COMPENSATION MANAGEMENT
HRM3705

<u>Study unit 10</u>

Compensating executives

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Open Rubric

Learning outcomes of study unit 10

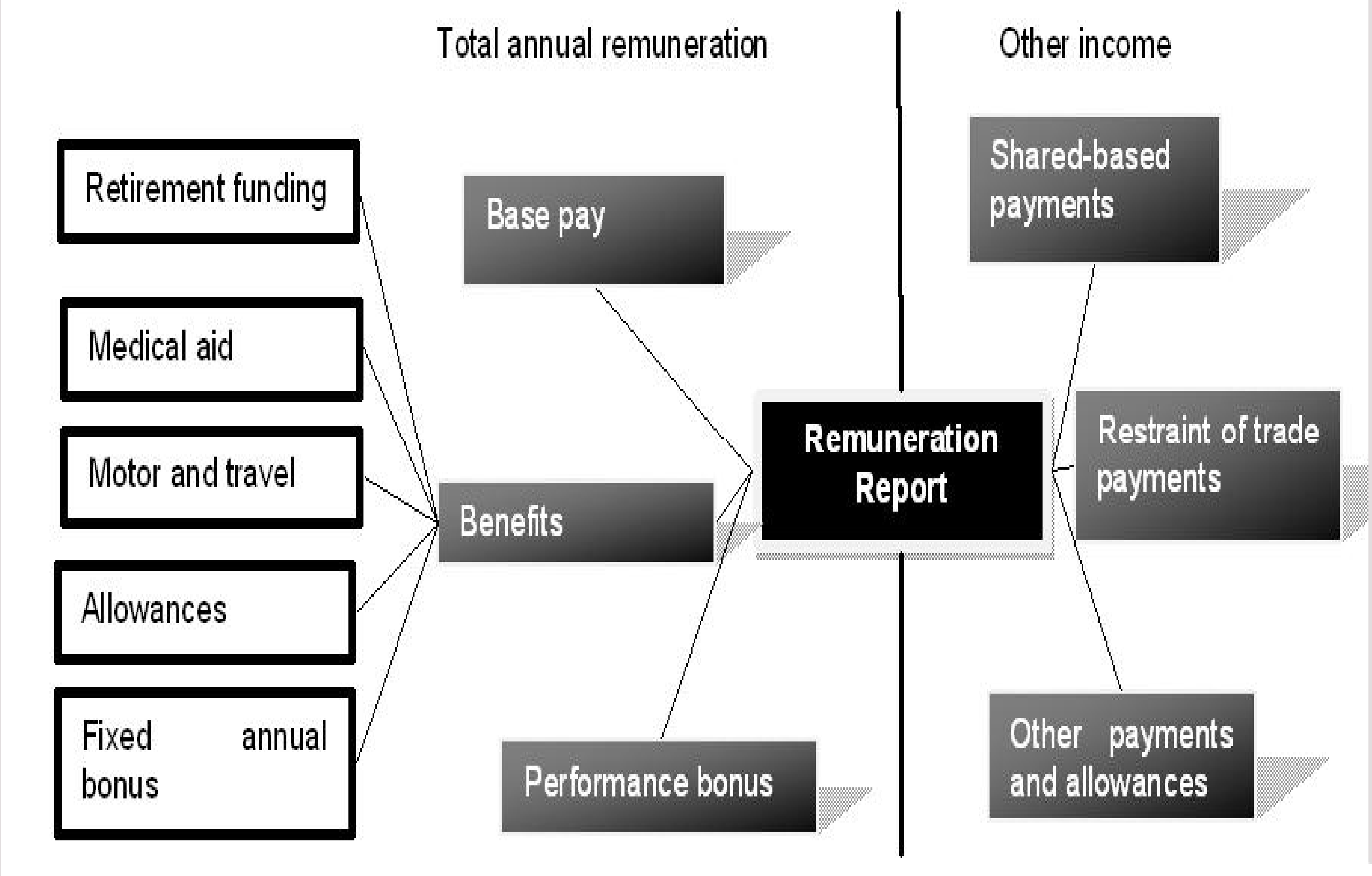
Once you have completed study unit 10, you should be able to:

- Discuss the structure of executive compensation
- Critically discuss the principles and processes of setting executive compensation
- Indicate how corporate governance and executive remuneration fit together
- Critically discuss the structure of executive pay and whether it is fair, ethical and linked to performance
- Discuss the role of remuneration committees in executive compensation
- Discuss how to set CEO pay

Who are executives?

