companies, and why it is that efficiency is not always present in these decisions) suggests that this method is appropriate (Leonard-Barton, 1990; Eisenhardt, 1995). For Eisenhardt (1995), the case study is applicable for exploratory purposes when a phenomenon lacks clarity or is subject to different explanatory approaches; in addition, this method allows the use of several complementary techniques for gathering information, which should deepen the study.

The organization selected for our case study is Bankinter.[3] The banking sector is one of those classified by Scott (1998)[4] as exposed to *both* strong competitive pressures (to become more efficient) and institutional pressures (to become more legitimate), and is therefore, according to Oliver (1997), interesting to analyze. In order to identify patterns of change over time in the variable component of the compensation system, and the evolution of the indicators of legitimacy and organizational performance, we carried out a longitudinal and process-based study covering the period since 1978 until 2005 (although the year 1997 is crucial for our research, since in that year a system for encouraging employees to propose ideas and improvements was implemented).

According to the protocol of Yin (1984), once the theoretical arguments underlying the research propositions have been presented and the case study for analysis has been selected, the next step is to compile data from three information sources: interviews and questionnaires, for the primary information, and documentary archives, for the secondary information. We conducted interviews with both management and non-management personnel in the company's head office and in one of its regional branches. The

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interviews were based on a semi-structured questionnaire; written notes were taken, and in some cases the interview was recorded. The questionnaires were used for two reasons: first, to probe more deeply into some of the research questions, and second, to triangulate the information gained (to validate content). From the documentary archive we analyzed Annual Reports,[5] management reports, relevant publications and especially the collective agreements made with employees' representatives.[6]

Following, in the order in which these variables appear in the propositions, are the constructs we used to measure popular management practices, legitimacy, performance, and compensation. Taking into account the findings of Staw and Epstein (2000), we identified the specific popular management practices of: 1) empowerment through employee participation schemes; 2) total quality management; and 3) the creation of work groups or teams. The first of these variables, employee participation, was analyzed by counting the number of employees who contributed ideas and improvements in the way the company is managed. Additionally, we use a variable to measure the implementation of ideas/improvements suggested by employees. The second variable, TQM, was measured by the percentage of employees who participated in quality programs, the existence of quality projects and improvement missions, and the number of quality leaders and advisers in the company. The third variable, use of work teams, was determined by the number of teams or work groups created.

The company's reputation was taken as a surrogate variable for measuring legitimacy (Staw & Epstein, 2000). Specifically, reputation was measured by taking into account the market, accounting, institutional and strategic indicators identified by Fombrum and Shanley (1990), which reflect a) social responsibility, measured by the company's participation in activities with social objectives, b) visibility in the media, in terms of the company's appearance in press articles and presentations, and c) size, which proxies familiarity to the relevant audiences. With respect to this last variable, Haveman (1993) and Goodstein (1994) argue that larger organizations attract more critical attention because of their greater visibility and exposure to institutional pressures, but, since size is also usually a measure of success and prestige, the larger companies also have greater capacity than smaller ones to avoid or escape institutional pressures. In short, it is easier for larger companies to acquire or maintain legitimacy.

Lastly, the organization's performance was measured by the financial indicator Return on Investment (ROI), and compensation was measured by 1) the use of variable compensation in terms of the percentage of employees who receive variable compensation and 2) the component base of this variable compensation.

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5. Exploratory study of a case: Bankinter

Historical information on the case: Relevant changes in management practices

Bankinter (Bank Intercontinental Spanish S.A.) was constituted in 1965 as an industrial and business bank, with the participation of the Bank of Santander and the Bank of America at 50 percent each (Annual Report, 1988). Currently, Bankinter has a total of 3712 employees and a turnover of €187.702 million (Annual Report, 2005). This financial group, which has operated through telephone banking since 1992, and via the Internet since 1997, continues to hold the leading position among online banking operators in Spain (Europe Press, 2003); it is this online mode of operation that has given Bankinter its success and survival in a sector that is very competitive in the capture of customers (Annual Report, 2000).

The following section presents the antecedents that explain the company's preoccupation with incorporating popular management practices, including human resources initiatives aimed at developing new knowledge and innovation by managing intellectual capital. As a consequence of external competitive pressures due to globalization and technological innovation, of social pressures such as the growing demands of stakeholders in respect of quality and environmental protection, and of internal pressures such as new structures for managing the business by Internet, the functions of most personnel have undergone fundamental changes. According to the Director of the Department of Management of Persons and Knowledge, one of the more relevant changes occurred in 1997, when the company constructed a model for managing its intellectual capital – human, relational and structural – through the following intangible values: innovation, learning, collaboration, flexibility, diversity, motivation, transparency, flattening the hierarchy, and transformation of structures and processes (Annual Report, 1998).

