

CRISIL YOUNG
THOUGHT
LEADER 2009

WHAT IS THE BEST APPROACH TO EXECUTIVE COMPENSATION? (POST GRADUATE CATEGORY)

TOTAL WORD COUNT (EXCLUDING TITLE COVER, TABLE OF CONTENTS): 2496

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EXECUTIVE SUMMARY

The dissertation examines the importance of appropriate executive compensation level and corporate governance & social issues arising out of the excessive executive compensation. There can be several approaches to regulate executive compensation which include moderation by non-executive independent directors & shareholders or regulation by government & regulatory bodies like SEBI/SEC. However, the regulations have failed to work effectively because compensation can come in many forms. Moreover, regulations can potentially drain away the talent. The level of executive compensation should be such that it is able to attract and retain the talent while at the same time representing value for shareholders.

Since, the companies do not operate in vacuum without any social obligations, executive compensation has the dimension of business ethics also associated with it. However, the issue of excessive compensation is systemic in nature and it is very difficult for a single company to adopt a policy to restrict executive compensation. Therefore, the change must be on the level of the business system itself. Instead of anybody regulating the executive compensation levels, industry should self-regulate through self-imposed reasonable caps on executive compensation. Executive compensation should be linked to CSR with right tax incentives. The media, academia & analysts should play a greater role in a meaningful discourse on compensation ethics to inform industry and to bring greater attention by changing focus from mere ability of the companies to achieve quarterly and annual earnings forecasts.

1 | INTRODUCTION

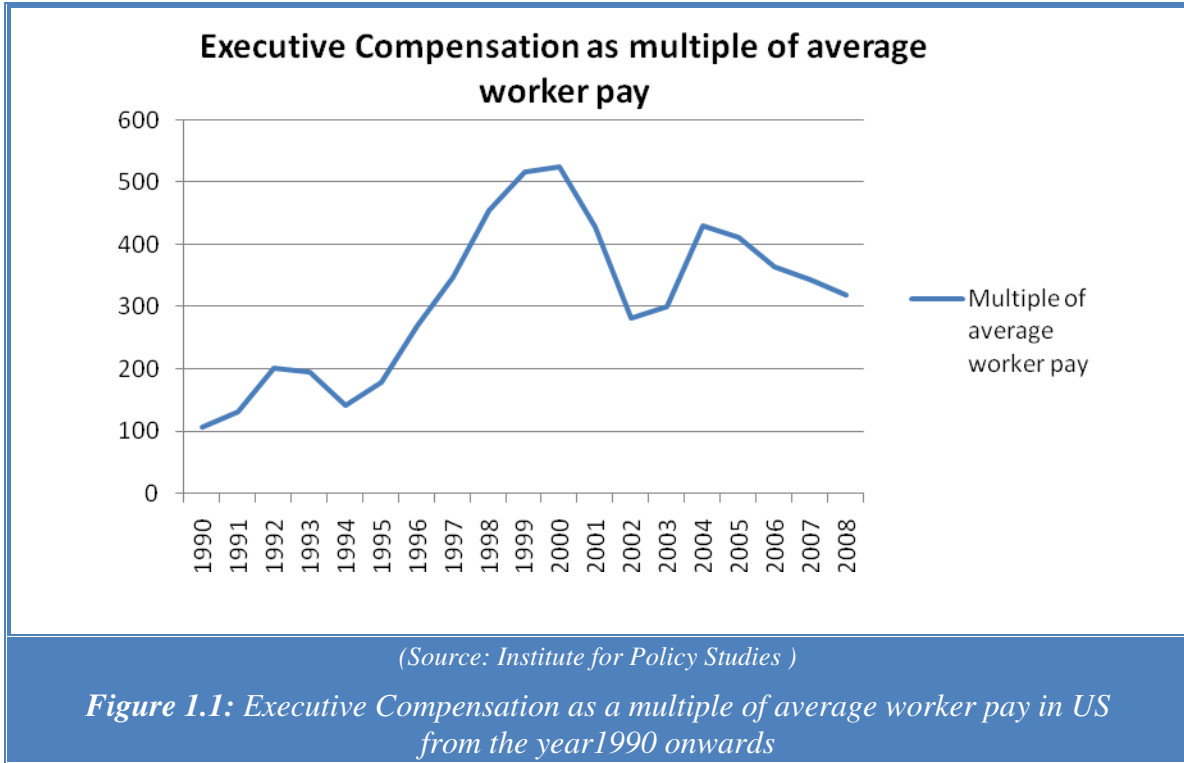
The executive compensation has undoubtedly stirred a lot of debate. The subject of executive compensation has become extra sticky since the global financial meltdown. While the global economy faced a crisis, executive salaries were touching new peaks. Amidst collapsing institutions, executives walked away with millions of dollars in the form of compensation despite accelerating economic crisis. Despite decline in corporate profits by more than 10%, executive compensation dropped by merely 4.4% in US for financial year 2008 (Refer *Table 1.1*).

