Executive Compensation: Transparency, Corporate Governance and Corporate Social Responsibility Perspectives

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Learning Objectives

At the end of this chapter, learners should be able to:

- Explain the major components of executive compensation.
- Understand the role of objectives, costs and risk in designing executive compensation packages.
- Explain the influence of transparency, corporate governance and corporate social responsibility practices on executive compensation in an organisation.

Keywords: Compensation and benefits; corporate governance; corporate social responsibility; executive reward; gender diversity; pay ratio
“It is hard not to conclude that this further huge rise in executive pay is more about greed than performance … the stratospheric levels of directors’ pay compared to average wages mean that executives now live in a class apart, even from employees in their own companies. It is not just socially divisive, but bad for the economy” – Brendan Barber (TUC, 2006)

Introduction

Executive compensation refers to the reward provided to chief executive officers (CEO), corporate-level directors and some senior organisational managers. Executive compensation is usually more complex and reflects much higher payouts than reward provided to employees at lower levels in an organisation.

The goal of executive compensation is usually to motivate executives to improve the productivity and performance of organisations. Due to the influence and power of executives in managing organisation and the impact this can have on societies and economies as well as their relatively high rates of compensation compared to other employees, executive compensation is often a focus of attention by shareholders, regulators, media, members of the public and other stakeholders.

This chapter focuses on the components of executive compensation package such as: salary, bonus, stock options, stock grants, other forms of stock-based compensation, pensions, benefits and perquisites, severance payments and change-in-control clauses. The role of objectives, costs and risk in designing executive compensation packages will be explored. Executive compensation often raises issues of organisational justice, ethics, sustainability, social justice and fairness, as well as good corporate governance. The influence of transparency, corporate governance and corporate social responsibility (CSR) practices on executive compensation in an organisation will be discussed.
**Major Components of Executive Compensation**

According to WorldatWork (2007), the major and most popular components of executive compensation packages are:

**Salary**
Fixed cash payment spread equally over 1 year usually on a monthly basis. Monthly salary payments do not vary with performance although the annual salary amount may be reviewed regularly and a salary increase may be based on the performance of the employee.

**Bonus**
An additional form of compensation usually paid in cash which may vary conditional upon meeting or exceeding pre-set performance targets. Bonus may be awarded conditional upon individual, group or corporate performance. Generally calculated as a percentage of salary and linked to one or more performance targets which may be financial or non-financial, quantitative or qualitative, objective or subjective, implicit or explicit in nature.

**Stock Options**
This is a right to purchase shares rather than a grant of shares. The executive has the right to buy stock (shares) in future at a fixed exercise price, irrespective of the actual value of the shares in the stock market.

By setting the exercise (purchase) price at the share price on the date of grant (e.g. £5 per share in 2020), the executive is incentivised to ensure the corporation’s share price increases in value such that the exercise price is lower than the share price at the future date when the option is exercised (e.g. £12 per share in 2025) and the difference (e.g. £7 per share) is a ‘profit’ made by the executive. This rewards performance (increase in share price) and is worthless if the share price drops below the exercise price. In the previous example, if the executive purchases
10,000 units of shares in the year 2025 based on a stock option in year 2020, this would result in a ‘profit’ of £70,000 and form part of their executive compensation package.

Stock options usually last for a fixed period of time and expire at the end of the term, usually 10 years. There may be a maximum cap on the value of shares that can be purchased using a stock option.

**Stock Grants**

This is a form of compensation where the corporation grants share to the executives who become the owner of such shares. The grant of shares may be conditional upon meeting or exceeding performance targets, this is similar to cash bonus but rather than cash, the compensation is in form of shares. This is an outright grant of shares rather than a stock option; hence, there is no exercise price as the shares are not purchased. An increase in future stock price would increase the value of the shares and a drop in share price would reduce the value; however, a stock grant has value as long as the share price is above zero.

Either *restricted* or *unrestricted* shares may be grants. Restricted stock grants may involve restrictions on the transferability of shares such that the executives cannot sell the shares until they have worked at the corporation for a fixed period of time or can only sell them back to the corporation. *Long-term incentive plans (LTIP)* are stock grants awarded for meeting or exceeding performance targets that vest at a future date (e.g. 5 years). They may be forfeited if the performance conditions are not met.

