# EXECUTIVE COMPENSATION: USES AND DESIGN

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**Abstract:** *Executive compensation has been a topic of significant interest and debate among scholars and stakeholders due to the persistent increase in pay for top executives. This paper presents an overview of executive compensation, its impact on a company's performance, and the traditional belief that high compensation is tied to performance. The paper also examines the different components of CEO compensation in developing countries such as Nigeria. The paper explains the agency theory, which concerns resolving the conflict that arises from the difference in objectives between the principal (shareholders) and the agent (executives). Corporate governance measures such as executive and board compensation plans have been put in place to improve internal control and align the goals of management with those of shareholders, thereby reducing the agency issue. The study highlights the need to align CEO compensation with their performance for sustained returns for shareholders.*

## Introduction

Executive compensation has been a widely discussed topic in recent times because of the persistent increase in pay for top executives. The systems and processes for determining compensation at publicly traded companies have sparked debate among scholars. Shareholders anticipate that a CEO with a high salary will perform well and justify their pay, as stated in the study by Akinwunmi (2020).

The traditional belief was that CEO pay was directly tied to their performance and that high compensation was a result of their expertise and abilities. However, studies have shown that CEO pay has risen significantly regardless of performance, as reported in a study by Akinwunmi (2020). To tackle this challenge, corporate governance measures such as executive and board compensation plans have been put in place to improve internal control and align the goals of management with those of shareholders, thereby reducing the agency issue.

Chief Executive Officers play a vital part in the management and running of companies, occupying the top executive position. They are responsible for devising and executing high-level strategies, supervising the company's activities and resources, making crucial decisions, and serving as a link between senior management and the board of directors. (Akewusola & Saka, 2018; Ismail, Yabai, & Hahn, 2014).

According to Akewusola and Saka (2018), the CEO plays a vital role in the day-to-day functioning of a company. As the top level executive, CEOs are appointed by the board of directors and are responsible for developing and executing high-level strategies, overseeing company operations and resources, participating in corporate decision-making, and acting as a link between top management and the board of directors, as highlighted in the study by Ismail, Yabai, and Hahn (2014).

The impact of CEO compensation can be observed on a company's performance, organizational efficiency, and employee capabilities. It is sometimes thought to create a divide between the CEO and employees due to the significant difference in pay, including salary, bonuses, benefits, and insurance coverage, as stated by Ismail et al. (2014). Aligning CEO compensation with their performance is crucial for achieving sustained returns for shareholders, as outlined by Deysel and Kruger (2015).

As reported by Akinwunmi (2020), CEO compensation has not been a significant topic of discussion in countries like Nigeria, which are still developing. Unlike in developed countries such as the United Kingdom and the United States, where CEO compensation is made up of multiple elements, in Nigeria, CEO compensation mainly consists of cash bonuses, salaries, and additional payments, as mentioned by Odum (2018).

**Definitions**

Executive

According to Chijioke (2014), executive directors usually reach their position by climbing the corporate ladder, and as a result, they automatically become members of the board.

The CEO, who holds the highest executive position in a company, has the power to make significant business decisions and is responsible for the overall performance of the organization. According to the agency theory, the CEO, who acts as an agent, is chosen by the shareholders, who act as the principals, to maximize their value. Executive directors, who are usually appointed by the board, typically receive a base salary and performance-based rewards, making them among the highest-paid members of the company.

Long-term contracts are commonly used for executive directors of major corporations, with renewals taking place on a yearly basis, as stated in ACCA (2012). The CEO and CFO are often examples of executive directors that hold high-level positions within the organization and are responsible for making vital strategic decisions, as noted by Akinwunmi (2020).

Compensation

Compensation, also referred to as wages and salaries, is a means of offering financial rewards to employees in exchange for their work in the organization. This compensation includes both cash payments and non-cash benefits such as incentives and benefits, aimed at motivating employees. As per Gary (2012), employee compensation encompasses all forms of remuneration received by employees as part of their employment.

Milkovitch, Newman, and Cole (2005) define compensation as all financial rewards, tangible benefits, and services given to employees as part of their employment. This includes the basic salary, both long-term and short-term incentives, as well as benefits such as insurance, pension plans, employee discounts, and paid time off.

