COMPENSATION SYSTEMS

STEPPING OFF THE MONEY-GO-ROUND

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Much of what is accepted as fact about the relationship between compensation systems and overall firm performance are merely assumptions. Compensation is a pivotal mechanism that deserves to be analyzed in its entirety and not in a piecemeal fashion.

COMPENSATION • STOCK OPTIONS • INCENTIVES • MOTIVATION

Compensation's central variable of interest – money – represents the most generalized medium of exchange known to humankind, making it an integral part of practically all transactions within and across organizational boundaries. Money is the quintessence of business language and compensation dollars have a direct impact (and in most firms, the most important one) on the cost side of all financial statements and few doubt the importance of its impact on the bottom line.

However, many of the accepted "truths" about the relationship between compensation systems and overall firm performance are in fact little more than assumptions. The traditional compensation model based on job evaluation and market surveys, while popular, has provoked criticism over the years and has led to the search for more complex models that enables a strategic analysis of how pay resources may be used that go beyond the "attraction, retention and motivation" mantra.

Furthermore, the ethical problems arising out of the cases of Enron and Wall Street, among others, have called into question the link between incentives and decision making where so-called perverse incentives, such as managerial bonuses linked to revenue growth, have been a major force in these debacles, not only for the organizations involved but for the global economy. Incentive systems, therefore, are a double-edged sword.

Our research was carried out from the standpoint that a new approach is needed if compensation is to transcend the traditional paradigms grounded in industrial / social psychology and labor economics and incorporate such notions as the development of systems for monitoring and incentive alignment, coping with environmental uncertainty and balancing the needs and demands of multiple constituencies. Compensation is a pivotal, organization-wide control and incentive mechanism that should be analyzed *in toto* rather than in a compartmentalized, piecemeal fashion.

Organizational members from the highest to the lowest levels in the pyramid respond to how they are rewarded and hence the design of the compensation system influences strategic choices made by top executives as well as how those choices are eventually implemented throughout the entire firm.

Organizations face an array of compensation policy choices that are more or less elitist or egalitarian. The number of management levels included in executive compensation

IDEAS

REWARDING CORPORATE SOCIAL PERFORMANCE MAY PROMOTE ACTIONS THAT ARE GOOD FOR BOTH THE FIRM AND SOCIETY.

programs affects the firm's decision to develop a hierarchical or more egalitarian culture. The number of levels also affects the extent to which the interests of lower-level managers are aligned with those of top management. The extent to which the incentive system covers different management groups, and not just the CEO and his or her immediate lieutenants, sends powerful signals to the rest of the organization as to what is valued and important. It can also promote a more participative image of the authority structure.

Pay disparity remains highest in the United States. One survey of 365 of the largest publicly traded U.S. companies showed that CEOs earned 531 times what the typical hourly employee took home, while the ratio of CEO pay to the average employee's pay for the same sized British, German or French companies is less than 5 percent that of the United States. At the other end of the spectrum, Japan has the smallest gap between CEO and average worker pay.

While risk bearing and risk taking have increasingly been discussed in the aftermath of the financial meltdown, uniform metrics of risks and how to apply such metrics in determining executive compensation remains unclear. What is clear, however, is that in most (if not all) of failed companies in the 2008-2010 financial crisis, the majority of executive compensation packages were provided in the form of variable, performance-based incentives delivered in both cash and equity awards.

One potential problem of stock options and similar instruments is that the executives rewarded with stock options benefit when the stock price rises but experience no reduction in real wealth when the price falls. Managers may respond to these instruments with excessive risk-taking actions since they would not see their wealth damaged if stock prices drop. Moreover, executives need only short-term improvements in share value to exercise their options. In fact, executives are not required to hold stocks for more than one day. Raising a company's stock price for a single day clearly is not a real advance for the business. Rather, this stimulates balance sheet misrepresentation, tax evasion and other corporate malfeasances.

CEO compensation has been the subject of intense public debate as executive pay has risen dramatically as compared to the pay of the average worker and to the actual growth of companies. Other aspects of CEO employment contracts that outrage the public are the use of exorbitant perks, golden parachutes for ousted executives, large sign-on packages for their replacements and very weak to non-existent pay-for-performance relationships. All of these have created the impression that there is something deeply wrong, perhaps even "immoral" (in the words of U.S. President Obama) about these corporate practices.