> Intellectual capital is one of the key factors in making possible the development of an intelligent organization, a different company model, that will be capable of continually generating new business opportunities from a singular and independent company and from more flexible and innovative internal structures.
>
> (Annual Report, 1997: 2)

From that time, by means of what it calls 'Plan 2600', Bankinter has built its competitive advantages on these values.

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Through Plan 2600 and by particular interventions in the field of human resources, such as internal job turnover and training, innovations were promoted in the company's organization; these included improved transmission of knowledge, participation, teamwork and the creation of an attractive and satisfactory work environment, and were intended to develop the capacities of the firm's human resources, to promote initiative and to further employees' professional careers (Director of the Department of Management of Persons and Knowledge, 2001). Accordingly, the management of intellectual capital sought 'the generation, the transmission and the conversion into value of the knowledge that resides in the persons, in the organization itself, and in the relationships of the company' (Annual Report, 1997: 63). This management approach has involved diverse types of HRM intervention that have modified the organization structure – promoting greater flexibility, and reducing the number of hierarchical levels – and affected job design, by creating multifunctional teams, which pursue enhanced learning and collaboration. This approach not only is clear in the Annual Reports since 1997 but also was confirmed by the regional director whom we interviewed.

From 1998, the human resources management function was renamed 'management of persons and knowledge'. The emphasis on knowledge was already evident in the preceding years in such statements as 'the capacity for continuous learning, at both the individual and collective levels, constitutes an essential value within the culture of the bank, which facilitates an innovative climate for promoting the creation and transmission of new ideas and opportunities' (Annual Report, 1998: 80). 'The department for the management of persons and knowledge currently comprises three sub-departments: management of persons, management of training, and management of knowledge and innovation. In the hierarchical structure, this department is part of the operations area, and decentralization is being increasingly sought in the management of persons' (Director of the Department of Management of Persons and Knowledge, 2001). Some of the tools developed for the management of knowledge in Bankinter are the creation of an Intranet and the use of electronic mail, discussion forums, video chats and video conferences to facilitate communication between its employees (Annual Report, 2002). In consequence of the company's interest in developing knowledge, 'a new style of management arose that supported the introduction of popular management practices' (Director of the Department of Management of Persons and Knowledge, 2001). The documentary analysis of the reports reveals that the three popular practices defined by Staw and Epstein (2000) were being considered in the organization to promote innovation. We can therefore study the repercussions of proposing and/or implementing these

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popular management practices: 1) on the legitimacy of the company; 2) on its efficiency; and 3) on the design of variable compensation for the employees involved in these popular practices.

Popular management practices, legitimacy and organizational performance

To validate the first two propositions, those that associate the proposing/implementing of popular practices with the legitimacy of the company and its performance, we analyze three variables jointly: 1) the popular practices defined by Staw and Epstein (2000) (employee participation; quality improvement programs; and creation/use of work teams); 2) the company's performance; and 3) the company's reputation (as a surrogate for its legitimacy). The analysis addressed the popular practices individually; hence this part of the article contains three sections, each analyzing separately the relationship between one of the popular practices and the performance and reputation of the company.

Employee participation

According to the Director of the Department of Management of Persons and Knowledge, from 1997, aiming to increase its intellectual capital, the company encouraged employees to propose ideas for innovations and improvements. The data on this are very revealing: the percentage of the total workforce that provides ideas and better practices has grown from 13 percent in 1998 to 52 percent in the year 2002 (see Figure 3). The company considers that 'persons and the knowledge that they receive, create, exchange and share are the rails along which the leading companies advance at increasing speed' (Annual Report, 2001). This increased participation is attributable to the Department of Management of Persons and Knowledge, 'which has promoted a culture that actively seeks innovation, and to new technologies that have facilitated communication' (Director of the Department of Management of Persons and Knowledge, 2001). The increasing attention of the firm on this popular management practice is reflected in a higher number of mentions in Annual Statements since 2001 regarding the participation of employees in biannual opinion polls, the firm's commitment with quality projects, and participation in debate forum (see Figure 3).