Executive Compensation

Executive compensation refers to all forms of monetary and non-monetary rewards given to executives for their work in the company. This can include a base salary, benefits, performance-based bonuses, perks, and stock options, which are typically designed to meet regulatory requirements, adhere to tax laws, align with the company's goals, and incentivize the CEO's performance (Emmanuel, Michael, Akanfe & Oladipo, 2017).

Executive compensation, or "executive pay," refers to the financial rewards and benefits provided to top-level executives, such as CEOs and senior managers, as compensation for their services to the company.

As stated by Sun Xianging and Huamg (2013), "executive compensation" refers to the financial rewards and benefits given to top-level managers and executives, particularly the CEO, within a company. These pay packages are typically distinct from those offered to other employees in terms of scale and perks, often featuring a substantial base salary and stock options. Additionally, some companies opt to provide a lower base salary to their CEO in exchange for a greater number of stock options to minimize tax liability (Emmanuel et al., 2017).

**Agency Theory**

Murphy (2002) explains that agency theory concerns resolving the conflict that arises from the difference in objectives between the principal (shareholders) and the agent (executives), as well as the cost of monitoring the agent (the board of directors). This theory has been widely examined in regards to executive compensation and performance by various researchers.

Agency theory proposes that when a principal, like shareholders, gives decision-making authority to an agent, such as a CEO, a mismatch in objectives and interests may occur. This leads to a situation known as the "principal-agent problem," where the agent's actions may not align with the principal's best interests. Scholars have utilized this theory to examine executive compensation and performance.

An agent is someone who acts on behalf of a principal, using their resources to make decisions and carry out actions. The principal, in this case, entrusts their resources to the agent without having direct involvement in the day-to-day operations. The agent makes decisions without incurring much risk, as any losses will be borne by the principal.

According to Kopp (2021), agents, such as financial planners and portfolio managers, are given the responsibility of managing assets on behalf of their principals. The lessee, in this case, may be responsible for protecting and maintaining assets that do not belong to them, but they may have less of an interest in preserving these assets than the actual owners.

Different solutions have been suggested by agency theory experts to address the issue of disagreement between agents and principals. These solutions are referred to as "reducing agency loss," which means minimizing the losses suffered by the principal due to the agent's actions that are not aligned with the principal's interests.

To address the principal-agent problem, agency theory suggests various methods for aligning the interests of agents and principals. One such method is the use of incentives, such as stock options, to motivate corporate managers to act in the best interest of their principals. Additionally, linking executive compensation to shareholder returns is another example of how agency theory is applied in corporate governance.

One way to align the interests of corporate managers with those of shareholders is by providing incentives, such as stock options, to executives. However, this can lead to concerns that management may prioritize their own pay and short-term profits over the long-term growth of the company. One solution to this is to implement a compensation scheme where a portion of executive pay is linked to long-term goals and deferred to a future date. This can help to ensure that management is focused on the long-term well-being of the company.

These strategies for resolving agency conflicts are not unique to the corporate world. Similar methods, such as linking pay to performance, implementing performance guarantees, and terminating the agency relationship, can be seen in other areas where an agent is acting on behalf of a principal.

**Components of Executive Compensation**

Executive compensation can take on various forms, each providing its own set of tax advantages and performance incentives, such as:

Base Salary:

The base salary is the most typical element of executive compensation. Most executives are provided with a base salary. These salaries are typically determined through a process known as competitive benchmarking, which involves comparing the salary to similar positions within the same industry and organization size (Murphy, 1999). It is also worth noting that there is a correlation between the size of the organization and the level of compensation offered (Okasmaa, 2009).

The base salary is a standard component of executive pay and is usually determined by using competitive benchmarking, which compares salaries based on the organization's performance, sicommonnd industry. It is also worth noting that there is a correlation between the size of thpreviyear'snization and the level of compensation. Historically, executives in larger compani,s have been compensated more than those in smaller organizations. However, the significance of base salary in executive compensation negotiatiodetermine thecreased in recent years, particularly since the 1990s.

The Bonus:

Executive bonuses are a prevalent form of remuneration, particularly for top executives. They are usually paid out yearly and based on previous performance. The calculation of bonuses often involves a percentage of the executive's base salary, emphasizing the significance of the base salary in determining overall compensation. There are various types of bonuses that can be distinguished (Okasmaa, 2009).

The bonus is a commonly used form of compensation among executives, and is often tied to financial goals, such as reaching a certain revenue or profit. The amount of the bonus can vary depending on how well these goals are met. If the results exceed expectations, the bonus may be increased, but if the goals are not met, the bonus may be cancelled altogether.