**Other Forms of Stock-based Compensation**

*Stock Appreciation Rights (SARs)* provide the benefit of the increase in share price of stock options without the executive actually having to provide capital to purchase the stock. The difference (‘profit’) between the exercise price and the actual price for a fixed number of shares is awarded to the executive without the
executive having to purchase the shares.

*Phantom stock* provides the benefits of dividends and increase in share price to the executive to whom they have been awarded without the right to ownership of the corporation. Thus, an amount of phantom stock awarded to an executive provides the financial benefits of share ownership without diluting existing ownership among shareholders.

**Pensions**

This is a type of compensation that makes provision for retirement. Pension is usually a deferred compensation which is payable on retirement in the form of a monthly income with the option to receive part as a lump sum on retirement. Pension payments awarded to an executive annually may be paid into a pension scheme (or an equivalent arrangement). However, in some cases the beneficiary may have the option to take the equivalent to pension as a cash payment (i.e. not deferred income).

**Benefits and Perquisites**

These include a range of benefits and perquisites (‘perks’) such as company car, company airplane, health insurance, medical insurance, life insurance, liability insurance, disability insurance, membership of clubs, special dining facilities, use of tax consultants and financial planners, etc.

**Severance Payments**

This is designed to compensate an executive when they have to exit the company under pressure or are fired without cause. This may include a payment in lieu of notice of termination. Severance payments are often controversial when the executive is relieved of their job due to underperformance or their part in a corporate scandal yet are entitled to a payment for termination without notice or early termination of contract of employment.
Change-in-Control Clauses
This is a form of payment to compensate executives for any change to their original contract of employment which puts them at a disadvantage. This often occurs during a merger or takeover by another corporation when executives may lose their job or change their role.

Role of Objectives, Costs and Risk in Designing Executive Compensation Packages
The components of executive compensation have varying effects on the motivation and risk appetite/behaviour exhibited by employees (executives) and these can be explicitly considered when designing executive compensation packages. Other key considerations are the cost of the individual components in the executive reward mix and the total cost, as well as the objectives of each reward component (e.g. what aspect of performance does each component reward? what risk to the organisation does each component mitigate or create?). While many organisations design each component with objectives seeking to align executive reward with specific organisational and shareholder interests, some organisations are beginning to also include objectives which take into consideration wider stakeholder interests and CSR considerations. Designing executive reward packages therefore involves combinations and trade-offs between different components of the reward package in order to maximise the benefit to the organisation and incentivise executives appropriately (WorldatWork, 2007).

In many organisations, fixed pay (base salary) forms a much smaller proportion of overall executive compensation packages while variable pay constitutes a larger proportion of the overall executive compensation package. Variable pay will usually be some form of performance-related pay (PRP) such as annual bonus/short term incentive plans and stock grants/stock options/LTIP. For PRP to reward performance in an executive compensation package the incentives need to be
correlated with performance goals.

Executive compensation can often be measured at three different stages:

- **Expected pay**: The value of compensation promised in a given year.
- **Earned (realisable) pay**: The value of compensation an executive ‘earns the right to keep’ which is delivered after any vesting conditions are fulfilled.
- **Realised pay**: The value of compensation an executive ‘takes home’ as cash is delivered and vested awards are sold.

The following example illustrates the design of an executive compensation package showing commonly used objectives and operational design considerations (see e.g. AstraZeneca, 2016; BT Group, 2018; CIPD-HPC, 2017; Perkins & White, 2008):

**Example**

**Base Salary**

Objectives:

- To reflect the value of the role and the individual occupant, and to recognize skills and experience.
- Intended to be sufficient to attract, retain and develop high-calibre individuals.

Operation:

- Payable monthly in cash and counted as salary for pension accumulation purposes.
- Base salaries are normally reviewed annually with any change usually taking effect from 1st January.
- While there is no formal maximum, any increases in base salary will normally be in line with the percentage increases awarded to the employee population.
- Higher increases may be made if appropriate, for example to reflect:
  - an increase in the scope and/or responsibility of the individual’s role; or
• development of the individual within the role.

• Benchmarked against a selection of FTSE 100 firms and individual salary levels positioned against the median in relevant comparator group for each role.

Activity 1.