To analyze the company's reputation during the period when it was developing this practice, we considered the three indicators identified by Fombrum and Shanley (1990). Various sources gave positive evidence for the first indicator – social responsibility, measured by the company's participation

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in activities with social objectives. The human resources director stated that the company not only was a pioneer in responsibility towards its employees (including ratios of intellectual capital in its reports) but also assumed its social responsibility towards those outside it. From the corporate website, it can be observed that society exerts considerable pressure, demanding ever more social responsibility from the company towards the various collectives with whom it has a relationship, such as the shareholders, investors in general, clients and employees, with environmental responsibility acquiring special relevance (*Actualidad Económica*, 1997; Annual Report, 1998). Among all these stakeholders, the shareholders are particularly important, and the aim to search these interests, principally by creating value in the long term, has led the company to adopt a style of management based on transparency and on ethical and professional conduct (Director of the Department of Management of Persons and Knowledge, 2001). The company created a series of codes of conduct and internal organs, explained in Chapter 10 of the 2003 Annual Report, in order to fulfill this obligation to the shareholders and respond to these pressures and external social demands. Worthy of mention among these are the Rules of Corporate Governance, the various Codes of Ethics, and some of the commissions delegated by the Board of the Bank, such as the Auditing and Control Commission and the Appointments and Remuneration Commission. Mention should also be made of the Internal Auditing Division, the Rules/Procedures Compliance Unit and the Institutional Control Unit, as well as the assumption of the company of social responsibilities, and its environmental policy. Finally, Bankinter has traditionally been characterized as managing with a sense of social responsibility, and is one of the few Spanish companies included in the prestigious FTSE4 Good Europe index. In short, the evidence shows that the company is strongly committed to fulfilling its social responsibilities.

Annual Statements show the importance given by the firm to its social responsibility. So, we found that 'the bank has assumed its social behavior as a complementary way to create value' (Annual Report, 2002); and 'the firm's value is no longer measured regarding only the accounting benefit but it should consider as well the firm's reputation and the firm's commitment to environmental, social or cultural variables' (Annual Report, 2005). In addition, Annual Reports add a specific section referring to the firm's social responsibility and intellectual capital since 2002, and information about relational capital and the firm's social image since 2003. However, 2005 is a point of inflexion in the firm's commitment to social responsibility as the firm edited a report dedicated to this topic in a separate volume apart from the legal Annual Reports. More specifically, this report details three sections referring to the firm's social responsibility: 1) support for education, culture

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and innovation; 2) attention to environmental issues; and 3) social action[7] (see Figure 2).

With respect to visibility in the media, the 2000 Annual Report refers to awards and recognition that the company has received from numerous publications, including *Euromoney*, *Actualidad Económica*, *Investment Ranking* and Ganar.com; from consultants like Merrill Lynch and AT Kearney; and from agencies like Bluesky International Marketing. And this media presence has been increased by the company's efforts to promote innovation and encourage employee participation. In fact, the company has received numerous awards, such as a prize for the small bank that best promotes innovation and creativity among its employees, and this has made Bankinter a company of reference that others seek to imitate. The reputation of Bankinter, measured through this second aspect, is becoming higher as Annual Reports since 2003 confirm in their section 'Relation with Society, Firm's Image and Brand' where data are available on awards or public recognitions received by the company, and the positive evaluations of Bankinter's behavior that appeared in the mass media (see Figure 2). The analysis of these data suggests that the visibility of the firm in the media is growing as the number of awards has increased from 13 (in 2001) to 18 (in 2005), and the percentage of positive evaluations represents 88.92 percent in 2005.

Our third indicator, size, does not seem, in our case study, to be related to reputation, since Bankinter is smaller than its main competitors and other companies in the sector which have nearly 100,000 employees, and yet has become a company of reference, particularly for the design and

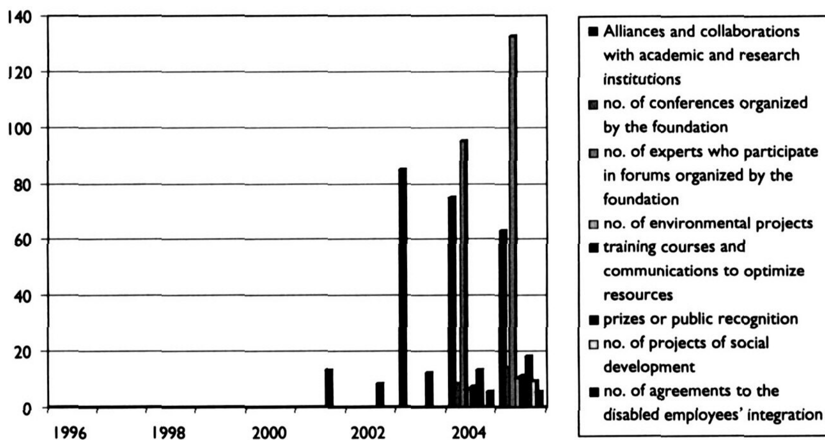

Figure 2 Firm's reputation: social responsibility and visibility

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implementation of its virtual banking model, and for the way it manages its human resources (*Actualidad Económica*, 2000). Despite its relatively small size, the company has a strong image, one with which audiences are very familiar.