The third type of bonus is not linked to specific targets, but rather to overall positive performance. Unlike the other types, this bonus does not have to be awarded consistently and may be granted when the executive has made a significant impact on the organization's results.

The stock options:

Stock options have become a prevalent means of executive compensation in recent years. These options give executives the chance to buy company shares at a predetermined price for a specified duration, with the aim of aligning the executives' objectives with those of the company. The options usually vest gradually, with a certain portion becoming exercisable after a set period, as described by Murphy (1999).

Stock options have become a popular form of compensation in recent years. These contracts give executives the right to purchase shares at a pre-determined price for a specific period of time. The options can be exercised over time, with a certain percentage becoming "vested" after a predetermined period. While stock options can serve as an incentive for executives to align their interests with the company's, they should not make up a large portion of the compensation package, as they may lead to a focus on short-term stock price rather than other important aspects of the company.

Long-term incentive plans:

Long-term incentive plans (LTIPs) are a type of compensation that link an executive's pay to the company's long-term strategic goals. These plans are typically based on an average of past performance over a period of several years. Unlike stock options, LTIPs are not necessarily tied to the stock price. Executives may be eligible to receive free shares after a certain period, subject to certain conditions such as remaining with the company or achieving certain goals. This system is designed to keep executives invested in the company for a longer period, as they cannot receive benefits until several years have passed, unlike stock options, which can be exercised after just one year. As a result, LTIPs are more effective at fully engaging executives in the company's development and performance.

Perquisites/Benefits:

Executive compensation packages, besides cash remuneration, often include various non-cash benefits known as perquisites or perks. These perks are utilized by employers to attract, retain, and inspire executives and generally consist of benefits like company vehicles, housing allowances, club memberships, and similar privileges. These non-cash benefits are given in addition to salaries, commissions, or incentives.

Executive remuneration frequently incorporates non-financial benefits, commonly known as perquisites or perks. These are supplementary benefits given by employers to entice, compensate, and enhance the efficiency of executives. These perks can comprise of company-supplied vehicles, compensated meals and lodgings, access to recreational amenities, reimbursement for entertainment expenses, educational reimbursement programs, free parking, holiday packages, memberships to prestigious clubs, and various electronic devices like smartphones and laptops.

Executives in some organizations may have access to additional health and welfare benefits beyond the standard offerings. These benefits may be fully covered by the employer or may be offered as part of a pretax payment plan. Alternatively, the executive may have the option to pay for these benefits out-of-pocket on an after-tax basis.

Executive benefits can include life insurance, split-dollar life insurance, disability insurance, long-term care insurance, job liability insurance, medical insurance or reimbursement, and additional vacation days or sabbatical leave.

In the past, many organizations have provided executives with a variety of perks and fringe benefits as a way to attract, retain, and reward them. However, in recent years, due to increased scrutiny and government regulations, many organizations have begun to reduce or eliminate the perks they offer to executives. Additionally, the value of all fringe benefits must be included in an employee's income for tax purposes, unless they are specifically exempt or excluded by law.

The provision of perks to executives at smaller organizations should be closely examined, as excessive use of such benefits may lead to financial struggles for the company, including bankruptcy or ongoing deficits.

**Uses of Executive Compensation**

The main objective of executive compensation is to recruit and retain top executives and at the same time, communicate with stakeholders such as investors, other executives, and employees. The compensation package for executives is negotiable between the employer and the potential executive and may not align with the norms for regular employees. The significance of executive compensation lies in its ability to influence the behavior and performance of the company's leaders.

- Achievement of Organizational Goals

An effective executive compensation program aligns with an organization's goals, objectives, and strategies and contributes to creating value for shareholders, employees, and customers. This alignment helps to bring consistency and harmony to the overall purpose and operations of the organization.

- Attract and Retain Talent

Effective executive compensation programs also align with the organization's goals by linking the incentives and rewards of the executives with the company's mission and performance. This helps to attract and retain the right kind of talent and promote the values and behaviors that align with the company's objectives.

The role of senior management and executive-level employees is vital for the success of a company, as they are responsible for creating and implementing strategies, making important decisions, and more. To ensure that they remain motivated and satisfied in their roles, it is essential to establish an appropriate compensation package. Without the proper incentives, executive-level employees may not act in the best interest of shareholders, which can result in financial losses for those shareholders.

