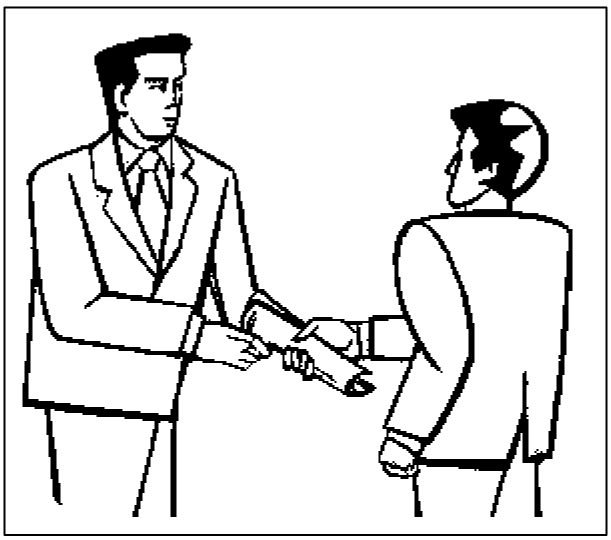
Do CEO compensations match their performance?

Ravi Madapati*

Many surveys have found out that CEOs are getting paid exorbitantly and this obviously is not going well with the investors. The problem is because many of the investors are aware of the compensation being paid to the CEOs of the companies they invested in, but are powerless in that they are unable to make their voice heard. This article finds out few things about CEO compensations and how many of them are destroying shareholder wealth.



Since 1980, the average pay of regular working people increased just 66%, while CEO pay grew a whopping 1,996% [1]. According to *Business Week* [2], the average CEO of a major corporation made 42 times the average hourly worker's pay in 1980, 85 times in 1990 and a staggering 531 times in 2000. If runaway CEO pay growth continues at its current exponential rate over the next 50 years, the average CEO will be paid more than 250,000 American workers put together.

CEO's are paid very well for their time and effort. Not only do they earn million dollar salaries and bonuses; they also receive stock-based pay. This means that the executive is also an owner of the corporation he or she works for. Stock-based pay is usually in the form of stock options or stock grants.

Stock options are the most popular form of stock-based pay. A stock option is the right to buy a share of stock at a fixed price for a specified period of time, usually five to ten years. If the price of the company's stock rises above the exercise price, the CEO realizes gains equal to the difference between the exercise price and the current fair market value of the stock.

Stock grants are also commonly used in addition to stock options. Here, the company grants employees shares of the company stock. These shares of stock can be restricted for a certain period of time or can be performance based. Performance-based stock grants are given to employees based on the company's performance over a specified period of time.

Stock-based programs are a large part of a CEO's compensation. Many CEO's are reaping large rewards merely because their company's stock price

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[1] *http://www.aflcio.org/paywatch. htm.*
[2] Business Week *April 22, 2002.*

Box 1

Managerial remuneration and Companies Act

The Companies Act, 1956 [3], contemplates five categories of managerial personnel:

- An ordinary director, who is the director *simplicities*;
- A part-time paid director, being a director in the part-time employment of the company;
- A whole-time director, being a director in the whole-time employment of the company;
- A managing director, being a director entrusted with substantial powers of management; and
- The manager, having the management of the whole, or substantially the whole, of the affairs of the company.

The remuneration payable to a director may take any one or more of the following forms: Sitting fee for each meeting of the Board, or a committee thereof, attended by him; monthly, quarterly or annual payments made to him; or a commission payable to him at specified percentages of the net profits of the company computed in the manner referred to in Section 198(1). Thus, the Companies Act enlarges the ordinary meaning to the word 'remuneration' to payment in money or otherwise for services rendered. A CEO may be paid remuneration by way of a monthly payment and/or at a specified percentage of the company's net profits. While, some companies prefer not to pay any commission and in lieu thereof absorb the element of commission into the monthly salary so as to ensure a steady income for the CEO irrespective of fluctuations in the net profits of the company from year to year, others go to the extent of linking the CEO's pay with the share price of the firm by issuing employee stock options to him/her. Consider the remuneration paid to Corporate CEOs (that is, Managing Directors or Chairman in some organizations). Section 198 of the Companies Act, 1956, limits the overall maximum managerial remuneration payable by a public company to persons entrusted with managerial functions to 11% of the company's net profits (percentage of the net profits as contemplated by Section 198 (1) is to be computed in the manner laid down in Sections 349, 350 and 351 in the Companies Act).