A 2.5% increase was awarded to the overall employee population, calculate the new base salaries of the executives listed as follows:

CEO: £1,000,000 – to increase in line with employee population but must not be more than median of comparator group (£1,500,000).
Chief Operating Officer (COO): £800,000 – to increase by 4% to reflect increase in scope and responsibility after expansion of international operations.
Chief Finance Officer (CFO): £700,000 – to increase in line with employee population but must not be more than median of comparator group (£710,000).

Suggested Answer

• CEO: (£1,000,000 × 0.025) + £1,000,000 = £1,025,000 (less than £1,500,000 so new salary set at £1,025,000)
• COO: (£800,000 × 0.04) + (£800,000) = £832,000
• CFO: (£700,000 × 0.025) + (£700,000) = £717,500 (more than £710,000 so new salary set at £710,000)

Core Benefits

Objectives:

• To provide market competitive benefits.
• Non-cash benefits are designed to be sufficient to attract, retain and develop high-calibre individuals.
Operation:

- Executive Directors are provided with a fund, the value of which is based on a range of benefits including: car allowance, private medical insurance for partner and children, permanent health insurance, life insurance, tax advice, relocation expenses, housing and education allowances, tax equalisation, exchange rate adjustments and gym membership.
- Executive Director may choose to take a proportion of, or the entire, fund as cash.

Pension

Objectives:

- Provision of retirement benefits to attract, retain and develop high-calibre individuals.

Operation:

- Executive Directors are provided an annual pension allowance based on a percentage of base salary, which the Director may elect to pay into a pension scheme (or an equivalent arrangement or take as cash). CEO and CFO receive pension allowances of 30% and 25% of their base salaries, respectively; other executive directors receive an amount benchmarked against a selection of FTSE 100 firms with a maximum allowance of 20% of base salary.
- Pension is deferred income which is payable on retirement in the form of a monthly pension with the option to receive part as a lump sum on retirement. Executive directors have the option to take equivalent to pension as a cash payment (i.e. not deferred income).

Activity 2.

Using the new salaries set in the activity above calculate the new annual pension
allowances for the CEO, COO and CFO.

*Suggested Answer*

CEO: £1,025,000 × 0.03 = £30,750  
COO: £832,000 × 0.02 = £16,640  
CFO: £710,000 × 0.025 = £17,750

**Annual Bonus**

Objectives:

- To offer an incentive to achieve short-term performance targets year on year.
- The annual bonus rewards short-term (annual) performance against specific organisational targets and individual objectives.
- The deferred share element of the annual bonus is designed to align Executive Directors’ interests with those of shareholders.

Operation:

- A performance-related cash payment awarded annually, not counted for pension accumulation purposes.
- Payment can be up to 100% for ‘on target’ performance and 200% as a maximum award for ‘outstanding’ performance.
- For an award of 150% of base salary or above in the case the company would consult major shareholders in advance.
- Performance is measured over 1 year and the bonus, if awarded, is paid after the year end. Two-thirds is delivered in cash and one-third is delivered in shares, which are deferred for 3 years under the deferred bonus plan.
- For bonuses awarded, the company has discretion, for up to 6 years from the payment date, to *claw-back* from individuals some or all of the cash bonus award in certain circumstances including: (i) material restatement of the results of the company, (ii) significant reputational damage to the company,
or (iii) serious misconduct by the individual. However, in the case of (i) and (ii) the company may only exercise its discretion for up to 2 years from the payment date.

- For deferred shares relating to bonuses the company has discretion:
  - to reduce or cancel any portion of an unvested deferred bonus share award in certain circumstances (*malus*), including (i) material restatement of the results of the company, (ii) significant reputational damage to the company, or (iii) serious misconduct by the individual.
  - for up to 6 years from the vesting date, to *claw-back* from individuals some or all of the deferred bonus share award in certain circumstances, including (i) material restatement of the results of the company, (ii) significant reputational damage to the company, or (iii) serious misconduct by the individual. However, in the case of (i) and (ii) the company may only exercise its discretion for up to 2 years from the vesting date.

*Activity 3.*

Calculate the annual bonus (cash bonus and deferred shares) of the CEO, COO and CFO based on the salary information in the previous activities and the performance ratings as follows:

CEO: ‘on target’ performance.

COO: ‘outstanding’ performance.

CFO: performance rated as 50% of ‘on target’.