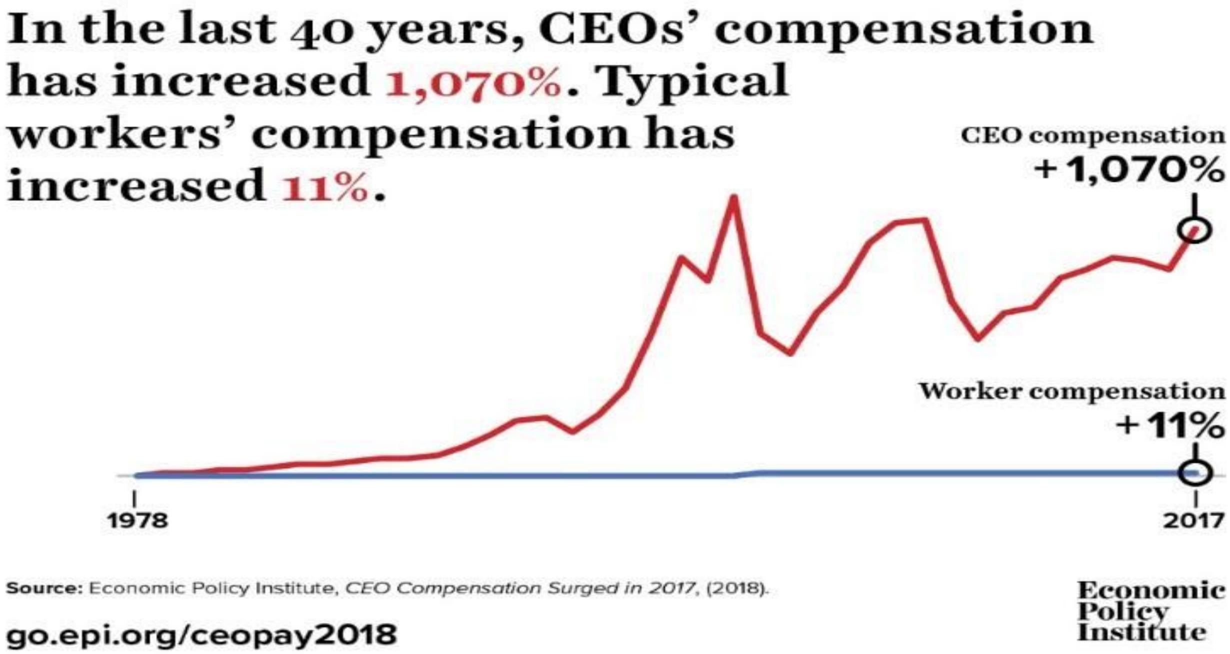
**Abuse of Executive Compensation**

A recent study by the Institute for Policy Studies (2022) revealed a wide gap in compensation between the top CEOs at 300 major US companies and their median employees. On average, CEOs in the sample earned $10.6 million per year, while the median worker earned just $23,968. The study also revealed that many of the companies in the sample received substantial government contracts, with 40 of them receiving a total of $37.2 billion from October 2019 to May 2022. Amazon, the second-largest contractor in the sample, received $10.3 billion in federal contracts, and its CEO, Andy Jassy, was paid a package worth $212 million, which was 6,474 times greater than the median pay for Amazon employees.

This disparity in pay has been the subject of criticism, with many CEOs facing accusations of excessive compensation and overly generous perks, such as those listed by Forbes (2011).

Basketball Tickets

Aubrey McClendon, the CEO of Chesapeake Energy, used $5.9 million of the company's funds to purchase tickets to the Oklahoma City Thunder basketball games in 2010, despite being a partial owner of the team.




Corporate Purchases

In 2009, to save his company from bankruptcy, Lonnie Pilgrim, the founder of Pilgrim's Pride, invested his own money into the company. As a form of repayment, the company bought his egg farm for $12 million, along with repaying the loan, interest, and an annual consulting fee of $1.5 million.

Aubrey McClendon, CEO of Chesapeake Energy, sold his collection of antique maps to the company for $12.1 million, in addition to his interest in sports.

CEO Martha Stewart generated $2 million in profit by granting her company the rights to produce and air her TV show.