This percentage is exclusive of fees payable to directors for attending meetings of the Board or committees thereof. The Section is concerned especially with managerial remuneration payable to managing directors. On the other hand, Section 309 is concerned with total remuneration payable to directors; whatever is the nature of such remuneration, managerial or otherwise. Obliging to the frequent demands/representations of the different industry chambers and with the shifting economic policy, the Companies Act was amended from time to time. For example, from a salary limit of Rs. 90,000 pa in 1969-74, in 1994, the upper limit for salary was eliminated (the only limiting factor being Section 198).

has soared. In fact, many CEOs are receiving large gains on stock-based compensation, even though their company may be losing millions of dollars.

Runaway CEO pay

Business Week stated that the average salary and bonus for a chief executive rose a phenomenal 39%, to $2.3 mn in 1996. Retirement benefits, incentive plans and gains from stock options are also added to the CEO's compensation package. This increase in CEO pay is spreading a message that the CEO deserves nearly all the credit for the company's success. Managers and other key employees who are responsible for day-to-day company activities are receiving much smaller compensation for their efforts.

The IRS found that between 1980 and 1995, total tax-deductible executive pay rose from $109 bn to $307.6 bn, even after adjusting for inflation. That 182% increase in taxable pay far exceeded growth in either corporate revenues or net income. Revenues grew from $6.4 tn to $14.6 tn during the 15-year period, up 129.5%. Corporate profits rose from $246.6 bn to $560.1 bn, an increase of 127%. Due to slightly lower corporate tax rates, the amount of corporate income taxes grew more slowly, at 114%, from $91.9 bn to $197 bn.

[3] *This section draws from the analysis of Ram Kumar Kakani and Pranabesh Ray, faculty members at XLRI Jamshedpur.*

Exhibit 1

Company	Performance	Executive Pay
AT&T	Company recently announced $1 bn in restructuring costs and more than 10,000 job cuts.	No matter how far the stock price falls, CEO C Michael Armstrong gets a $10 mn minimum guarantee on his restricted stock.
Coca-Cola	After cutting 5,200 jobs, company looses domestic market share and misses earnings goals.	CEO Douglas N Daft takes home $105 mn and gets the earnings targets on his restricted stock reduced.
Enron	Company bankrupt, 6,100 out of work and 401(k) participants lose millions.	In 2000, CEO Ken Lay exercised $123 mn in stock options prior to the accounting scandal.
General Electric	Workers' pension plan boosted company earnings by $1.5 bn in 2001.	CEO John Welch Jr. gets a pension of almost $10 mn annually for the rest of his life.
Hewlett-Packard	15,000 jobs cut in controversial merger with Compaq.	Executives to receive $337 mn in retention bonuses.
IBM	Pension conversion to a cash-balance plan saves company $200 mn a year.	Retiring CEO Louis V Gerstner Jr. is entitled to a double pension benefit worth millions.
Kmart	Company bankrupt and 22,000 laid off with no severance.	CEO Charles Conaway bagged at least a $9.5 mn severance package.
Lucent Technologies	Company cut its workforce in half and froze workers' 401(k) plan as the stock plummeted.	Ousted CEO Richard McGinn gets a $5.5 mn cash severance payment plus pension.
Polaroid	Company bankrupt, 2,000 laid-off and ESOP plan erased.	Executives had wanted $19 mn in retention bonuses, including $1.7 mn for CEO Gary DiCamillo.
Tyco International	Company plans to break up into four pieces after cutting 11,000 jobs in merger consolidations.	CEO and CFO cashed out half-a-billion dollars in shares and stock.

Examples

Business Week named two CEO's, Bill Gates of Microsoft and James Preston of Avon Products, as the best-performing executives over a three-year period. Gates, who made $1.436 mn in total pay from 1994 to 1996, gave Microsoft shareholders a very good return for their investment. Microsoft's shareholders received a 310% return for the period. Preston, whose three-year total pay was $7.907 mn, racked up the highest return on equity. Relative to Preston's pay, Avon's return on equity was 141% for the three-year average.

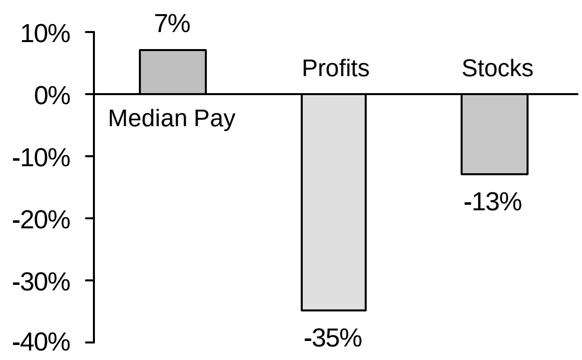
Among the top of low performing CEOs was America Online's CEO, Steve Case. He earned $33.5 mn over three years, while the return on equity was a negative 413%. Some more such examples are given in exhibit 1.

