

# How to determine logical executive compensation?

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## **With so many competing factors, how should executive compensation be determined? Perhaps by not aligning pay with shareholder value.**

Determining logical executive compensation is a tricky blend of art and science. Culture, country, history, social responsibility and, of course, the quest for company success all play a role in structuring executive compensation schemes.

For much of history, however, shareholder value has been the driving force behind how executive compensation plans are created. But is this the most logical determinant? Is there evidence to support the link between executive compensation and company performance? And should other factors play a role?

In Chapters 9 and 16 of *Global Compensation: Foundations and Perspectives*, IESE Prof. [Pascual Berrone](#) and his colleagues Jordan Otten and Luis R. Gómez-Mejía discuss the global nature of executive compensation and suggest potential revisions to widely accepted structures.

## **Agency theory under review**

Why is executive compensation such a thorny - and critical - issue? Because it's a key factor in any discussion of corporate governance. The goal of any governing structure is to minimize "divergence of interests between firm owners and management." Executive pay is clearly a way to control managers' behavior and ensure that it aligns with the goals of the company.

The field of executive compensation has long been dominated by "agency theory," which predicts a "positive relationship between executive compensation and firm economic performance." According to this view, managers receive pay-for-performance awards in order to give them incentive to pursue the shareholders' values; pay is established based on "arm's length contracting between shareholders and management."

Though this line of thought is pervasive among researchers (it's often considered the "neoclassical" approach), the surprising truth is that little evidence exists to support such a relationship between executive pay and firm performance. In fact, some researchers attribute recent corporate scandals to the overemphasis on maximizing shareholder value, without regard for the effects on other stakeholders.

## **Individual, organizational, institutional influences**

In lieu of agency theory, other internal and external influences may actually have greater effects on executive pay. These influences work on three levels: individual, organizational and institutional. At all three levels, the executive compensation planning process takes the social environment into consideration, and all three levels treat managerial discretion as a vital element.

The individual level, in particular, takes managerial discretion into strong account. Discretion refers to "the latitude of actions of executives and the individual's set of responses available which influence the context." Managerial discretion turns agency theory's "contracting" idea on its head: contracts are not perfect or completely thorough, and executives' personal beliefs and perceptions give them the power to instigate negotiations around their compensation (though they are somewhat limited by "market forces and other corporate governance mechanisms"). Managerial discretion can also lead to harmful outcomes, as managers may choose to act in their own self-interest rather than the firm's.

The organizational level addresses corporate purpose and a company's board of directors. According to this approach, shareholder value is not the same as long-term value for a company. To achieve long-term value, *all* stakeholders' interests, not just the shareholders', must be considered. Discretion is used not only by managers but also by the firm and the board when it comes to establishing pay schemes. This explains why "comparable firms may pay comparable executives differently."

At the institutional level, executive compensation is considered "socially embedded," and decision making is affected by a variety of factors including culture, history, norms and

values. This view holds that corporate governance is "a problem of social action," and that executive compensation depends on societal needs and opinions. Executive pay differs widely among different countries, and even within a single country. There is still much to learn about the exact effect national conditions have on compensation plans.

## **Pay linked to stakeholder value**

With all this in mind, a new question arises: what's missing in executive compensation plans? The answer is clear: social responsibility. In the wake of corporate scandals like Enron, in which highly paid but unethical executives wreaked havoc on their workers' lives, business ethics and corporate social responsibility (CSR) have entered the discussion around executive compensation.

The neoclassical economic view of executive compensation, as just discussed, focuses on maximizing shareholder value, and "any financing or investment decision that is not expected to improve the value of the shareholder's stake in the business is not acceptable." Executives are judged against "accounting and market-based measures of performance." As stated before, such a single-minded focus on financial performance can have negative consequences.

But what's the alternative? A stakeholder management approach, which asserts that a company is "a network of relationships with multiple constituencies," holds a possible solution. When diverse stakeholders' goals are all part of corporate strategy, a firm cannot be so single-minded. Indeed, a firm's CSR becomes "a source of competitive advantage"; 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 strengthen the bottom line.

The exact connection between CSR and financial performance, however, is yet to be established; much research remains to be done. Some studies, in fact, have uncovered potential problems with CSR as it relates to executive compensation.

Executive compensation is, at this point, an imperfect science. But one thing is clear: "relying exclusively on financial performance measures as the single criterion to which to link executive pay might well be the cause of undesired corporate behaviors."

Furthermore, "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."

The effort to link executive compensation to social responsibility as well as financial performance is worthwhile, and promises to benefit executives, shareholders, additional stakeholders - and the companies to which they owe their livelihoods.

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