Average total compensation for S&P 500 firm CEOs in 2008	\$10,084,328
Decline in CEO Compensation compared to 2007	4.4%
Decline in corporate profits compared to 2007	10.1%
Ratio of average CEO compensation to average US worker pay	319:1
Ratio of average CEO compensation to minimum wage	740:1
<i>(Source: Institute for Policy Studies)</i>	
<i>Table 1.1: Worker Pay versus Executive Compensation in US for financial year 2008</i>	

Before 1980s, top executives in US seldom earned more than 40 times the average pay of the workers. *Figure 1.1* summarises the trend of executive compensation over the years in terms of multiples of average worker pay in US. In 2008, amidst the financial meltdown, top executive compensation averaged 319 times the average pay of US worker. Top 20 financial industry executives of US, considered to be the architects of the economic collapse, earned 436 times the average US worker pay. On the other hand, the level of top executive compensation of equally powerful global companies in Japan, Germany & other developed nations ranged from 10 to 25 times that of average employee salaries.

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All this has resulted in public outcry for sanctions and better oversight of executive compensation levels.

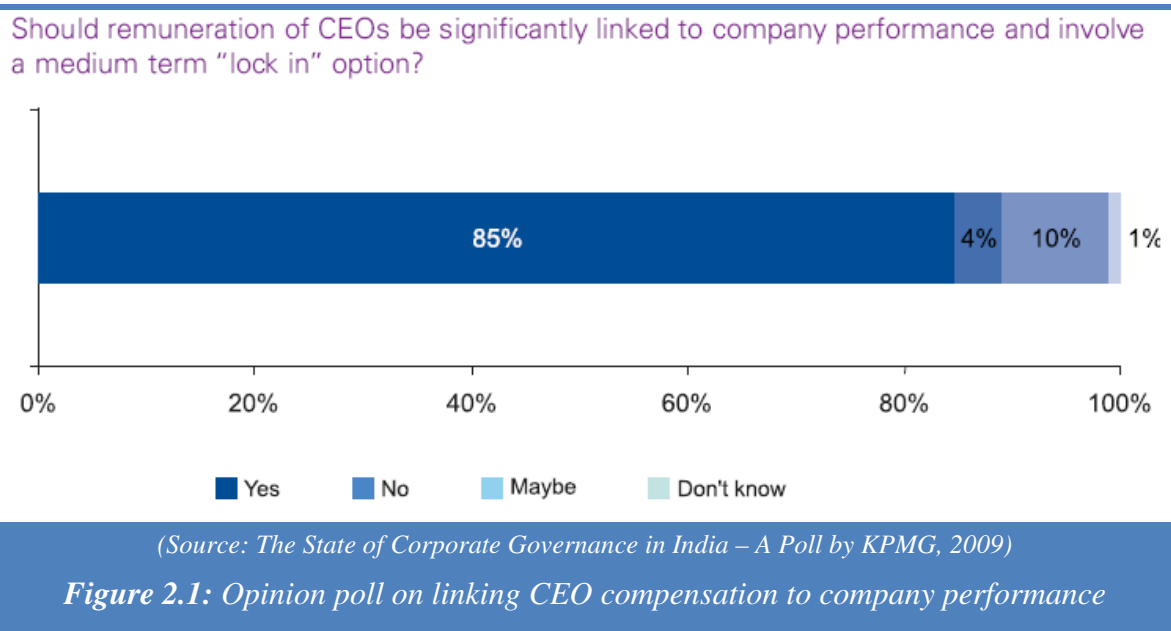


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LINKING EXECUTIVE COMPENSATION TO COMPANY PERFORMANCE

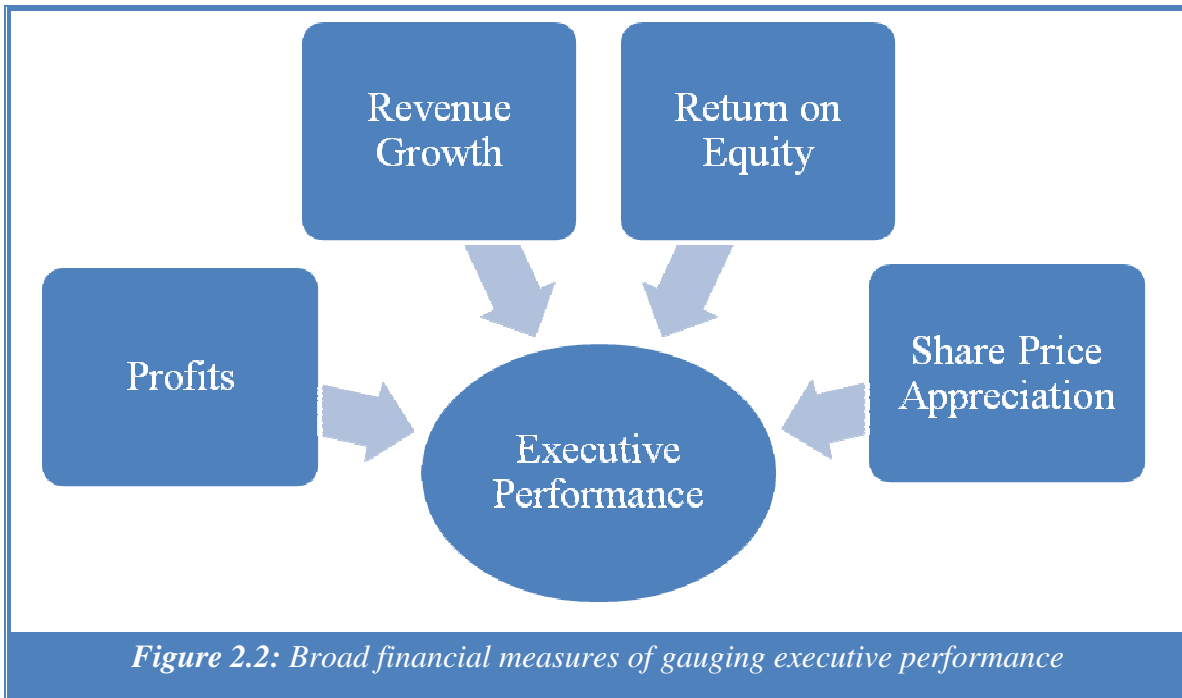
The level of executive compensation should be such that it is able to attract and retain the talent while at the same time representing value for shareholders. Setting the compensation level too low can get the executive talent tempted by competitors while setting it too high can fail to deliver value for the stockholders. Therefore, in setting compensation levels, a firm must seek to attract and retain executive talent while satisfying itself that management is delivering returns appropriate for the level of investment made in the company by shareholders.

A vast majority of the respondents in a poll conducted by KPMG favoured linking the CEO remuneration to the company performance (Refer *Figure 2.1*).



There can be several metrics of measuring executive performance when it is linked to the company performance. Simple financial measures of gauging performance of executives are listed in *Figure 2.2*. However, these measures fail miserably in some cases as in oil industry where many a time large profits are attributable to irrational increase in oil prices.