*Suggested Answer*

CEO total annual bonus: (£1,000,000 × 1) = £1,000,000

CEO cash bonus = \( \frac{2}{3} \times £1,000,000 = £666,667 \)

CEO deferred shares = \( \frac{1}{3} \times £1,000,000 = £333,333 \)

COO total annual bonus: (£800,000 × 2) = £1,600,000 (subject to company consulting
major shareholders in advance)

COO cash bonus = \( \frac{2}{3} \times \£1,600,000 = \£1,066,667 \)

COO deferred shares = \( \frac{1}{3} \times \£1,600,000 = \£533,333 \)

CFO total annual bonus: (\£700,000 \times 0.8) = \£560,000

CFO cash bonus = \( \frac{2}{3} \times \£560,000 = \£373,333 \)

CFO deferred shares = \( \frac{1}{3} \times \£560,000 = \£186,667 \)

**Share Options**

Objectives:

- To offer an incentive in relation to share price earnings growth over 3 years, discounted for the cost of capital, providing alignment of executive reward with shareholders’ interests in increasing share price over the medium to longer term.

Operation:

- A maximum 300% of salary may be granted in share options annually.
- A parcel of shares is granted with an exercise price set at the market value on date of grant.
- Performance is judged against set financial performance targets and share price increases above the grant value.

**Long-term Incentive Plans**

Objectives:

- To align the variable pay of Executive Directors with the successful execution of the company’s strategy.
- This is a discretionary annual award; a parcel of shares is awarded to individualsto offer a performance incentive over the long term.

Operation:

- Vesting is dependent on the achievement of stretching performance targets
and continued employment. Performance targets are set by the company at the beginning of the relevant performance period. They are closely aligned to the company’s strategy. Performance targets set by the company relate to key measures critical to the company’s long-term success and measure the company’s performance relative to peer group of companies.

- Performance is assessed over the 3-year period commencing on 1st January in the year of grant. Shares are then subject to a 2-year holding period following the performance period, so full vesting takes place on the fifth anniversary of grant. During the holding period, no further performance measures apply. The 2-year holding period ensures individuals retain exposure to the share price for at least 5 years in total.

- The maximum market value of shares that may be awarded in any year is equivalent to 600% of the participant’s annual base salary at the date of grant. The market value of shares that may be awarded for ‘on target’ performance is 400% of the participant’s annual base salary at the date of grant.

- Payout under the LTIP can range from 0% to 100% of the original award. Typically, 20% of an LTIP award linked to a performance target will vest on the achievement of threshold level of performance and 100% will vest if the target level of performance is achieved.

**Activity 4.**

Calculate the vesting of the LTIP of the CEO, COO and CFO based on the salary information in the previous activities and the performance ratings as follows:

- **CEO:** ‘on target’ performance.
- **COO:** performance rated as 80% of ‘on target’.
- **CFO:** ‘Threshold’ performance.
**Suggested Answer**

CEO LTIP vesting: (£1,000,000 × 4) × 1 = £4,000,000  
COO LTIP vesting: (£800,000 × 4) × 0.8 = £2,560,000  
CFO LTIP vesting: (£700,000 × 4) × 0.2 = £560,000

**Activity 5.**

Calculate the fixed pay, variable pay and the sum of both types of pay of the CEO, COO and CFO based on the executive compensation calculations undertaken in the previous activities.

**Suggested Answer**

CEO fixed pay: CEO: new salary (£1,025,000) + annual pension allowance (£30,750)

= £1,055,750  
CEO variable pay: total annual bonus (£1,000,000) + LTIP vesting (£4,000,000)

= £5,000,000  
CEO total: £6,055,750

COO fixed pay: CEO: new salary (£832,000) + annual pension allowance (£16,640)

= £848,640  
COO variable pay: total annual bonus (£1,600,000) + LTIP vesting (£2,560,000)

= £4,160,000  
COO total: £5,008,640

CFO fixed pay: CEO: new salary (£710,000) + annual pension allowance (£17,750)

= £727,750  
CFO variable pay: total annual bonus (£560,000) + LTIP vesting (£560,000) = £1,120,000  
CFO total: £1,847,750
Influence of Transparency, Corporate Governance and CSR on Executive Reward

Very high levels of executive pay can erode public trust in organisations, exacerbate economic inequality and highlight failings in corporate governance and CSR. Excessive levels of executive reward may signal poor shareholder stewardship while doing little to improve organisational performance where such executive compensation is poorly aligned to rewarding individual executives’ contribution to enhancing organisational performance.

