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Importance of Stakeholders for Balanced Executive Compensation and Shareholder Value Maximization

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ABSTRACT: Designing of executive compensation is undergoing significant changes in contemporary business conditions. Stakeholders directly influence, with varying but strong intensity, the design and administration of compensation models. Each group of stakeholders has different, sometimes conflicting, goals. In order to achieve the right balance of interests, in terms of rewarding the highest managerial levels, shareholders, the Board of Directors, other stakeholders and managers need to clearly define goals. The paper analyzes the importance of stakeholders in the process of designing balanced executive compensations, which leads to an increase in shareholder value. The aim of this paper is to explain the importance of balancing the different stakeholders' interests in the process of designing executive compensations, in order to achieve shareholder value maximization.

KEYWORDS: executive compensation, stakeholders, shareholder value, agency problem

Introduction

Stakeholder concept contains three fundamental factors (Clarkson 1994): the organization, the other actors, and the nature of the company-actor relationships. Each of these stakeholder groups can be analyzed in more detail and divided into several subgroups, or depending on the specifics and similarities between the groups, new ones can be formed that will include one or more of already mentioned stakeholders. Stakeholders could be defined also as "any group or individual who can affect or be affected by the achievement of the organization's objectives" (Freeman 1984).

Contrary to the classical theory that gives absolute importance to capital owners, and sees the purpose of business organization in creating value for owners, "stakeholder theory" takes into account interests of other stakeholders (Mainardes et al. 2011). In contemporary business conditions, it is clear that business organization that does not take into account employees, the environment and other issues related to socially responsible behavior, cannot count on long-term survival. At the same time, by neglecting the needs of owners and the economic effects, the demands of other stakeholders cannot be met either (Rajablu et al. 2015).

Stakeholders directly influence, with varying intensity, the design of managerial compensation and incentives (Petit-Romec 2019). The following groups of stakeholders have the strongest influence on the design of compensation systems (Ramachandran, 2008): shareholders (directly and indirectly - through their representatives on the Board of Directors, which approves the compensation model and forms the Remuneration Committee to administer the adopted model), managers, community, customers and suppliers. The interest of the community (and legislation) has been constantly increasing over time, the interest of managers is constantly high, especially because in contemporary conditions the business environment risks do not decrease but constantly increase.

Each group of stakeholders has different, sometimes conflicting, goals. Shareholders expect an adequate return on invested capital, legislation prescribes regulations to be followed, suppliers demand the widest possible market for their products and services, customers demand an adequate price-quality ratio, while managers insist on high rewards for achieving all of the above (Jensen & Murphy 1990).

The role of shareholders as the most important stakeholders

When analyzing the shareholders as one of the most important stakeholders, a distinction should be made between shareholders-investors (who are willing to buy or sell shares quickly depending on the expected short-term returns on invested funds) and shareholders-owners (who are committed to long-term business system success) (Omran et al. 2002). The value of shares is the ultimate goal for the investor and a periodic measure of business success for the owner.

The shareholders' interests, in the process of designing the managerial compensation models, are satisfied by variable incentives, depending on performances, expressed in the shares of business organization (Marinovic Matovic 2019). They require the application of compensation models based on increased value of invested capital. Shareholders oppose compensation models based on internal financial goals, rather than on performances. It is also against the interests of shareholders to sell shares without precise plans and pre-set deadlines, and to automatically replace shares with new cash benefits ("evergreen" plans) (Cheffins & Thomas 2001).

Modern business is marked by a trend of increased influence of shareholders on managerial compensation models. This trend is the result of shareholders' reaction to the general decline in stock prices, due to global financial crisis. Since 2003, public organizations in the UK have been required to respect the advisory voice of shareholders on managerial compensation packages (Mercer 2009). Although the shareholders' vote is non-binding, this decision has led to increased dialogue between management and large investors and to changes in compensation models (Mercer 2012), thus improving the alignment between pay and performances. Several other European countries have enacted laws that have given shareholders the right to vote when considering managerial compensations, in some cases binding. Shareholders in the Netherlands, Sweden and Norway have binding voting rights, while some organizations in Spain and Switzerland have voluntarily introduced shareholder advisory votes (Mercer 2012). Efforts are being made across Europe to improve the transparency of managerial compensation programs.

Following the UK, Australia introduced a non-binding, advisory shareholder voting right on managerial compensations for public organizations in 2005 (Alissa 2015). In case of negative vote, a clear message is sent to the Boards of Directors and management, prompting some organizations to change the proposed compensation programs.

