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Factors Affecting Executive Compensation

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ABSTRACT: Executive managers represent the smallest percentage of employees in a business organization, but also the most important. An ideal executive compensation strategy ensures retaining and attracting the best talents, while minimizing the fluctuations. Executive compensation consists of basic pay, short and long-term incentives, benefits and perquisites. Since the 1970s, executive compensation started and continued to grow exponentially. The compensation ratio between executive manager and average employee has increased year by year. For these reasons, special attention of the scientific and general public is paid to the executive compensation, and to the factors affecting its level and structure. The paper provides an overview of factors that may influence the executive compensation, while seeking to determine the executive compensation strategy design, that supports the long-term business objectives. The paper analyzes the effect of organizational size, growth opportunities and risk, ownership and capital structure, as well as manager age, on the level and structure of executive compensation.

KEYWORDS: executive compensation, executive compensation components, executive compensation factors, salary, incentives

Introduction

Executive compensation is one of the most important corporate governance mechanisms. Affirmative design of compensation model should encourage managers to make profitable decisions and bind them to the organization in the long run. The compensation strategy is developed as a part of human resources management (HRM) strategy and is designed to support the strategic direction of organization. The compensation strategy develops and improves compensation structure, which will assist in attracting and retaining the appropriate employees, professionals and managers, necessary for organizational survival and development.

Executive compensation motivates managers towards higher volumes and quality of work. Appropriate structure of executive compensation is shaped by several criteria, the most important of which is the right relationship between reward and risk. The use of short- and long-term incentives, which is becoming increasingly popular in recent times, encourages managers to take short-term actions, or maximize shareholders value over the long term.

This study examines executive compensation as the important aspect of corporate governance. The purpose of this paper is to define and analyze the basic factors that influence executive compensation level and structure. The aim of this paper is to examine how executive compensation is determined, and what factors affect its level and structure.

Executive compensation strategy

Executive compensation strategy is developed within human resource management (HRM) strategy and is designed to support organizational strategic direction. It represents the design of motivational and incentive executive compensation model. Although each organization is specific, and has different requirements for managers; certain responsibilities, competencies and performances are almost unique in every executive compensation strategy. Organizations expect managers to achieve certain goals, to achieve specific performances, and to apply leadership skills that will lead all employees to desired behavior, and sustained organizational success (Davis & Edge 2004).

Executive compensation should primarily be aligned with organizational business strategy (Romero & Cabrera 2001). In doing so, the strategic perspective focuses on selection a compensation model that helps achieving and maintaining an organizational competitiveness. Executive compensation programs are subject to special requirements; they should maintain accountability to shareholders, competitiveness in order to motivate and retain key managers, effectiveness for successful managing of organization, and be aligned with existing law regulations.

Large organizations are constantly reviewing their executive compensation models, to determine if its structure and level are following general market trends. It is also important to determine, through executive compensation strategy, the desired compensation level relative to expected business performances. Different authors define various rules, steps, or principles in the process of defining an executive compensation strategy. According to Berger & Berger (1999), the optimal process of defining an executive compensation strategy consists of the following steps:

- determine the expectations of organization and managers regarding the compensation strategy; implement benchmarking process to determine the success of compensation strategy,
- identify organizational and HRM strategy, define all factors that affect the compensation strategy as a part of HRM strategy,
- define executive compensation strategy, identify the gap between current executive compensation programs and proposed future strategy, define a model to bridge that gap,
- design final executive compensation strategy, including specific programs, define the costs of each element of the new strategy,
- implement and test defined executive compensation strategy.

Executive compensation strategies should reflect the remuneration philosophy and goals, but also be in line with organizational culture. Tipuric (2008, pp. 448) believes that executive compensation strategy should include:

- definition of a competitive market and/or comparable group,
- target position of various components of executive compensation,
- target mix of total compensation (e.g. fixed to variable part, short-term to long-term incentives, etc.),
- desired relationship between achieved performances and executive compensation,
- importance of shareholder capital, value creation for shareholders, management of equity ownership,
- compliance with key legislative, tax and accounting regulations,
- executive compensation philosophy in organizational units outside the home country.