- An **executive** is a person or group responsible for the administration of a project, activity, or business and a **chief executive** is the person with overall responsibility for the efficient running of a company, organization, etc.
- A simplistic approach in defining an executive is to say that anyone who has a real influence on a company's profits is an executive.
- A **key employee** is an employee with a major ownership and/or decision-making role in the business. Key employees are usually highly compensated. They may also receive special benefits as an incentive both to join the company and to stay with the company.

Components of Executive-Pay



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Bonus types

- Discretionary—awarded on an objective basis
- Performance-contingent—based on the attainment of specific performance criteria
- Predetermined allocation—based on a fixed formula
- Target plan—ties bonuses to executives' performance

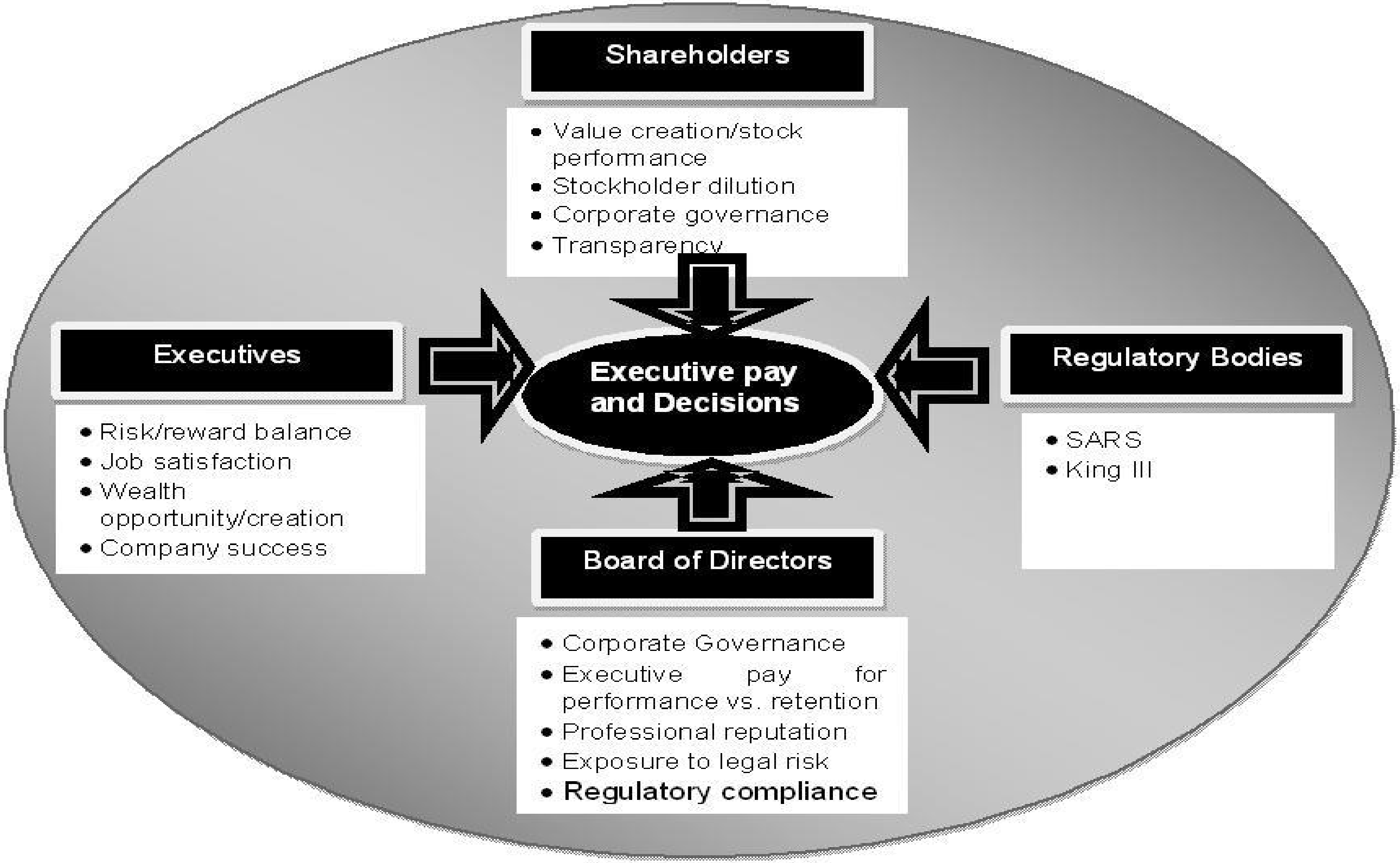
Golden Parachutes

- Provides executives pay and benefits following termination due to ownership change
- Income and benefits for 1–5 years
- Not triggered by retirement, resignation, or disability
- Treated as a business expense