Corporate governance refers to the system by which companies are directed and controlled (Cadbury, 1992, 2000), and this includes the process by which it determines executive compensation levels and in whose interests these decisions are taken, for example, executive directors’ interest or shareholder interests or wider stakeholder interests? (Ejiogu, Ozoh, & Ejiogu, 2013). According to Carroll (1991), CSR involves the expectations that society has of business; these expectations encompass economic, legal, ethical and philanthropic responsibilities. Corporate practices such as the comparative levels of executive pay and worker pay as well as gender pay gaps should therefore be assessed against these societal expectations placed on companies (Ejiogu, 2013; Ejiogu et al., 2013).

Corporate governance reforms in the United Kingdom have been driven by regulatory changes introduced by the UK government and these have recently focused on increasing transparency and stakeholder voice around reward packages payed to CEO and other senior executives. The UK Corporate Governance Code now requires boards to give workers, customers and wider society a voice in corporate governance structures. The UK government will from 2020 require large listed companies to report and explain the ‘pay ratio’ which compares the pay of their CEO to their median employee pay, as well as report on how their boards consider a range of stakeholder interests, beyond shareholder interests (CIPD-HPC, 2019).
The quality of information disclosed is a key requirement of transparency and this may potentially improve organisational accountability and expose corrupt practices (Ejiogu, Ejiogu, & Ambituuni, 2019). Transparency in reporting executive compensation highlights the importance of translatable concepts and practices in the ‘contact zone’ between accounting and human resource management (Ejiogu & Ejiogu, 2018). Greater transparency regarding executive compensation is important to evaluate organisational corporate governance, ethical behaviour and commitment to CSR in relation to internal (e.g. employees) and external stakeholders (e.g. shareholders, regulators, society). This requires transparency in the reporting of pay levels and the components of pay packages as well as the financial and non-financial measures used to determine pay and performance. Understanding executive compensation would provide greater insight into pay levels at the top of organisations and the basis for such pay (CIPD-HPC, 2019). Furthermore, it would enable a critical evaluation of fairness and equity in rewarding different categories of workers and the opportunity costs that might impact not only on organisational performance (e.g. lower investment in research and development or staff training as a result of higher levels of executive compensation) but also on organisational justice (e.g. pay levels for low and middle earners compared to top earners in an organisation, gender and ethnic pay differences, etc.).
Summary

The design of executive compensation is important in determining its effectiveness in achieving goals such as improving organisational performance, incentivising executives appropriately and conserving organisational resources.

The main components of executive compensation package include salary, bonus, stock options, stock grants, other forms of stock-based compensation, pensions, benefits and perquisites, severance payments and change-in-control clauses. The components of executive compensation have varying effects on the motivation and risk appetite/behaviour exhibited by employees (executives), as well as different cost implications for the organisation. Designing executive reward packages therefore involves combinations and trade-offs between different components of the reward package in order to maximise the benefit to the organisation and incentivise executives appropriately.

Poorly designed executive compensation packages may waste organisational resources and fail to align the interest of executives and shareholders. Furthermore, there is an increasing call for executive compensation packages to reflect wider stakeholder interests rather than only narrow shareholder interests.

Greater transparency regarding pay levels and the components of pay packages as well as the financial and non-financial measures used to determine executive pay and performance is important in evaluating organisational corporate governance, ethical behaviour and commitment to CSR. Executive compensation should no longer be considered in isolation, rather it should include a critical evaluation of fairness and equity in organisations and society, such as a comparison of pay ratios between executives and other employees, gender, ethnic and other minorities’ pay gap and how executive compensation may promote or hinder ethical practices and long-term sustainability of organisations.
Reflective Question.

Discuss the following questions:

• Should the pay of CEOs and senior executives be determined solely by the going market rate for their services?
• How may transparency, corporate governance and CSR considerations affect executive compensation practices?
• What do you think about the opening quote by the then General Secretary of the Trade Union Congress (TUC), Brendan Barber, at the start of this chapter? What role can trade unions play in ensuring fair pay for workers and executives?
References