Large organizations define a competitive market for executive positions so they can continually, through benchmarking, check executive compensation practices. Compensations are ultimately based on current market trends, by comparison with „comparable groups“ that is, groups of the most important competitors. Numerous studies have shown that satisfaction with compensation is dependent on compensation level in organization's close environment (Wagner & Harter, 2008).

Cadman et al. (2010) state that executive compensation strategy also determines the desired level of executive pay, compared to expected business results and goals. In this context, it is necessary to effectively determine the ratio of fixed and variable part of executive compensation, the ratio of short-term and long-term incentives, as well as the relationship between payments in cash and in shares.

Joh (1999) states that by linking executive compensation to organizational performances, managers are motivated to achieve goals. The relationship between pay and performance is critical to organizational success. Therefore, organization must determine the required level of performances for the desired level of executive compensation. It is quite logical to expect an average salary for average performances, while salary above average is paid for significantly exceeded expectations, and salary below average is paid for poor performances. Therefore, managers should be paid according to the complexity of their job. As tasks change over time, so should the compensation contract. Greater incentives should be given to managers at riskier positions (Schwalbach 2001).

Adequate structure of executive compensation is shaped by several factors. The proper relationship between reward and risk is certainly one of the most important. While basic pay is a stable income, short-term and long-term incentives encourage managers to take short-term actions or maximize shareholder value over a longer period. Retirement programs, severance programs, special benefits and perquisites attract and retain talents in executive market. Buble & Bakotic (2013) state that different external and internal factors influence executive compensation strategy. External factors that influence executive compensation strategy are: economic sector and financial state of sector; development of economic sector; long-term orientation of economic sector and the development of research & development in the sector; supply and demand for managers within economic sector; level of competition within economic sector; current and future economic conditions (Buble & Bakotic 2013). Internal factors that influence executive compensation strategy are: competitive position of organization within economic sector; level of organizational development; financial state of organization; ability to attract and retain talented managers (Buble & Bakotic 2013).

Authors, who have dealt with the problem of designing executive compensation strategy, have come to conclusion that an adequate strategy must support strategic orientation and strive to achieve the business goals of organization (Joh 1999; Romero & Cabrera 2001; Cadman et al. 2010); that it must be competitive to properly motivate and retain talented managers (Schwalbach 2001; Wagner & Harter 2008), and that it must comply with organizational culture and legal requirements (Tipuric 2008).

Influencing factors of executive compensation

There are many factors that, directly or indirectly, to a greater or lesser extent, influence the executive compensation. Following factors are considered to have the greatest effect on structure and level of executive compensation, as well as its components: organizational size, organizational growth opportunities, organizational risk, equity structure, ownership structure, manager age.

Organizational size. As control of manager work increases with the growth of organization, more detailed planning of executive compensation is needed in large organizations (Jensen & Meckling, 1976). Organizational size is a significant factor of executive compensation, and all its components. This positive connection means that larger organizations require higher quality of managers, and they must pay for such quality. Studies of Chalmers et al. (2006) have found a positive relationship between executive compensation and organizational size in Australian organizations but have not found a positive correlation between executive compensation and business performances. Numerous authors, such as Chourou et al. (2008), Core & Guay (1999) have found that rewards in stock options are significantly and positively related to organizational size. One of the best explanations for high compensations, and their positive relationship with organizational size, was given by Rosen (1992). In state of market equilibrium, the most talented managers would occupy the leading positions in the largest organizations; the marginal productivity of their stock options is significantly increased ahead of others, at lower hierarchical levels.