Platinum parachutes

- Lucrative awards that compensate departing executives with:
  - Severance pay
  - Continuation of company benefits
  - Stock options
- Given in order to avoid legal battles or critical press reports

Key players in setting executive remuneration



Key Players

Compensation Consultants

- Propose recommendations
- Develop packages based on strategic analysis
  - External market context
  - Internal factors
- Possible conflicts of interest

Key players

Board of Directors

- Represent shareholders' interests
- Usually 15 members
  - CEOs and executives
  - Community leaders
  - Professionals
  - Not less than 2 executive directors and 3 non-executive directors
- Give final approval to recommendations
- Are compensated well for services

Key players

Compensation Committees (RemCo)

- Usually other board of directors' members
- Major duties include:
  - Develop an executive compensation strategy
  - Review consultants' recommendations
  - Discuss assets and liabilities
  - Make final recommendations

Key issues in executive remuneration

- Do executives deserve the amounts paid t them?
- Is pay linked to performance and is it linked to appropriate performance measures?
- Is it ethical and are these payments fair?

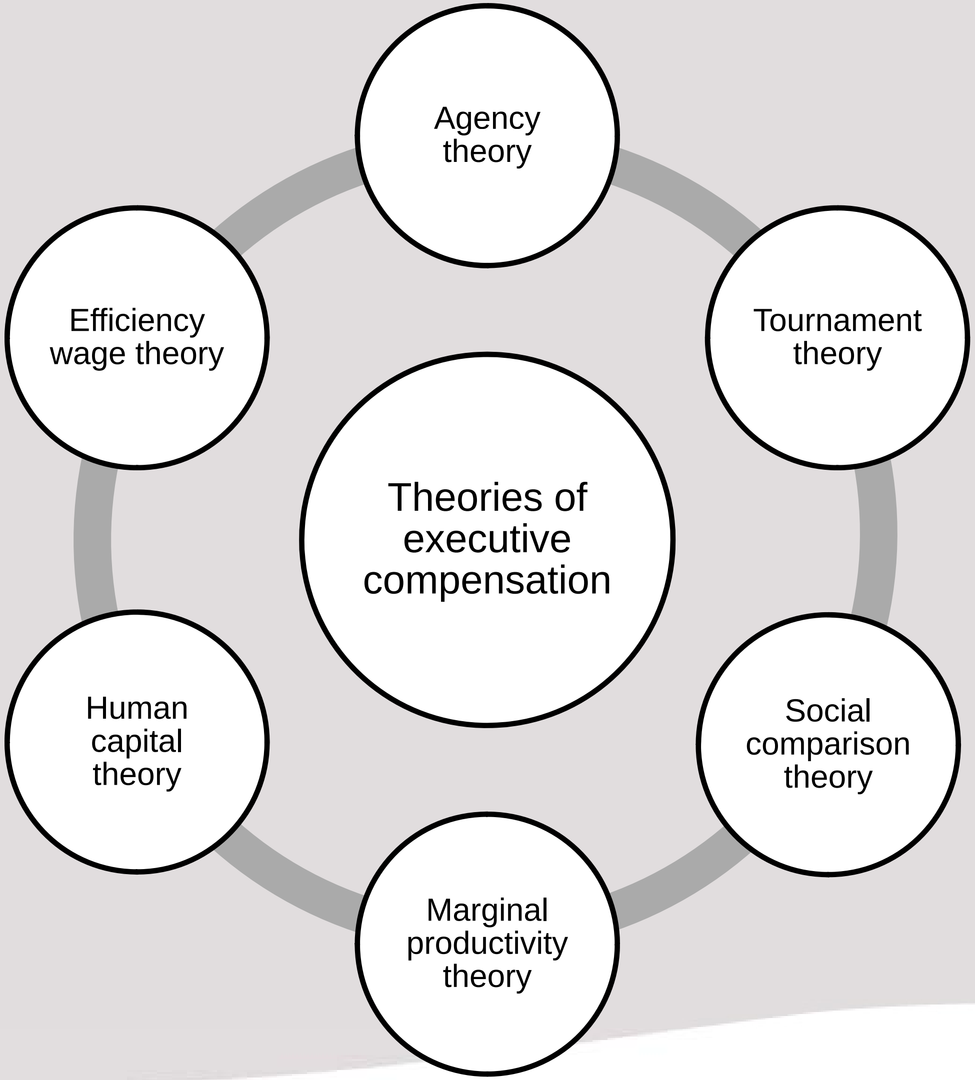
What can the board do to act ethically in matters of executive compensation?