Regarding the effect of employee participation on firm performance, empirical data suggest that Bankinter had not either formally or informally designed a link between this practice and performance. The following statement of the Director of the Department of Management of Persons and Knowledge (2001) appears highly revealing:

> We believe that the promotion of employee participation per se helps to create a communicative climate. It is not only a question of fostering innovation at the workplace but also to hear employees' opinion and give them the opportunity to express their ideas and feel useful. You can't imagine the variety of ideas that employees are able to submit [. . .]. Then, we are highly satisfied with the results we are getting. Our aim to improve collaboration and communication within the firm is being achieved.

From interview data, we knew that these suggestions made by employees were assessed through different ways: by the evaluation committee, consisting of 80 members; by a vote of all the employees; and finally, by those responsible for the area affected by the implementation of the suggestion, to determine its viability (in terms of resources allocation). But, the analysis of archival data regarding these assessments allows us to confirm that there were not appraisals of effects that such employee participation practice could have on performance.

Additionally, from the empirical evidence obtained, we suggest that the firm has continued the implementation of the first popular management practice, employee participation, although organizational performance has not improved (see Figure 3). Then, it makes sense to think that the continuous effort of the firm to promote this practice is due to the positive repercussion that this practice generates on the firm's reputation, which has been proved to be high regarding social responsibility and the firm's visibility in the information media. In terms of agency theory, this fact suggests that the firm was focused on generating certain behaviors (employee participation) regardless of the economic effects that this practice had on the firm's performance. This finding confirms Proposition 1 for the first of the variables defined by Staw and Epstein, employee participation: the popularity conferred by establishing fashionable practices explains their adoption by the firm to increase the company's legitimacy, independently of their economic consequences.

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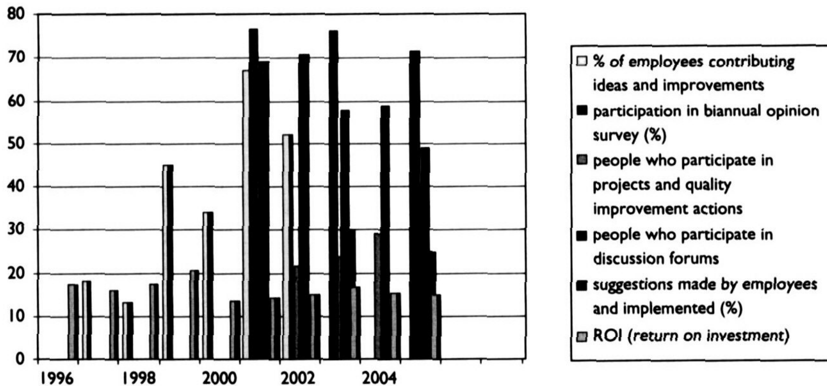

Figure 3 Employee participation and organizational performance

Quality programs

To analyze the effect of quality improvement programs, the second of the popular practices considered, we studied reports that referred to quality as an essential value in the management of the company. 'Quality in Bankinter is the universal value that influences all the actions of all our people every day of the year. The quality system, orientated to customer satisfaction, is operative in all the internal processes, and consolidates a culture and practice of continuous improvement in each of the fields of management and persons' (Annual Report, 1997). In the opinion of the Director of the Department of Management of Persons and Knowledge, the bank has gained legitimacy and has received numerous awards for its efforts in this field,[8] for example, for the projects undertaken and the company's quality improvement actions, wherein multidisciplinary groups of employees identify possible quality improvements and work as a team to achieve them. However, as happened with employee participation, data collected did not show any (formal or informal) intention of the firm to link this practice with performance.

Figure 4 clearly demonstrates the company's concerns about topics related to quality, although the indicators used to measure it evolve in different ways. The number of projects and missions of quality improvement in which the company was involved increased up to the year 2000, thereafter began to decrease, but showed again a new increment since 2004. The number of advisers and/or leaders related to these projects maintained a slow but gradual growth for all the years studied, while the percentage of employees participating fell.