Relocation Expenses

James Bernhard, CEO of the Shaw Group, has the most unusual and extravagant perk when it comes to relocation expenses. While it is common for companies to provide significant sums of money to their CEOs and corporate executives to prevent them from divulging company secrets or competing with the company if they are hired by a rival firm, Bernhard's perk goes beyond this norm. His agreement with the company includes a provision that his heirs will receive $15 million plus interest for two years after his death, in order to ensure that the company's secrets remain protected even after his passing.

**Designing an Executive Compensation Plan**

Organizations must consider various accounting, tax, and regulatory factors when creating an executive compensation plan. A comprehensive strategy should be developed to effectively utilize each component of the plan and ensure that the overall compensation package aligns with the organization's goals.

When crafting a compensation strategy, it's important for employers to consider the following internal factors within the organization:

1. Business philosophy, mission, and vision.

The values and beliefs of an organization, as outlined in its mission and vision statements, play a significant role in shaping the total compensation strategy for executives. Additionally, the objectives and performance metrics outlined in the organization's business plan also inform the design and implementation of the executive compensation plan.

2. Legal, Tax, and accounting regulations.

In Nigeria, there are no specific guidelines for determining the maximum limit of share options or bonuses for companies, according to Udo Udoma and Belo-Osagie (2021). However, the Nigerian Code of Corporate Governance 2018 and the Securities and Exchange Commission Code of Corporate Governance for Public Companies in Nigeria, 2011, do outline regulations for executive director compensation. These regulations state that executive compensation should be tied to long-term performance and may include share options and bonuses. The company must disclose such compensation in their annual report.

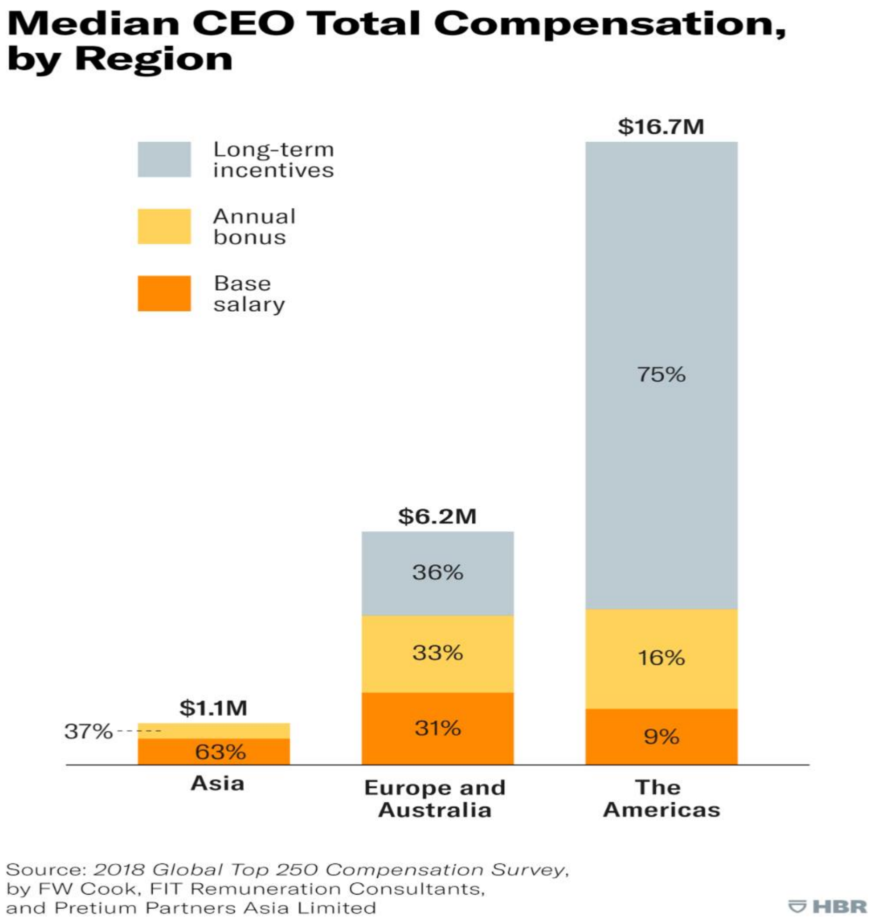
According to Section 295(1) of the Companies and Allied Matters Act 2020 (CAMA 2020):

*It is illegal for a company to provide a director with compensation, whether as a director or in any other capacity, that is exempt from income tax, that is based on or affected by the amount of income tax they pay, or that is determined by the rate of income tax.*

Any additional incentives given to employees beyond what is legally allowed will be subject to taxation according to the Personal Income Tax Act, which states that they can be up to 24% of the employee's total compensation. This is outlined in Chapter P8 of the Laws of the Federation of Nigeria 2004, and the Personal Income Tax (Amendment) Act 2011.