The performance of companies is not at all on par with the money their CEOs are getting paid. Exhibit 2 explains how the company stocks and profits are doing in relation to their CEO pays.

CEO remuneration in India

CEO salaries in India are on an uphill ride. The pay packages are getting bigger and organizations are willing to loosen their purse strings. The general opinion is that the growth of an organization is dependent on the dynamism of the CEO. So, if any organization grows because of the capabilities and abilities of the CEO, profitability should be linked to the salaries. The debate on the issue begins here. Do profitabilities of companies and CEO pay cheques match? Are Indian CEOs overpaid?

Exhibit 2



Source : The New York Times.

As per a recent *Economic Times* report, "the CEOs of India Inc., are raking it in, recession or no recession." Salaries of chief executives here have risen by 40-50% even during a recession-hit period. One way to measure the performance of the company would be to measure its Economic Value Added (EVA), which shows whether it is creating or destroying wealth for its shareholders.

An Outlook report quoting a recent study of 16 top manufacturing companies—including ACC, Arvind Mills, Bajaj Auto, Ceat Industries, Century Enka, L&T and Tisco, says top management salaries have grown at 20.4% annually during 1979-80 to 2000-01. This was more than the annual increase of 12.9% for other employees.

The report also points out that Bajaj Auto's Rahul Bajaj saw his compensation going up by nearly 60 % between 1999-2000 and 2000-01, the company's EVA declined from a negative Rs. 252.74 cr to a negative Rs. 335.16 cr. Similarly, the Zee Telefilms CEO saw his salary rise from Rs. 48.90 lakh to Rs. 84.6 lakh in the same period, even as the company's EVA dropped from a negative Rs. 1,016.2 cr to a negative Rs. 1,169.1 cr.

Meanwhile, corporate watchers tend to believe that the CEOs take home big money while the shareholders are left to languish with the stock of the company down in the doldrums.[4] This takes us to the point Infosys' chairman and mentor N R Narayana Murthy made recently. According to Murthy, the salary of the CEO of a company should not be more than 15-25% that of the lowest-paid worker in his company. This means there should be some amount of transparency in the money drawn by the chief executives.

It may be seen that Infosys CEO Nandan Nilekani justifies his mentor's piece of advice by taking home Rs. 20 lakh as salary, even while Infosys makes bigger profits. Taking the case, another software behemoth Wipro's chief Azim Premji's salary went down by 61% in 2001-02, according to the *Economic Times* report. This, sadly, is not the case with many old economy firms, where the CEOs still take home a fortune, even as their companies test depths.

Talking of such big amounts doesn't mean that all head honchos take home amounts not proportionate with their companies' performance. Nilekani, Reddy, the Munjals, the Ambanis and many others may be exceptions. But, there are many who aren't. Are they worth the money they pocket every year. May be, the balance sheets of the companies could provide an answer. Remunerations of a few top Indian executives for the year 2001-2002 are given in Exhibit 3 .

Exhibit 3

Top Executives	2000-01
Dhirubhai Ambani	Rs. 8.85 cr
Anil Ambani	Rs. 7.13 cr
Mukesh Ambani	Rs. 7.13 cr
Azim Premji	Rs. 4.29 cr
Pankaj Patel	Rs. 3.91 cr
K Anji Reddy	Rs. 3.40 cr
Pratap C Reddy	Rs. 2.08 cr
G V Prasad	Rs. 1.70 cr

Compiled from Reliance corporate website, Dr. Reddy's corporate website, Limca Book of Records and Business Standard.

Since the mid 1990s, salaries in new businesses such as financial services and information technology have increased four-fold, registering a three-fold increase between 1997 and 2000 itself, according to industry estimates.

In the list of top ten highest paying companies in India for 2001, old economy companies and conglomerates still rule the roost. Only two new economy ventures, the Rs. 3,053 cr Wipro and the Rs. 1,900 cr Infosys Technologies, figure in this list.