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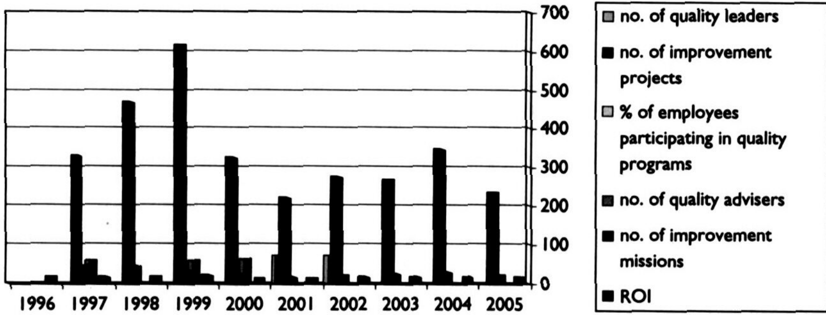

Figure 4 Quality programs and organizational performance

ROI remained constant during this period, confirming Proposition 1 also for the second of the popular practices analyzed, quality improvement programs. In other words, the company did adopt practices specifically related to the management of quality (mainly up to the year 2000), and these practices have led to increased reputation and legitimacy for the company in its environment, although not to an improvement of organizational performance. As with the previous popular management practice, the firm has continued the implementation of this practice because its elimination would provoke a negative effect on the firm reputation.

Use of work teams

The third of the popular practices studied, the creation and use of work teams, was verified as present, according to the interview with the Director of the Department of Management of Persons and Knowledge, only for 1997 and 1998, when the groups termed 'hierarchical multifunctional teams' were constituted (Annual Report, 1998). During this period, as we have already seen, there was no significant change in the company's performance, but it continued to enjoy a positive reputation, which appears to be due in part to the increased innovation and creativity attributed to these work teams. Nevertheless, we could not confirm Proposition 1 for this practice as work teams were actually kept only for two years. (See Figure 5.)

All in all, Proposition P1 is confirmed for two popular management practices: employee participation and quality programs.

The second of our propositions related the legitimacy of the company to whether it projected an image of using popular management practices, independently of whether these were being effectively put into practice or not. Our case study appears to confirm the adoption and continuance of two

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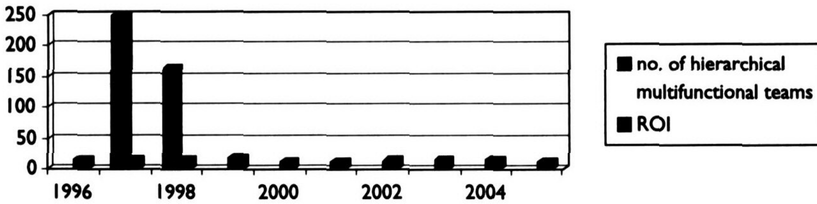

Figure 5 Use of work teams and organizational performance

popular practices, employee participation and quality programs. Regarding participation, the number of ideas suggested by employees that actually were implemented seems to increase for all years with exception of 2004. Similarly, promotion and implementation of quality programs took place in the firm up to 2005. Regarding the third practice, the existence and functioning of work teams were confirmed only for two years of the period studied (1997 and 1998). However, the firm went on promoting continuous learning, both individually and collectively, and creating an innovative climate fostering multifunctional communication among areas. Then, although the firm was no longer implementing work teams, the firm's image and philosophy seemed to be linked to this practice.

On the basis that we are not able to isolate the effect provoked individually for each practice, and taking into account that reputation has been increased during the period of analysis, two explanations could be made. First, employee participation and quality program influence legitimacy more than work teams do. So, the elimination of the former, work teams, did not imply a reduction of firm legitimacy. A second interpretation would be that despite work teams not being kept, the image of the firm was actually linked to them. That would imply the admission that it is not only the effective implementation of practices but the association of the firm to them (the image given by the firm) that explains a high reputation. It would allow us to validate, at least partially, Proposition P2 for one popular practice, work teams.

Summarizing all the above, we could conclude from this exploratory study that the effective implementation of popular management practices enhanced firm legitimacy, since the good reputation of the company was maintained for the whole period during which the implementation of two popular practices was verified. So, Proposition P1 is confirmed for these two practices, employee participation and quality programs. In addition, we could partially accept Proposition P2 that merely publicizing the adoption of popular management practices, such as occurred with work teams, and not

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necessarily really implementing them effectively, is sufficient to reflect positively on the legitimacy of the company.

Compensation, popular practices and organizational performance

As pay agreements show, from 1992 the remuneration system at Bankinter has undergone important changes in response to the demands of the stakeholders, in particular the trades unions, and the need to strengthen customer loyalty and commitment. From 1992, Bankinter established a system of variable compensation linked to management results, emphasizing among other factors quality of service, measured by customer surveys (Annual Report, 1997). As above, we analyze the relationship between this compensation policy and the various popular management practices selected for study.