- Identify the true compensation being paid to an executive.
- Keep the RemCo independent.
- Tie pay to performance.
- Recruit by character as well as by credentials.
- Avoid basing decisions on self-interest.
- Align compensation with long-term strategic and economic goals.

Factors that result in adverse publicity in the area of annual incentive payments

- Competitive pressure
- Timing mismatch
- Wrong measures
- Poor calibration

Theoretical explanation for setting executive compensation



Executive compensation theories

- **Agency theory**
  - Shareholders give control to executives
- **Tournament theory**
  - Managers compete for promotions
- **Social comparison theory**
  - Compensation compared to others
- **Efficiency wage theory**
  - Executives are paid a premium to provide them with the incentive to exert enough effort to avoid being fired
- **Marginal productivity theory**
  - Executive should receive as compensation according to his/her value to the organisation
- **Human capital theory**
  - The value of the executive and hi/her compensation is based upon the executive's accumulated knowledge and skills.

Setting CEO's pay – Determinants of executive pay

1	**Organisation size**	Turnover, number of employees, value of assets
2	**Organisation performance**	Profitability, return on investment, value added
3	**Executive-specific factors**	Age, experience, tenure, career path
4	**Organisation structure**	Holding, subsidiary or single-unit organisation, capital or labour intensive
5	**Job- or position-specific factors**	Level of decision-making, consequence of error, organisation level
6	**Job complexity**	Job-sizing instruments are used to determine job size

Source: Bussin (2011:115)

Guidelines for setting CEO pay

- "Defensible" is the key word in terms of pay
- Pay should be directly tied to the value delivered
- Market norms are a valuable guideline
- Robust remuneration policies and strategies are a must
- Impeccable governance is mandatory

Source: Bussin (2011)

Corporate Governance

Corporate governance is a set of processes, systems, policies, laws and codes that influence or affect the way an organisation is directed, administered or controlled. Corporate governance also includes relationship with all its stakeholders. Principal stakeholders are among others the shareholders, management, regulators suppliers, board of directors, employees and the community. An important theme in corporate governance is that individuals are accountable for certain organisation outputs achieved in a manner that does not prejudice any stakeholder (Bussin, 2010:387).

Remuneration Governance

King III

The primary purpose of King III is to improve governance practices continually within South Africa, which then has a direct bearing on remuneration practices. The following three over-riding principles pertaining to remuneration governance are include in the Code:

- Principle 2.25: Companies should remunerate directors and executives fairly and responsibly
- Principle 2.26: Companies should disclose the remuneration of each individual director and certain executives
- Principle 2.2.7: Shareholders should approve the company's remuneration philosophy

Remuneration Governance

The fairness principle – to consider:

- The level of guaranteed pay as compared with the market;
- The mix of fixed and variable pay;
- The role played by performance conditions;
- Rewarding performance and not failure; and
- Aligning the interests of executive directors, and other senior executives, with those of shareholders.

The executive remuneration principles of King III require the following:

- Preparation of a comprehensive remuneration report;
- Disclosure of remuneration paid to employees other than directors; and
- Non-binding advisory shareholder vote on the remuneration policy and application.

Remuneration Committees

- RemCo’s address governance issues and aims to restore investor confidence.
- Non-executive directors and remuneration committees (RemCo's) are playing an increasingly important role as companies focus on issues of **corporate governance**.
- The collapse of major organisations has put certain ethical dilemmas regarding executive pay practices.
- To restore investor confidence, good remuneration governance is important. And this is where the RemCo comes in.

RemCo membership

- RemCo members appointed by the Board of Directors
- Members not fewer than three serving directors of the organisation
- Majority members should be non-executive directors

Powers of RemCo

- Full access to all company financial information
- May appoint external consultants for the purpose of obtaining salary survey information
- May consult with the organisation's attorneys and its auditors where necessary
- Empowered to obtain the assistance of the HR executive or department in obtaining relevant information

High level duties of RemCo

- Adherence to good corporate procedural rules
- Knowledge of the big picture
- Decision on how much remuneration is enough
- Review of programmes form the shareholders' perspectives
- review of complex plans and programmes
- Review of controversial plans and programmes

Source: Bussin (2011:380)

Main considerations in Executive remuneration

- Company's ability to attract and retain top executives
- Income disparity between executives and non-executive employees
- Layoffs of thousands of non-executive employees

Source: Martocchio (2011)

END OF STUDY UNIT 10

(Refer to the study guide for more detailed discussions on the topics presented here)

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