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Also, several pros and cons are associated with linking executive compensation to the company performance as listed in *Table 2.1*.

Pros	Cons
<ul style="list-style-type: none"> - Performance targets when linked to executive pay motivate executives while still delivering the value for shareholders. - Evaluation of executive performance sends a clear message that the executive is accountable to the shareholders & the board and introduces a healthy balance of power. 	<ul style="list-style-type: none"> - Linking of executive compensation with company performance encourages excessive risk taking which is believed to be one of the prominent reasons for the present financial crisis. - It is difficult to quantify the correlation between the precise contributions of an executive to the overall performance of a company. An underperforming executive may end-up receiving excessive compensation and vice-versa.

Table 2.1: Pros and cons of linking executive compensation to the company performance

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Therefore, an appropriate compensation program must pay the executives for performance and at the same time mitigate/minimize the excessive risk. The balanced view of performance should also include non-financial measures rather than a mere overly focus on the ability of the companies to achieve quarterly and annual earnings forecasts.

3

ISSUES ARISING OUT OF EXCESSIVE EXECUTIVE COMPENSATION

The importance for the need to streamline the excessive executive compensation can be gauged from the fact that it may lead to numerous issues. The following corporate governance and social questions may arise out of the excessive executive compensation:

Corporate Governance Issues / Questions

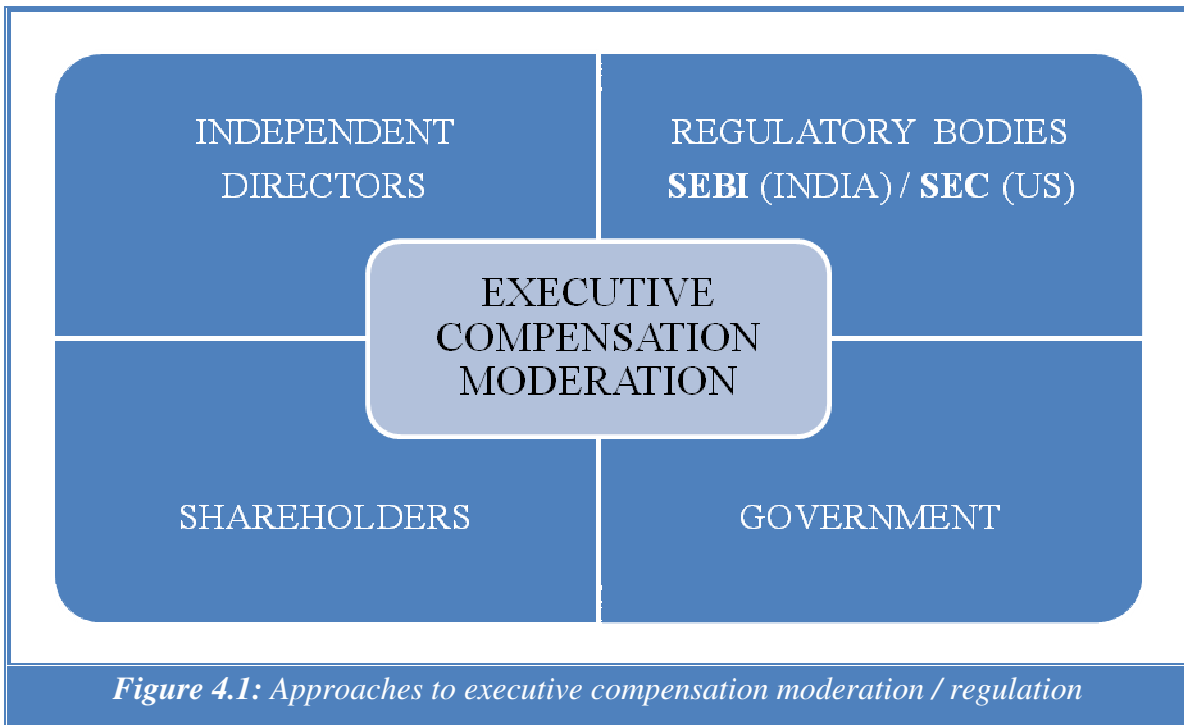
- Is excessive executive compensation package in the best interests of the stockholders?
- Are all means / sources of executive compensation package clearly reported & segregated in the financial statement?
- Being the crucial link between the shareholders and the management, does Board of Directors ensure that sanity prevails on aspects such as risk-taking and executive compensation?
- Are the auditors appointed and held accountable by the board of directors or are they beholden to the management and the executives?
- Does the lack of accountability, monitoring & control, as exemplified by scandals like Enron, WorldCom etc., hold true in boardrooms even today or is it an exception?