Ryan & Wiggins (2001) include the natural logarithm of organization's total assets to measure its size. As the organization grows, managers have more and more assets at their disposal, activities become more complex, and the possibility of agency conflict is simultaneously growing. Executive compensation increases with the size of organization and is approximately one-third higher for each doubling of organizational size (Sung & Swan, 2009). Gabaix & Landier (2008) emphasize that there is a positive relationship between compensation and organizational size, as large organizations employ managers with superior capabilities who deserve higher pay.

According to He (2011), pay-performance is negatively correlated with organizational size, while Kose et al. (2010) use two control variables as additional determinants of pay-performance sensitivity: organizational size and organizational risk. The same conclusion was reached by Schaefer (1998), who confirms that pay-performance sensitivity decreases with the size of organization. Bulan et al. (2010) argue that highly qualified managers of large organizations require greater compensations, because the nature of their work.

Organizational growth opportunities. A fundamental feature of each organization is future investment opportunity. Managers of growing organizations have higher levels of total compensation; consisting of base salary in a lower proportion, and long-term incentives in a higher proportion. Thus, the greater the organizational value represented by growth opportunities, the greater executive compensation (Gaver & Gaver 1995).

According to Giannetti (2011), the managerial job market and organizational growth opportunities have great influence on the structure of executive compensation. If the growth opportunities are large, shareholders find it optimal to offer long-term incentives and the overall level of compensation increases; if the growth opportunities are weak, shareholders find it optimal to offer less short-term incentives and lower compensations. In growing organizations, long-term incentives have higher share in total compensation, while in non-growing organizations, base salary occupies a larger share (Gaver & Gaver 1995).

Smith & Watts (1982) state that higher levels of compensation are expected because the choice of investment projects require a higher reward than controlling existing assets. In their research, Ryan & Wiggins (2001) find that managers of high-growing organizations are more difficult to monitor, because effective management of existing assets is less important than future investment decisions. Previous research has found that reward in the form of stock options can enable managers to act in the best shareholders interest. Moreover, several studies have found that asymmetric payments provided by stock options can reduce agency costs by encouraging risk taking (Efendi et al., 2007). Although Yermack (1995) has found a negative relationship between the growth potential of organization and the level of share-based compensation, he has stated that incentives in the form of stock options are greater in organizations with growth opportunities.

Previous research finds that growing organizations are associated with higher compensation and greater use of stock options. The authors believe that combination of growing level of stock options and high growth opportunities would lead to a lower agency costs and better organizational performances, because only in this way managers undertake risky investment ventures with positive results (Hutchinson & Gul 2006). Unlike managers of non-growing organizations, managers of growing organizations receive higher compensation; consisting of a base salary as a smaller part, and stock-based long-term incentives, as a larger part of compensation.

Organizational risk. Compensations based on equity are granted to managers to overcome managerial risk aversion and to introduce optimal risk taking. This is the main reason why equity-based compensation should align interests of managers and shareholders. Compensation risk (the level of expected compensation) can be reduced and increased with organizational risk. As the increase in compensation risk should translate into higher levels of compensation for risk-averse managers; an increase of compensation level as a decline in supervisory quality can be expected in equilibrium state (Core et al. 1999). As Core et al. (1999) stated, organization can choose a riskier compensation package if supervising managers is difficult. Thus, risk-averse managers will require higher levels of compensation when rewarded with riskier compensation packages. Organizational risk is also potentially important factor of executive compensation level. In his paper, Jin (2002) stated that base salaries of managers are related to organizational effectiveness in the stock market. Chourou et al. (2008) pointed to a negative relationship between incentives in the form of stock options and overall organizational risk.

Risk can be divided into two parts: systematic (market) risk and non-systematic (specific) risk (Hacioglu et al. 2014). Non-systematic risk is negatively correlated with the ratio of incentive compensation to total compensation, in other words, the higher the incentive or total compensation, the non-systematic risk is less, but there is no significant correlation between systemic risk and incentive level (Jin 2002). Because it is more costly for managers to take risks than shareholders, the optimal level of incentives should be reduced with market risk as well as organizational specific risk. It can be concluded that the main challenge is to formulate a compensation contract that balances the incentive benefits with disadvantages of assuming the risk. Other authors, such as Miller et al. (2002) believe that the effectiveness of compensation will be higher for moderate risk levels, than for high or low risk levels.