Employee participation

The proposal of ideas and improvements by the employees is obviously relevant to compensation, since one of the objectives of the variable compensation system was 'to strengthen the process of transforming ideas into reality, whether the idea was technological or social in nature or concerned with methods of management. Incentives will be given so that tacit knowledge, which is difficult to communicate and transfer, should flourish' (Annual Report, 2001). 'From then until now, modifications have been made to the system to improve it and adapt it to the changes taking place in the bank itself and in the environment' (Annual Report, 1997). The proportion represented by variable compensation has increased considerably since 1992. Thus, from 1998 to 2000, the proportion of employees receiving variable compensation increased from 69.33 percent to 96 percent, with fashionable formulas such as share options being offered. At the beginning, there were incentives schemes linked to two performance factors: the evolution of the share price and the financial results. These schemes were termed 'Action Program I' and 'Action Program II', and the objective was to strengthen employees' commitment to the bank's performance via the market's assessment of those results, that is, the share price (Director of the Department of Management of Persons and Knowledge, 2001). However, it was not until 1999, under the plan designated 'Participate 2000', that variable compensation was linked to employee contribution of ideas and the spread of improvements in work practices (a popular practice implemented since 1997). Currently, the compensation structure of Bankinter employees

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comprises the following elements: fixed remuneration, creation of value, variable remuneration and awards. Then, it seems that firm designs compensation regarding two aspects: 1) the firm performance (market value and financial benefit) considered as a component of variable compensation; 2) employee participation (regardless of the effect of this participation on performance) considered as a basis for giving awards. The former component of compensation (performance) allows us to describe an economic focus of the firm versus the second component which corroborates the symbolic use of compensation. Then, the firm compensation design suggests a complementary approach between agency and institutional theory.

The encouragement of employees to suggest innovative ideas and improved ways of managing was intended to stimulate ideas of all kinds, covering technology, social innovations or better methods of management, and to turn them into reality (Annual Report, 2001). The followed objective is that the knowledge possessed by individual employees, the human capital of the organization, should be transferred to other areas of the organization and restructured as group knowledge, that is, transformed into valuable capital of the organization. From this we can conclude that the management of the company is committed to the generation and transfer of knowledge among individual employees, and promotes this by offering variable compensation linked to the suggestion of innovative ideas.

Figure 6 relates the percentage of employees receiving variable compensation, the percentage of employees receiving awards, percentage of employee participation and percentage of ideas/improvements actually implemented, and ROI. As the preceding section explains, the organizational performance does not appear to have increased during the period of study. However, the percentage of workers to whom awards were made did increase (from 60.67 percent in 1999 to 73.55 percent in 2005). Considering that this type of compensation is not directly associated with organizational performance but rather with the policy that the company has been carrying out since 1997 to recompense innovation through employee participation, we corroborate the symbolic use of compensation. Additionally, we suggest the complementarity of agency and institutional theory to explain the design of compensation, as the existence of a variable component related to the firm performance supports an agency argument, and award of employee participation searching for firm reputation supports an institutional argument.

In other words, even though the ideas and improvements suggested by the employees were being directly linked to compensation, this compensation practice – the awards – was not related to organizational performance. This fact is difficult to explain under agency theory. At least with respect to participation, these findings confirm the symbolic dimension of part of the

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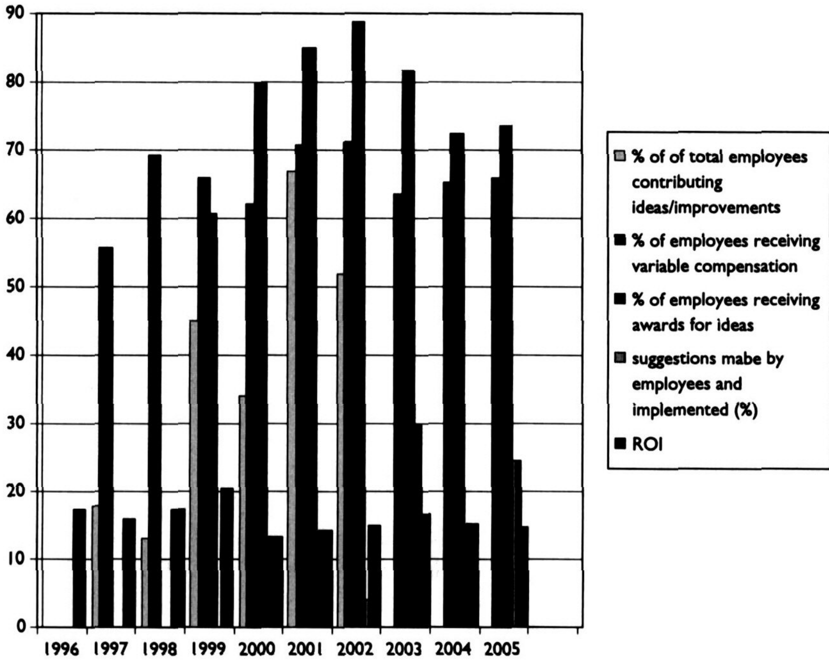

Figure 6 Variable compensation, employee participation and organizational performance

compensation system, thus confirming Proposition P3b and disconfirming Proposition P3a.