Social Issues / Questions

- Do the companies operate in vacuum without any social obligations?
- Can the behaviour of the companies be indecent in the social context in which they operate?
- Do the employees of an organisation consider the executive compensation vulgar when it is disproportionately higher than their average compensation?
- Do the executives in the government sector consider their compensation vulgar when compared to the compensation of those in the private sector?

**APPROACHES TO EXECUTIVE COMPENSATION
REGULATION / MODERATION**

Practically, the executive compensation can be moderated or regulated by the 4 prominent means as shown in *Figure 4.1*:



Moderation by Non-Executive Independent Directors:

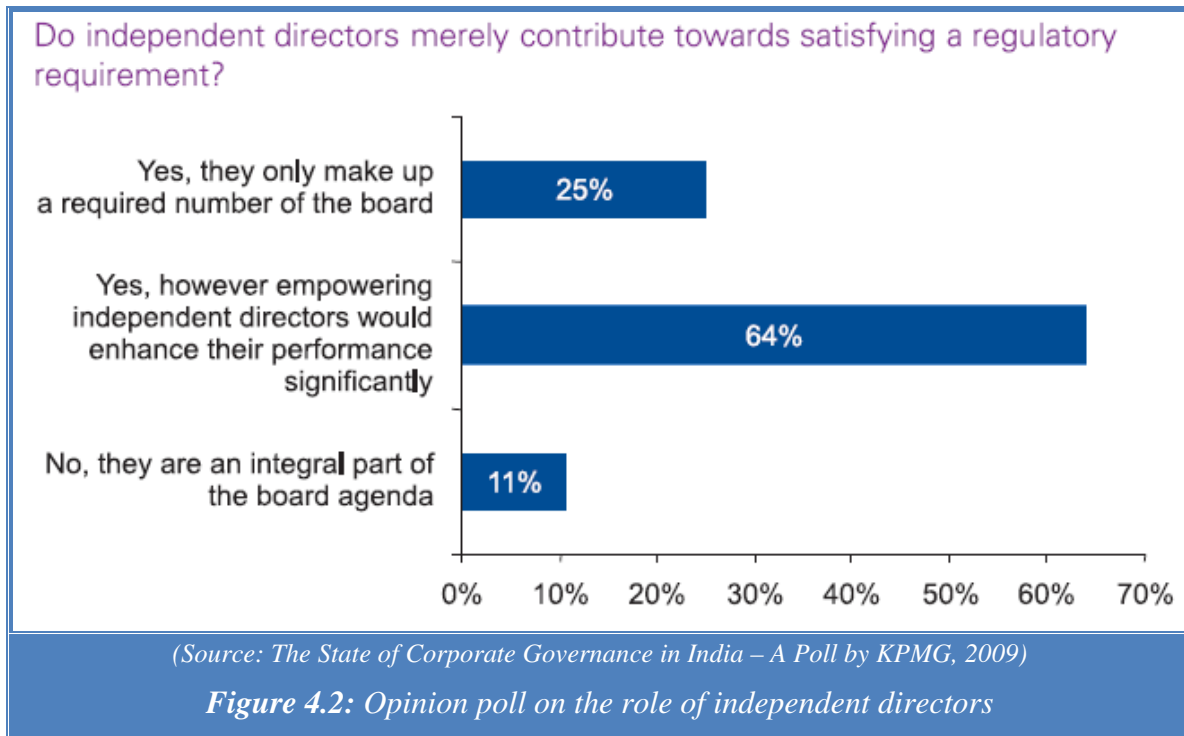
One approach to moderate the executive compensation is to leave it to the non-executive independent directors. This approach can be effective subject to the following conditions:

- Only independent directors should be the members of the remuneration committee with committee being headed by one of them. The committee members should have wide acceptability with respect to their credentials of impartiality and independence.
- The remuneration committee should have access to the external compensation expertise of consultants. However, the committee should ensure that the consultants are not linked to the management or the board in any way.