3. Workforce composition, region, and demographics.

Location is a crucial factor in determining the cost of living and, in turn, compensation. Major cities tend to have a higher cost of living, including housing expenses, which is why wages for similar roles are often higher in these areas compared to rural regions.




When creating a compensation package for CEOs, it is important to take into account the location and demographics of the workforce, as demonstrated by the disparity in executive pay between the US and Asia, with the latter being significantly lower. This difference would likely be even more pronounced when compared to Africa.

4. Industry and competition

Depending on the industry and level of competition, companies must decide compensation on four dimensions;

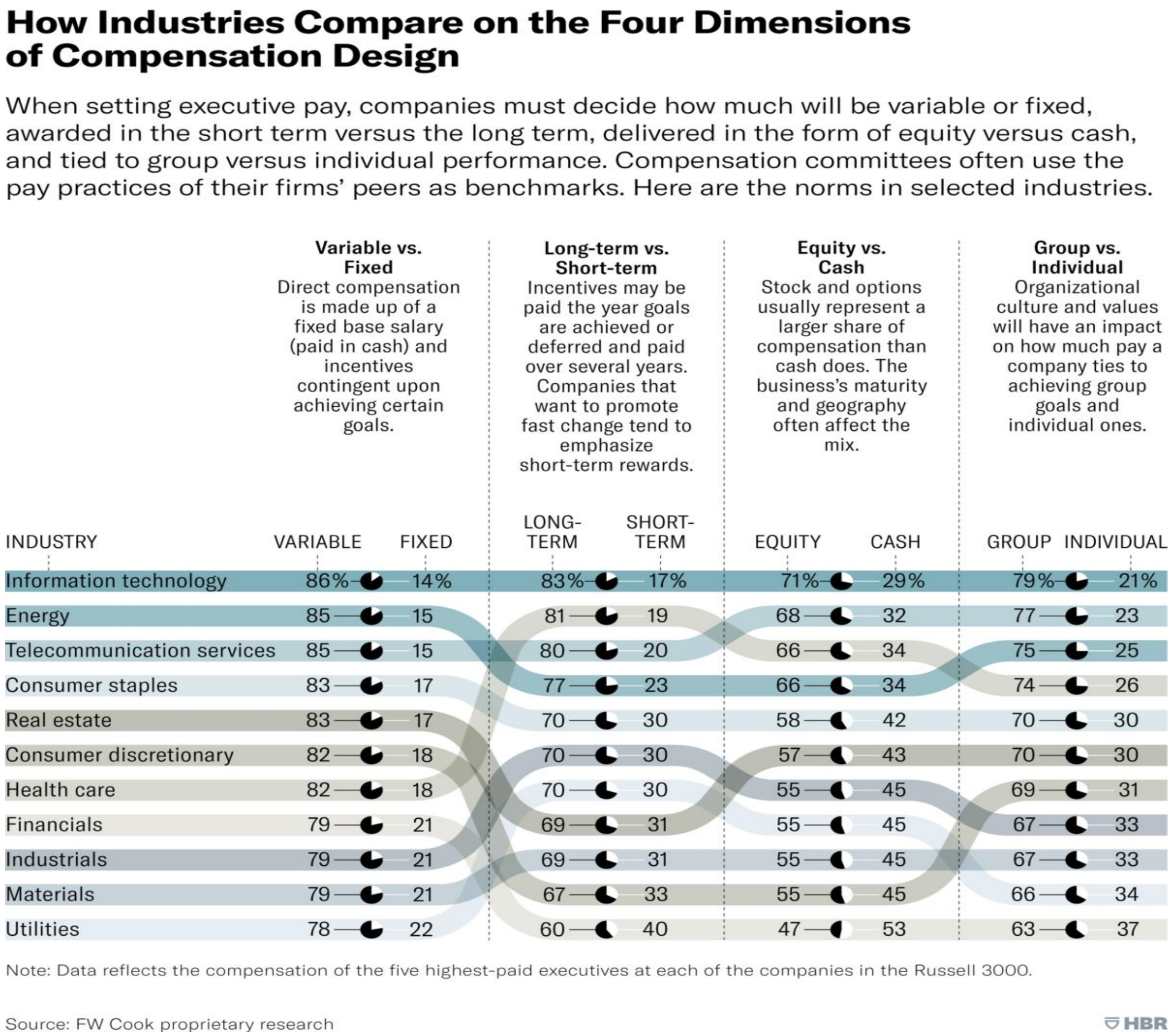
- Fixed versus variable. The fixed component is the base salary, which is a predetermined amount that is paid in cash. The variable component includes short-term and long-term incentives, which are based on the achievement of certain goals and are not guaranteed. These incentives can be determined by a set formula or by the discretion of management or the compensation committee of the board.