Capital structure. Major financial policy decisions on issues such as capital structure are made by managers, and this is one of the main assumptions of agency theory and conflict of managers and shareholders' interests. Numerous models of capital structure are based on the critical assumption that managers always act in the best interests of shareholders. Other theories, such as Jensen & Meckling

(1976), identify situations in which managers may deviate from maximizing the value of financial decisions crucial to shareholders, and represent their own interests.

Capital structure theories suggest that organizational ownership structure, executive compensation, and control mechanisms are interrelated. Managers are looking for the optimal capital structure to maximize their personal wealth. Many studies of executive compensation ignore the role of organization's capital structure, while Ortiz-Molina (2007) believes that capital structure is very important in determining executive compensation. According to contemporary agency theory, the financial structure of organization can affect the relationship between shareholders and managers, and conflicts of their interest can influence the optimal executive compensation. Grossman & Hart (1982) state that higher organizational indebtedness mitigates agency problems between shareholders and managers, forcing managers to focus on maximizing value when faced with the bankruptcy threats. Debt helps to mitigate agency conflicts between shareholders and managers (Jensen & Meckling 1976). It would be logical to expect that the higher debt level in the capital structure, the lower opportunity to use share-based incentives should be. Chourou et al. (2008) examine the relationship between debt levels in capital structure and capital based awards, and conclude that share-based incentives decline as financial leverage increases. According to Lin et al. (2012), shareholders are always capable of designing an optimal compensation contract to maximize their wealth, given the current capital structure of organization.

Ownership structure. Contemporary financial literature recognizes the link between organization's ownership structure and the executive compensation. Chourou et al. (2008) point out that in corporate governance systems, such as US and UK, where ownership is highly dispersed, managers seek to achieve their own goals. This could lead to excessive executive compensations and a lack of pay-performance sensitivity. In a corporate governance system like the Canadian one, a high level of ownership concentration serves as a monitoring mechanism, leading to a more effective executive compensations (Chourou et al. 2008).

The higher equity share of managers, the less need for equity-based incentive rewards. Thus, Chourou et al. (2008) point to a negative relationship between equity share of managers and incentives in the form of stock options. Equity share of managers and equity-based compensation plans reduce conflicts of interest between managers and shareholders. Equally, a large share of ownership by institutional investors is associated with lower base salaries and stronger long-term incentives for managers.

According to a study by Barontini & Bozzi (2008), shareholders with controlling stakes have greater interest to supervise managers. Therefore, high ownership concentration is associated with lower managerial pay. Better controlling activities by major shareholders should reduce the need for incentives for managers, and thus the sensitivity of executive compensation to organizational effectiveness. Murphy (1999) states that in economies with concentrated ownership, executive compensation is most often determined by large shareholders. In this way, the largest shareholders have a strong motivation to directly supervise the managers, and also to link executive compensation with organizational efficiency.

Ownership structure has a significant effect on executive compensation. Thus, Firth et al. (2007) find that organizations with significant state ownership, and organizations with large external investors, have lower executive compensation, while the presence of foreign shareholders is associated with higher managerial rewards. While Guidry et al. (1999) find that incentives and total compensation can motivate managers to act effectively in the short term, Jensen & Murphy (1990) find that managers have a long-term stake in ownership of their organizations as the greatest incentive. Hall & Liebman (1998) suggest that organizational performance is related to executive compensation. Lack of owner control allows management to extract greater compensation. Jiang (2011) finds that agency problems, caused by separation of ownership and control, exist because a greater concentration of ownership reduces the ability of managers to extract higher compensation levels.