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- Annual report should have statement from the chairman of the remuneration committee to facilitate direct communication with shareholders on policies pertaining to executive compensation.

However, independent directors need significant empowerment to discharge their governance responsibilities properly. Majority of the respondents in a poll conducted by KPMG recently felt the need to empower independent directors (Refer *Figure 4.2*).



Regulation by the Government

The government also has a responsibility to protect shareholders and the economy from a rash compensation system. In India, for instance, as per the prevailing laws the compensation of a managing director cannot exceed 5% of net profit, and pay & directors' compensation as a whole cannot exceed 11% of profit, without government permission. However, the following questions arise out of the pay regulation by the government:

- Should the government enact legislations to regulate the compensation in the private sector even when there is no government money at stake?

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- Will such regulations push the investments to other countries?
- Will executive talent head to other nations with no such regulations?

Therefore, the government regulations on executive compensation are not called for the companies which do not seek bail-out or subsidies from the government. Instead of directly interfering in the affairs of the companies, reasonable government regulations can do the following:

- Giving shareholders greater say over executive compensation
- Considering tax benefits for companies that voluntarily set sensible compensation limits

Moderation by the Shareholders

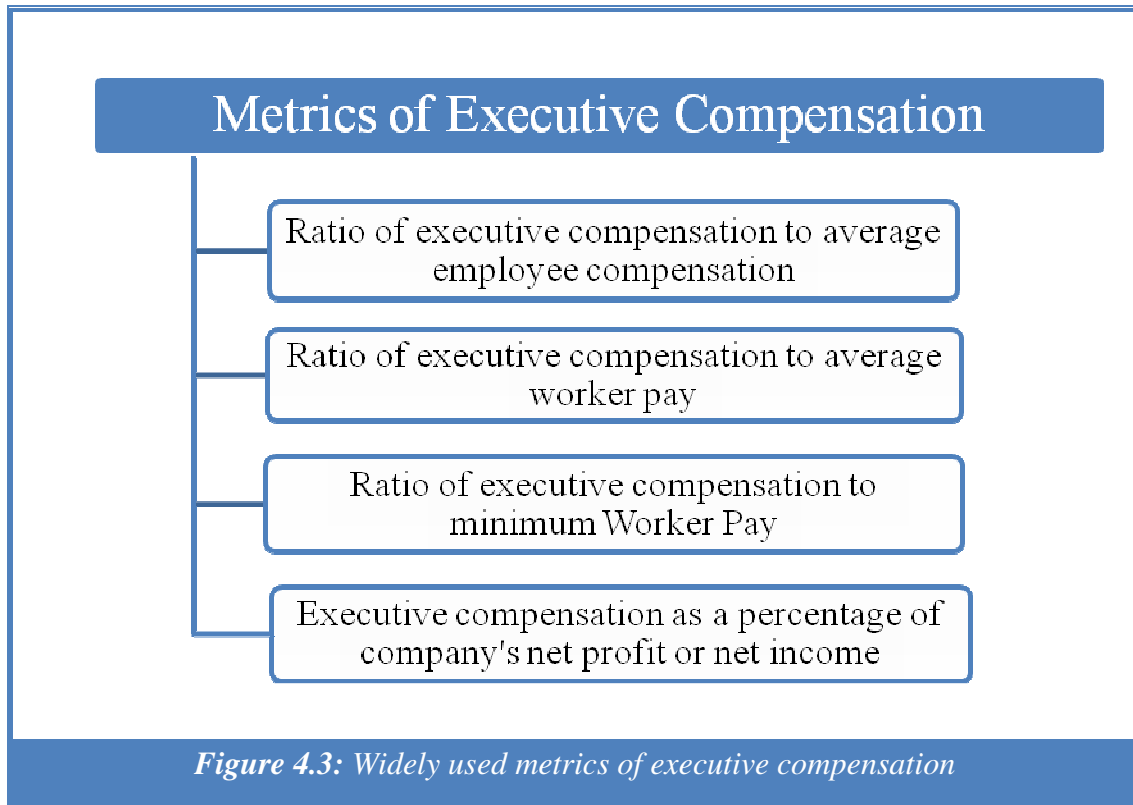
Shareholders may play a crucial role in putting a check on the excessive executive compensation. Shareholders can register their discontent in the Annual General Meetings and compel the board to review the compensation. US has already enacted the Shareholder Bill of Rights Act and The Corporate and Financial Institution Compensation Fairness Act with a purpose of providing shareholders "Say on Pay" of executives.