Quality programs

Quality programs were not adopted until 1997, when they were linked with systems of variable remuneration in the Annual Reports: 'quality is an important factor in the variable compensation of employees'. In 1997, 95 percent of the employees received a quality bonus. However, from this date on, there was a decrease in the percentage of workers receiving a quality-linked supplement; this may be explained by the parallel decrease in the number of employees participating in specific quality programs. The 1999 Annual Report states that '66.05% of the workforce of the bank received a part of their compensation based on the quality of service perceived by the customers'. Still, attention to quality is remunerated by the company, even when some of the indicators used to measure it show a decrease (see Figure 7). Since the evolution of the company's efficiency and legitimacy over this

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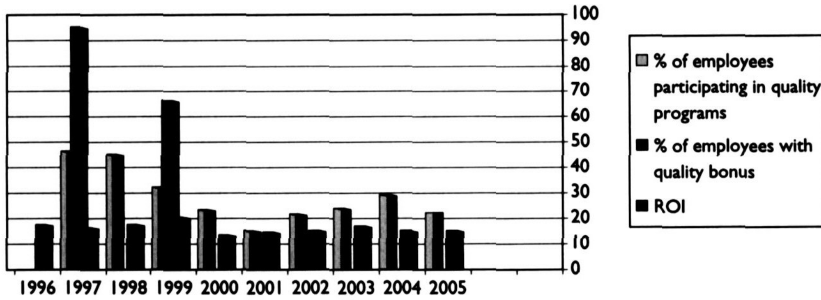

Figure 7 Variable compensation, quality programs and organizational performance

period has already been analyzed, Proposition P3b is similarly confirmed for this second popular practice.

Use of work teams

Since work teams were used for only two years, they would probably have had hardly any influence on the design of compensation schemes.

As a whole, it seems that firm compensation is linked to three elements: financial results, employee participation and quality. The results show that the company used employees' contribution of ideas and participation in quality programs in defining part of its variable compensation system. Participation in work teams could not have figured as a component to be remunerated, since it disappeared after 1998. The fact that compensation is linked to certain practices that enhance legitimacy but is not associated in any way with organizational performance validates Proposition P3b.

6. Discussion of the results and conclusions

This research aims to determine whether the design of a variable compensation system is conditioned only by objectives of efficiency or whether it reflects other factors such as the search for enhanced legitimacy. The case in hand allows us to relate the company's legitimacy to particular popular management practices (employee participation, quality programs, and work teams), and these practices to the compensation of its employees.

Over the period when the company was undertaking these popular practices, we measured both its efficiency (by means of ROI) and its legitimacy (by means of the degree of social responsibility demonstrated and

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visibility in the communications media). The company enjoyed high levels of legitimacy despite not having shown any clear improvement in organizational performance. The results confirm that the first two of the three popular management practices analyzed (employee participation, and specific policies to improve quality) were implemented effectively in the company. The existence and the functioning of work teams (the third popular practice considered) was confirmed for only two years (1997 and 1998) of the period studied, although the firm's interest in this practice remained over time.

Two alternative interpretations could be made of these results. First, it could be considered that employee participation and a focus on quality improvement influence legitimacy more than does the use of work teams, since the company apparently continued to be considered legitimate despite the discontinuance of the use of work teams after only two years. Second, there might be a delayed effect involved: the company continued to enjoy a reputation created during the two years that the work teams were active.

Although there is no evidence allowing us to opt for one or other of these two interpretations, given that in the study design we could not identify the effect on legitimacy exercised separately by each of the three popular practices, an initial contribution of this study is the confirmation almost completely of Proposition 1. The case study provides evidence that the implementation of these popular management practices enhances the company's legitimacy regardless of their effects on firm performance.

In addition, the case study detected significant transformations in the remuneration of employees, particularly the increase in the variable component of compensation. Initially, variable compensation was linked to firm performance. The new design responds to organizational and contextual changes. From the year 1999, employee participation was promoted through awards. These awards directly remunerate innovative behavior by employees, and indirectly promote the creation of intellectual capital, thus rewarding employees' participation and commitment. This compensation design could be not explained using agency theory but institutional theory. The company is remunerating employees for two popular practices (employee participation and attention to quality) that enable the company to enhance its legitimacy in the institutional environment. From these results, we make a second contribution regarding the complementary relation between agency and institutional perspectives to explain compensation design.