US countries are significantly lagging behind in these reforms, but the increase in shareholder influence on managerial compansation systems has been noticeable in recent years. The United States and Canada have adopted new rules that provide additional information to shareholders about compensation programs (Mercer 2012). US law investigates how to combat the abuse of compensation, including the binding vote of shareholders and the restriction of certain types of rewards. In the United States, the use of certain (unqualified) deferred rewards is limited, and the deteriorating economic situation provides further incentives for widespread reform.

Designing the managerial compensation plans by Board of Directors

Due to increasingly active role of shareholders in the process of designing executive compensation plans, the Board of Directors' role is in the process of transition. In developed economies, it balances shareholders' pressure to limit rewards with the need to attract and retain talented managers (Marinovic Matovic 2019). The trend of mergers and acquisitions of business organizations has resulted in larger organizational systems. Executives need to have the skills and experience to manage an organization of large size and scope. In the conditions of increasing mobility of executives, business organizations often have to compete against foreign entities. Given the range of interests that must be met, many Boards of Directors today are diligently aligning shareholder requirements with the practical needs of business (Mercer 2012).

In contemporary business organizations, the decision making on executive compensation plans is entrusted to the Board of Directors. The significance of this delegation is the subject of numerous theoretical considerations in recent years. On the one hand, it is recognized that labor market supply is a fundamental factor of compensation level and structure (Himmelberg & Hubbard 2000; Hubbard 2005). On the other hand, a number of scholars argue that delegation of decision making to the Board of Directors has a crucial impact on executive compensation (Chhaochharia & Grinstein 2009). Fama (1980) and Fama & Jensen (1983) concluded in their research that compensation decisions should be made by outsider directors, so their resolutions would be independent. Managers have great influence on directors' appointment, so compensations could not be monitored qualitatively in US business organizations (Jensen, 1993). Lack of monitoring by Board of Directors can lead to suboptimal contracts and inadequate managerial compensations (Bebchuk and Fried 2003; 2004). Higher compensations received by Board of Directors would lead to their greater engagement in designing CEO compensation (Spatt 2006).

The Board of Directors expects the recommendations regarding the executive compensation program, given by Remuneration Commission, to be adopted with possible minor modifications (Newman & Mozes 1999). The role of Remuneration Commission is to determine the executive compensation program, or to make partially binding recommendations to Board of Directors (Hengartner 2006). Remuneration Commission typically researches market levels of executive compensation, establishes performance standards and compensation policies, and assesses managers' contribution to financial and non-financial goals, and that depend on managers, their cooperation and advice (Crystal 1991). Although top management is not usually involved in the work of Remuneration Commission, it can sometimes attend their meetings. If no Remuneration Commission has been established within the Board of Directors (which is characteristic of Boards with a small number of members), then Board determines compensation plan for the highest level of management. Remuneration Commission uses the services of external agencies or consultants to determine market levels of executive compensation. Agencies (consultants) compare compensation levels and structures within organizations of similar size and industry, and make recommendations to the Board of Directors. There is also a practice, in some organizations, that internal audit revises the process of designing compensation system, and submits a report to the Board of Directors (Hengartner 2006).

Remuneration Commission usually consists of three to four members, who are also members of the Board of Directors, and they are serving a one-year term. Most members, sometimes all, are not part of the management team and have an independent status. This composition should ensure the objectivity of Remuneration Commission. However, it is not uncommon for Executive Board members and top managers to attend meetings of the Commission, without the right to vote. Human resources department directors may from time to time act as Commission Secretary. In addition, internal or external experts in the field of compensation may from time to time make oral and written presentations, if deemed necessary. Remuneration Commission meets less frequently than the Board of Directors, usually two or three times a year, unless circumstances require otherwise (Hengartner 2006).

Global financial crisis, which began in late 2008, highlighted the need for Commission's discretionary influence on defined short-term and long-term incentive plans (Ferrarini et al. 2015). Discretionary influence and decision-making are required due to failures in the process of setting goals, the emergence of unforeseen circumstances, and the volatility of business performance. Excessive rewards for inadequate performances will lead to strong oversight, cash outflows, dilution of shareholder value and, worst of all, risk of maintaining business solvency. Low reward, given for outstanding performance, will result in a loss of engagement with talented managers, and may jeopardize organization's core business.