Regulation by bodies like SEBI / SEC

The bodies which govern the stock exchanges of individual countries such as Securities and Exchange Board of India (SEBI), US Securities and Exchange Commission (SEC) etc. can also frame clauses for regulating the executive compensation. With the introduction of such clauses, compliance with their requirements becomes mandatory for the listed companies. Regulators can become proactive in imposing substantial penalties for non-compliance to regulations. For instance, clause 49 of the listing agreement with stock exchanges provides the code of corporate governance prescribes by SEBI for listed Indian companies. Such clauses can take into account the issue of excessive executive compensation also.

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For imposing regulations on executive compensation, the metrics listed in *Figure 4.3* can be employed:



From all the approaches mentioned in section 4 of this paper to moderate the executive compensation, it becomes increasingly clear that executive compensation is about ethics and not regulations. Ethics involve decision making at the following three levels:

- Level of the individual
- Level of the organization
- Level of the business system

Problems that result from accepted business practices or from features of the economic system cannot be effectively addressed by any single individual or any single organization. These are difficult for one company to change single-handedly, because the company is constrained by competition with possibly less ethical competitors. A single employer may not adopt a policy to restrict excessive compensation because the problem is systemic and consequently any substantial change must be on the level of the system. Given below is an excellent example of business ethics in executive compensation exhibited by Whole Foods Market.

Whole Foods Market Inc.

An example of business ethics in executive compensation in capitalistic system

Source: www.wholefoodsmarket.com

Founded in 1980 in Austin, Texas, Whole Foods Market is a Fortune 500 company and one of the largest natural and organic foods retailers. The Company had revenue of \$7.9 billion in fiscal year 2008 and currently has more than 275 stores in the United States, Canada and the United Kingdom. The company has a self-imposed limit on executive salary and bonuses. This limit is presently 19 times the average salary of all full-time employees. Whenever the average salary of employees shoots up, the company

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executives benefit. John Mackey, Founder & CEO of the company, takes a token US \$1 as salary and all his stock-based compensation is channelled to non-profit based foundations which engage in appreciable work the world over.

Under Mr. John Mackey's leadership, the company governs itself to maximise the benefits of all stakeholders including employees, suppliers, customers & community. Non-executive members are awarded 90% of the stock options. Generous health benefits are given to all the employees of the company. A certain percentage of company profits are diverted towards non-profit based community foundations. The roots of this noteworthy culture of the company lie in capitalism and corporate social responsibility.

However, it is worth noting that Whole Foods increased its salary cap¹ thrice since the cap was created in the year 1986. Originally set at 8 times the average wage, the cap was raised to 10 times in the early 1990s, 14 times in 2000 and finally 19 times the average wage in 2006. The reason given for increase in cap was to make the compensation of company's key executives more competitive in the marketplace and help ensure their retention.

Issue of excessive executive compensation is systemic.

It's difficult for a single firm to adopt a policy to restrict executive compensation.

This indicates that the issue of excessive compensation is systemic in nature and it is very difficult for a single company to adopt a policy to restrict executive compensation.