Thus a third contribution of this study is to provide empirical evidence, by a case study, of how a company's reputation (as a surrogate for legitimacy), but not necessarily its economic performance, may be increased by adopting popular management practices and compensating those who implement them effectively. These results allow us to state that, in the design

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of their compensation policies, organizations do not always pursue the maximization of profits (as agency theory argues), but sometimes prefer other objectives such as enhanced legitimacy (as institutional theory suggests). In short, the case provides empirical evidence of what has come to be called symbolic compensation.

Further, we could remark as a fourth contribution of this research the analysis of compensation in hierarchical levels different to managerial ones. Most of the previous studies have been based separately on either agency or institutional theory and have been focused almost exclusively on board-level or management compensation. Then, this research extends the traditional perspective, not only because the uses of both theories are combined but because the analysis is broadened to non-management levels. In addition, this study has considered the company's reputation not only from the perspective of the shareholders, as in other studies, but also from the perspective of the employees, in respect of their improvement ideas and suggestions as well as their compensation.

Among the possible limitations of this study, it should first be stated that the empirical data are from an exploratory case study; future studies will be necessary to test the results obtained here. Second, as with the results obtained by Staw and Epstein (2000), we found no direct relationship between the popular management practices used by the company and its organizational performance. There are two possible explanations for this fact: a) this relationship may be observable in the long term, after the innovative ideas and procedural improvements proposed by employees have been implemented, and b) the measure of organizational performance applied in this study (ROI) is influenced by other factors (for example, contextual variables) that have not been considered. Nevertheless, we have tried to eliminate this limitation through empirical evidence as managers confirmed to us that popular management practices were not formally linked to the firm's performance. In addition, we cannot ignore the possibility that these management practices and associated compensation policies could be generating other kinds of beneficial results for the company (different from the traditional financial indicators of performance), such as greater employee satisfaction, greater employee flexibility or a more ethical working environment. Possible extensions to this research could investigate the effects (positive/negative) generated by these popular management practices on the non-financial performance of the company.

Acknowledgement

This research has been financed by the Spanish research project SEC2003-07741.

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Notes

1 Many authors, such as Barringer and Milkovich (1998), consider agency theory too abstract in its mathematical formulation, a theory of static character in which the social context is forgotten. See Perrow (1986), Eisenhardt (1989), Nilakant and Hayagreeva (1994) and Wright et al. (2001) for a review of the limitations of agency theory and its possible extrapolations.

2 Since legitimacy is an ambiguous variable to measure given its many different dimensions, we consider that a company's reputation can be taken as an indicator of legitimacy, since both derive from the same origin and have the same results. 'Favorable reputation can therefore generate excess returns for firms by inhibiting the mobility of rivals in an industry,' and 'reputation reflects firms' relative success in fulfilling the expectations of multiple stakeholders' (Fombrum & Shanley, 1990: 233, 235).

3 This company is included in the FTSE4 Good Europe Index for the year 2003. This index measures the degree of social responsibility displayed by companies and is based on internationally accepted codes of conduct; companies are analyzed in respect of the effort dedicated to environmental protection, social and community topics, respect for human rights, and relationships with stakeholders (Annual Report, 2002). The index is compiled from information provided by companies in questionnaires that are sent either directly to the company or else to appropriate analysts. Depending on the responses given on the questionnaires, and on other information such as capitalization, presence in the sector, etc., the company may or may not be admitted to the index. The selection criteria include environmental sustainability, positive relationships with stakeholders, and support for human rights. In this respect, Bender (2003) analyzed from the institutional perspective too the compensation system design of two companies that were included in this index.

4 Scott (1998) classifies sectors according to their degree of exposure to competitive and institutional pressures of the business environment, and according to whether these pressures are strong or weak. Differences in organizational behavior are thus defined under four quadrants.

5 The Annual Reports are an essential source of information for the stakeholders, and in studies that have combined institutional theory with management theory they have been considered key instruments for detecting how companies attempt to gain or maintain legitimacy (Arndt & Bigelow, 2000).

6 The agreements were obtained from the Aranzadi database.

7 The first variable – support for education, culture and innovation – is measured by the alliances and collaborations with academic and research institutions, number of conferences organized by the Bankinter Foundation for innovation, and experts that participate in debate forums organized by this Foundation. The second variable – environmental issues – is measured by formative actions and communications taken to optimize resources used at the workplace. Finally, the firm's social action is evaluated through the number of projects of social development and number of agreements to integrated disabled persons into the firm's staff.

8 Particularly notable is the *Actualidad Económica*-A.T. Kearney Prize received in the year 2000.

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