Manager age. As both junior and senior managers try to achieve their goals in the shortest possible time, organizations should use more stock-based incentives for seniors as well as junior managers. While Lewellen et al. (1987) find a positive and significant correlation between the stock options rewards and manager age, Yermack (1995) does not find a significant correlation. Ryan & Wiggins (2001) state that senior managers have incentives for projects that will pay off before retirement, and younger managers have incentives to focus on short-term goals to build a reputation. Organizations should offer more equity-based incentives and less cash incentives to both junior and senior managers. Thus, a manager can earn his or her tenure by creating shareholder value, or may have a large ownership stake in previous rewards.

Manager tenure and age can determine their effectiveness in managing an organization. Thus, younger managers, with little experience, have limited performances because it takes time to gain a full understanding of the organization, while seniors or those with longer tenure may have a better understanding of organization and its industry. This leads to better business performances. As claimed by McKnight et al. (2000), the growth of a manager age improves his/her intellectual abilities, with respect to the knowledge and experience gained by position, as well as the education attained. So, managerial job market will determine the compensation that will grow with the growth of experience and education.

Cremers & Palia (2011) state that there is a positive relationship between tenure and executive compensation level, and a corresponding positive relationship between tenure and pay-performance sensitivity. Chourou et al. (2008) state that managers accumulate more and more shares in organization by extending their tenure, so that their interests become more aligned with those of shareholders, resulting in less need for incentives. The same thesis is confirmed by Ryan & Wiggins (2001), who find a negative relationship between managerial tenure and equity-based awards.

Conclusion

Executive compensation is one of the most important aspects of overall reward system that is closely linked to the successful business and competitiveness of the organization. Executive compensation differs from other employees' reward by structure and level. Managers are an important capital of every organization. Therefore, it is essential for an organization, that wants to achieve a business success and competitive position, to have managers with the right skills, and to enable continuous career progression and development through numerous programs and benefits. An adequate executive compensation strategy must be designed to support the strategic direction of organization, be competitive in order to properly motivate and retain talented managers and comply with organizational culture and legal requirements. It is necessary to determine effectively the ratio of fixed and variable components of executive compensation, then the ratio of short-term and long-term incentives, as well as the relationship between payments in cash and shares.

Adequately designed executive compensation consists of a base salary, short- and long-term incentives, benefits and perquisites determined by managerial status and position in organization. All of these components need to be properly aligned, and the relationship between them must be such as to motivate managers to achieve the desired business goals. The executive compensation should increase with organizational size, with above-average formal qualifications and proven entrepreneurial ability of manager. It should be competitive, that is, the „golden mean“ between the best and worst compensation of competing organizations.

This paper focuses on the certain factors that positively or negatively affect the executive compensation. A comparative literature analysis provides answers to research questions - how certain factors change the executive compensation. Study has confirmed that large organizations require higher quality managers and adequate compensation for such quality. There is a positive relationship between compensation and organizational size, as large organizations employ managers with superior capabilities who deserve higher pay.

The managerial job market and organizational growth opportunities have great influence on the structure of executive compensation. Growing organizations are associated with higher compensation and greater use of stock options. The combination of growing level of stock options and high growth opportunities would lead to a lower agency costs and better organizational performances. Organizational risk is also important factor of executive compensation level. Because it is more costly for managers to take risks than shareholders, the optimal level of compensation should be reduced with organizational specific risk.

Capital structure is very important in determining executive compensation, since high organizational indebtedness has impact on its structure. Ownership structure has a significant effect on executive compensation. If ownership is highly dispersed, managers seek to achieve their own goals, and this leads to excessive executive compensations and a lack of pay-performance sensitivity. High concentration of ownership serves as a monitoring mechanism, leading to a more effective executive compensation. Manager tenure and age can determine their effectiveness in managing an organization. The growth of a manager age improves his/her intellectual abilities, knowledge and experience gained by position. Managerial job market will determine the compensation that will grow with the growth of experience and education.

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