¹ Salary cap, in case of Whole Foods Market, is a limit on total cash compensation paid to any team member in any calendar year. Employee benefits, stock options and non-cash contributions are not counted in determining and applying the salary cap.

The executive compensation is about ethics involving decisions at level of the business system. Instead of anybody regulating the executive compensation levels, industry should self-impose reasonable caps on executive compensation using suitable metrics.

If every company replicates or builds upon the compensation system of Whole Foods Market as explained in section 5 of the paper, there will probably be no better economic system than the capitalistic system to create wealth and improved living conditions. Government will not be required to intervene and Corporate Social Responsibility with suitable tax incentives will be able address the societal needs.

The media, academia & analysts should play a greater role in a meaningful discourse on compensation ethics to inform industry and to bring greater attention. The balanced view of performance should also include non-financial measures. It should not be a mere overly focus on the ability of the companies to achieve quarterly and annual earnings forecasts.

Executive compensation is about ethics involving decisions at level of the business system

Corporate Social Responsibility with suitable tax incentives will be able to address the societal needs

Industry should self-regulate through self-imposed reasonable caps

Media, academia and analysts should play a greater role

Balanced view of performance should include non-financial measures

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EDUCATION

2006 :	B.E. (Electronics & Communication), Panjab University, Chandigarh	76.6 %
2002 :	HSC , Khalsa College, Patiala (Punjab School Education Board)	80.0 %
2000 :	SSC, Scholars Home, Dehradun (CBSE)	76.2 %

ACADEMIC ACHIEVEMENTS

- Ranked fourth in Panjab University, Chandigarh in B.E.(Electronics & Communication)
- Stood first in Khalsa College, Patiala
- Received letters of appreciation-cum-recommendation from Director as well as Head of the Department of Electronics & Communication Engineering of University Institute of Engineering & Technology, Panjab University, Chandigarh

WORK EXPERIENCE

Infosys Technologies Ltd. *Software Engineer (Developer)* *Sep'06 to May'08 (21 Months)*

- Worked as a Java Developer for Communications, Media & Entertainment Industry Business Unit of Infosys Technologies Limited.
- The responsibilities included working at various levels of Software Development Life Cycle

Professional Achievements

- Received **Organizational level award from Vice-President of Infosys** for excellence in Knowledge Management activities
- Received Certificates of Merit for outstanding performance in Telecom Quiz at Infosys Technologies
- Appreciated for anchoring the Telecom Bulletin initiative on unit level at Infosys Technologies

SUMMER INTERNSHIP

Idea Cellular, Hyderabad *Summer Intern - Total Quality Management*
Apr'09 to July'09

Project Name: Six Sigma DMAIC Improving key Service Delivery & Quality (SDQ) parameters affecting Customer Satisfaction

INITIATIVES AND LEADERSHIPS

- Serving as Coordinator of Communications & Publicity Committee of Symbiosis Institute of Operations Management (SIOM)
- Team Leader of Joyfest (part of the National movement called 'Joy of Giving Week') in Nashik
- Organized Drishti'09 (Annual National B-School fest of SIOM) as Core-Coordinator of Invitations & Publicity Committee
- Organized Tattv'09 (Annual National Summit of SIOM) as Coordinator of Program & Speakers Committee
- Serving as Campus Representative of Mozilla Firefox, Moderator of leading MBA portal CoolAvenues and Group Leader of PagalGuy management portal
- Served as a member of Training & Placement Committee during Engineering

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RESEARCH STUDIES

- **Authored a number of articles in reputed International & National magazines.** (Honored by South Asia's Most popular Electronics Magazine - "Electronics World" for contribution as an author)
- Worked on the **project of Ministry of Communication & IT, Government of India**, on developing IPR Protection Mechanism for Electronic & IT products

CURRICULAR/CO CURRICULAR ACTIVITIES

- Cleared 4 modules of **APICS CPIM**
- Undergone **Six Sigma Green-Belt Training** program conducted by **KPMG**.
- Trained in **SAP-PP** module.
- Attended a five-day workshop on **International Logistics** conducted by **CII Institute of Logistics**.