A troubling fact is that corporate malfeasance not only affects investors and pension holders but also has had important social costs. This brings to the forefront the relevance of corporations to society and their role within it. In this context, it has been widely urged that CEO contracts should incorporate non-financial social performance ratings as part of the CEO evaluation and reward process.

The argument is that rewarding corporate social performance would promote actions that are good for both the firm and society, enhance organizational legitimacy and reputation, the infusion of moral values at the top and a more humanistic management style. This implies a shift from the neoclassical approach and its shareholder maximization point of view to a stakeholder oriented perspective.

Corporate social performance (CSP) evaluates how well a company performs in its efforts to develop practices to deal with and create relationships with its numerous stakeholders. CSP is thus seen as a source of competitive advantage because when the firm meets the needs of a wide variety of stakeholders, it enhances its corporate reputation, improves trusting and cooperative relationships, provides access to superior resources, lowers liability exposure and enhances social legitimacy, all of which is ultimately expected to contribute to the bottom line.

Studies show that maximizing a sole set of criteria is one of the biggest dangers in poorly designed incentive programs. For example, pay schemes that only reward financial performance may deter managers from engaging in corporate social initiatives since the link between social actions and financial performance is not straightforward and could actually hinder more immediate results. Stakeholder theory suggests, however, that over-emphasis on financial performance and ignoring stakeholders' expectations can seriously damage the normal functioning of firms, for example, if the firm is associated with causing environmental damage.

This implies the adoption of a stakeholder approach, which focuses on the firm's long-term survival by balancing interests of multiple stakeholders. As a consequence, criteria that capture these interests should be included in executive compensation schemes.

However, three concerns cast doubt on these arguments. First, it is not clear whether social initiatives have a positive impact on financial performance. The second problem is "stakeholder mismatch," that is, it can't be assumed that all stakeholders favor responsible actions or have a preference for social initiatives. A third aspect is that social initiatives are mainly driven by intrinsic motivation. Indeed, many people and firms invest their time and money in improving the environment and supporting charities without economic returns. However, another intrinsic motivation is "impure altruism" that is, people (or firms) may try to improve their image by carrying out social works.

Much has been said about the motivational properties of money but performance-contingent pay can be such a powerful motivator that it may induce individuals to develop a very narrow focus to accomplish whatever will trigger the reward and neglect other important components or dimensions of the job. One of the ironies about the use of pay as an incentive mechanism is that the greater the strength of the outcome-reward connection and the magnitude of the reward, the more design flaws become apparent and the greater the potential harm to the firm.

While linking pay to productivity may be conducive to greater individual and unit performance, it does not necessarily follow that the performance of the entire organization will improve, because this performance derives from a complex, synergistic interrelation of all its component parts. Performance-contingent pay plans may improve the performance of a firm's constituent parts yet have dysfunctional consequences for the organization as a whole. The reason for this paradox is that each unit is bound by its own local rationality. Thus, linking rewards to the achievement of each unit or individual's objective may exacerbate a natural tendency toward parochialism and a disregard for overriding goals and organizational interdependence.

In conclusion, executive pay is perhaps the most crucial strategic factor at an organization's disposal. It can be used to direct managerial decisions and indirectly channel the behavior of subordinates. Because most organizations follow a pyramidal structure, whatever is rewarded at the top is likely to have a multiplier effect throughout the business.

Unfortunately, there is no simple model for understanding executive pay. Many judgment calls must be made and prescriptive statements are of little value. However, the decisions made are more likely to produce desired results if they are based on an informed consensus of all the key stakeholders involved in the process.

MAXIMIZING A SOLE SET OF CRITERIA IS ONE OF THE BIGGEST DANGERS IN POORLY DESIGNED INCENTIVE PROGRAMS.

MORE INFORMATION:
Compensation and Organizational Performance. Luis R. Gómez-Mejia, Pascual Berrone, Monica Franco-Santos. Publisher: M.E. Sharpe, 2010