Remuneration Commission should clearly define the critical activities of highest management level, necessary for business improvement. Then it is necessary to regularly evaluate managers' performance, comparing them with the defined competencies. Commission should identify development activities in areas that require improvement, as well as determine responsibility for their implementation. In addition, Remuneration Commission must approach the succession plan with full understanding - identify potential candidates for top management positions, their strengths and weaknesses, and assess the right time to take the lead. Following are the ten questions which

Remuneration Commission should be analyzing, for making informed decisions on policy and implementation of managerial compensations (Institute of Directors in South Africa 2020).

Table 1. 10 questions which cover the policy and implementation of CEO compensation

Section	Questions
1. Structure	Do we understand all the reward structures in operation, how they operate and how they interact with each other? Which reward structures are in place? How do these structures broadly operate, how were they determined and what is the range of likely outcomes? Are they appropriate?
2. Alignment	Do we have a clear understanding of the organisation's strategic objectives and value drivers, and how remuneration is aligned? Are all the important strategic objectives captured in variable pay schemes? Are the scheme targets aligned to strategic objectives?
3. Risk management	Do we have the correct set of tools in order to mitigate risk in the remuneration system? Malus provisions Clawback provisions Minimum shareholding requirements (MSR) Post vesting holding periods Maximum/ceiling payouts The remuneration committee's discretion
4. Fair and responsible	Are we regularly assessing the fairness of pay, how responsible are our policies and practices and how do our pay practices impact on the dignity of our employees? Stakeholder alignment Benchmarking Pay ratios Pay gaps Gini coefficient Living wage
5. Innovation	Do we understand the needs of all stakeholders and innovate policy and practice changes as circumstances demand?
6. Variety	Has the remuneration committee actively sought inputs from a variety of sources before making final decisions?
7. Evaluation	Has the remuneration committee been thorough in its interrogation of performance outcomes?
8. Disclosure	Have we appropriately considered what is and what is not disclosed in terms of remuneration?
9. Appropriateness	Are the remuneration outcomes appropriate and have we exercised appropriate discretion where necessary?
10. Achievement	Does the remuneration policy and implementation of policy achieve the stated objectives?

Source: Institute of Directors in South Africa (2020).
10 questions a remuneration committee should be asking, Position paper 9, p.30.

Continuous monitoring of top management creates a direct benefit for business organization, and provides insight into their treatment in terms of deciding on adequate compensation model.

The influence of customers, suppliers and the community on the process of designing managerial compensation

Until recently, customers did not have a direct impact on the managerial compensation design process. However, their decision to buy or not to buy a particular product or service affects profitability, which in turn affects short-term and long-term incentives, as components of managerial compensation. Some contemporary business organizations use the evaluation of products and services by customers as a significant factor in creating short-term incentive plans.

The quality, price and availability of products and services of suppliers have a direct impact on the financial success of business organization, and thus on the managerial compensation. Although suppliers are looking for long-term, predictable business relationships, this group of stakeholders is showing little interest in executive compensation packages.

The community is a significant stakeholder that requires the business organization to provide high taxable income. While this requirement is being respected, the community is showing low interest in executive compensation.

Conclusions

In order to achieve the right balance of interests, in terms of rewarding the highest levels of management, shareholders, the Board of Directors and managers need to clearly define goals, roles and responsibilities. The positive consequences of the increased shareholders' influence on compensation system are reflected in enrichment and innovation, through the inputs of investors and their experience. Compensation system is strongly associated with performance, transparency is increased and excessive incentives are suppressed. Negative consequences of the increased shareholders' influence on compensation system are reflected in their demands for harmonization of shareholder's value and compensation plans, but without unnecessarily complex organization of actions.

The Board of Directors should carefully balance the shareholders' interests with the strategic and operational objectives of business. It should promote stronger communication between managers and shareholders. Decisions concerning executive compensation are made by Board of Directors (according to recommendations received from the Remuneration Commission). However, Commissions do not have adequate information, they do not have the necessary expertise or negotiation skills necessary in conversations with managers. This results in poorly designed compensation programs and practices.

Changes in managerial compensation design have improved the link between the reward and the performances achieved, but there is still plenty of room for improvement. In order to significantly improve the rewarding according to achieved results, it is necessary to determine the right measures of realized performances. Without an adequate performance measurement system, it is impossible to assess the justification of management compensation programs.

Managerial compensation systems have undergone major changes in contemporary business conditions, such as increased focus on the variable reward, greater use of capital-based performances, elimination of oversized benefits and perquisites, imposition of limits on non-performance based pay, and greater diversification of compensation packages. These changes are driving managerial compensation systems in the right direction. With rise of variable rewards share in total compensation package, and with linking pay to performance, executive compensation models are becoming increasingly balanced, accountable, and justified, which leads to an increase in shareholder value.

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