In the illustration depicted below, there is a consistent distribution between fixed and variable compensation across different industries, although some, such as telecommunications, technology, and energy, pay a slightly greater proportion of variable compensation while others, such as financial services, materials, and utilities, pay a slightly greater proportion of fixed compensation.

- Short- versus long-term. Another aspect to consider is whether variable compensation is paid out immediately or deferred to be distributed at a later time. Awards that are linked to achieving specific goals in the future are typically given in the form of equity, such as stock options, restricted stock, and performance shares. In contrast, short-term variable compensation is usually provided in the form of cash.

On average, 72% of variable compensation for senior executives is deferred and paid in future years, with the remainder paid out in the year it is awarded. Industries such as technology, healthcare, and telecom have a higher proportion of long-term awards, with 83%, 81%, and 80%, respectively. In contrast, financial firms have a lower proportion of long-term awards at 60%.

- The distribution of cash and equity in executive compensation is an important factor to consider. Based on our study, the average of 41% of senior executive compensation is given in the form of cash, while 59% is provided as equity. The allocation of cash and equity often varies based on the stage of the business, with start-ups relying more on equity to entice and retain key personnel in the absence of a large amount of cash. Furthermore, our findings indicate that equity compensation makes up a higher percentage of total pay in larger companies (63%) compared to smaller ones (48%). Industries such as technology, telecom, healthcare, and energy tend to have a higher proportion of pay delivered in equity form.




- Individual versus group On average, 29% of senior executive compensation is based on individual performance, while 71% is based on the performance of the organization or company as a whole. The proportion of compensation linked to individual versus organizational performance can vary depending on a company's culture and values. Companies that place a high emphasis on personal accountability and individual contributions tend to have a higher proportion of compensation tied to individual performance, while companies that focus more on overall organizational results tend to have a higher proportion of compensation tied to organizational performance. Factors such as the industry and the type of business can also play a role in determining this balance.

5. Pay for Performance

The purpose of executive compensation agreements is to harmonize their behavior with the company's success, as per the direction of company boards (Mcclure, 2021). The concept is that a CEO's efforts should generate value for the organization. Many businesses refer to their compensation plans as "pay for performance," indicating that a CEO's compensation is connected to the company's performance.

The idea behind "pay for performance" is that a CEO's compensation should be connected to the success or failure of the organization. This means that as the company performs well, the CEO's pay will rise, and if it performs poorly, the CEO's pay will decrease. This concept links a CEO's financial stability to the success of the company, implying that they are taking on a certain level of risk.

Determining appropriate executive pay based on performance can be challenging, as performance can be measured by various factors such as financial metrics, revenue growth, return on equity, or share price appreciation. However, using these metrics alone may not accurately reflect an executive's performance. To incentivize executives to meet both individual and company objectives, companies often use cash bonuses that are linked to performance.

## Conclusion

According to some experts, CEOs have become increasingly valuable in today's competitive global economy as companies have grown larger and generated more wealth. Thompson (2013) argued that when executives fail, the consequences of their actions can have a greater impact than before. Supporters of this perspective often point out that while CEO compensation has risen, so have earnings for other highly skilled professionals whose abilities are critical to the success of their companies. With increased globalization, the demand for specialized skills has also increased, and thus, their value has risen.

The opposing viewpoint is that CEOs have a significant amount of influence over their corporate boards, allowing them to determine their own compensation packages with the help of supportive compensation consultants. This theory is known as "management power" (Weissmann, 2013).

Therefore, it is important to proceed with caution when considering CEO compensation. While it is understandable for a highly successful CEO to receive certain benefits, it becomes problematic when these perks negatively impact shareholders and employees, particularly during times of financial difficulty. In such cases, it may be necessary for boards to reevaluate their executive compensation plans.

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