[4] *The analysis draws a little from a report appeared in MSN.com.*

Box 2
Some statistics on CEO compensations

- The base pay for chief executives fell 15% in the first half of 2002. CEOs also lost 43% in bonuses for an overall decrease of 23%, according to a survey by Christian & Timbers. (*The Boston Globe*, September 8, 2002)
- In 2000, a CEO earned more in one work day than what an average worker earned in 52 weeks, according to the Economic Policy Institute. This ratio fell in 2001, but remains above historical levels. (*The Boston Globe*, August 4, 2002)
- On average, American bosses take home pay packets that are 475 times more than their workers. This survey conducted by Towers Perrin, of S&P 500 leading companies, found that CEOs in America receive more pay relative to workers on the factory floor than any other country. (*Management Magazine*, June 6, 2002)
- CEOs of large corporations made 411 times as much as the average factory worker in 2001. (*Business Week*, May 6, 2002)
- In the past ten years, average wages have increased by 36%. For CEOs, it was 340%. (*Business Week*, May 6, 2002)
- In 2000, CEO compensation was 531 times that of the average worker. In 1980, CEO compensation was 42 times that of the average worker. (*Business Week*, April 22, 2002)
- The average compensation for chief executives declined 8% to $15.5 mn, according to a survey of 200 large companies conducted for Money & Business by Pearl Meyer & Partners. (*The New York Times*, April 7, 2002)
- One out of five CEOs received no bonus in 2001and the typical bonus fell 23%, according to Pearl Meyer. (*The New York Times*, April 7, 2002)
- CEOs in other countries are increasingly compensated with a mix of salary, benefits and long-term incentive programs that mirrors that of American bosses, according to a recent study from New York consulting firm Towers Perrin. American CEOs are still paid more than anybody in the world. (*Chief Executive*, March 2002)
- In an executive-compensation survey of 50 large companies overall pay for the nation’s top CEOs fell 4% in 2001, with the average CEO earning $10.46 mn, according to Pearl Meyer & Partners consultant. (*Business Week*, March 18, 2002)
- Salaries and bonuses of CEOs dropped a median of 2.9% to $1.24 mn, according to a William M Mercer Inc., survey of 100 companies’ proxy statements. (*The Asian Wall Street Journal*, March 6, 2002)
- Only three of the 30 highest-paid female executives of 2000 occupied the corner office. (*Business Week*, April 23, 2001)
- The average CEO earned $13.1 mn in 2000. Cash compensation for the CEOs at 365 of the largest US companies increased 18%in 2000, while total pay increased 6.3%. Salaried workers received a 4.3% pay hike. (*Business Week*, April 16, 2001)
- The average CEO pay in the US has risen from 42 times the average blue-collar worker’s salary in 1980 to 475 times the average blue-collar workers' salary in 1999, according to the AFL-CIO. (*Chief Executive*, February 2001)

Conclusion

CEOs should do some soul-searching at this point of time. After the great debacle of the Internet companies, which in fact was the trigger for CEOs raking in millions of dollars through stock options, it must become the agenda of board of directors to compensate CEOs by their performance. The gap between other managers in companies and CEOs is increasing year after year. Though the contribution made by CEOs in most cases is undisputable, the same cannot be said about their compensations.

Many surveys have found that CEOs are getting paid exorbitantly and this obviously is not going well with the investors. The problem is because many of the investors are aware of what is being paid to the CEOs of the companies they invested in, but they are powerless in that they are unable to make their voice heard. In this situation it is up to the regulating bodies to clearly give guidelines protecting the interests of the common investors.

Clearly, the contributions of a CEO should be on par with the compensation he/she gets. Unless this is ingrained in a company's culture or rubbed in by an outside regulating body, the controversy of CEOs being paid more than they deserve will continue. Until then, CEOs will keep getting what they desire and not what they deserve. ■

Reference # 15-02-12-02

Ten top-paid CFOs

S. No.	Executive and Company	Base Salary	Bonus	Total Annual Compen-sation	Gain on Option Exercise	Total Long-term Incentives	Total Direct Compensation
1.	Michael E Lehman, Sun Microsystems	$600	$0	$600	$36,027	$36,601 [a]	$37,201
2.	Mark H Swartz, Tyco International	$969	$2,500	$3,469	$13,700	$28,900 [b]	$32,368
3.	Larry R Carter, Cisco Systems	$424	$0	$424	$29,009	$29,009	$29,433
4.	Anthony S Thornley, Qualcomm	$529	$350	$879	$19,408	$19,408	$20,287
5.	James G Stewart, Cigna	$702	$600	$1,302	$9,424	$14,133 [c]	$15,434
6.	Dennis L Winger, Applera	$427	$202	$629	$7,969	$11,985 [d]	$12,614
7.	M Scot Kaufman, MBNA	$1,600	$3,601	$5,201	$0	$5,540,625 [e]	$10,742
8.	David L Shedlarz, Pfizer	$773	$737	$1,510	$4,047	$7,908 [f]	$9,417
9.	David A Viniar, Goldman Sachs	$600	$8,381	$8,981	$0	$0	$8,981
10.	John R Joyce, IBM	$519	$650	$1,169	$4,696	$5,436[g]	$6,065

[a] Includes $573,442 in long-term incentive plan payouts.

[b] Includes $15,199,440 in restricted stock grants.

[c] Includes $2,841,500 in restricted stock grants and $1,867,000 in long-term incentive plan payouts.

[d] Includes $4,015,688 in restricted stock grants.

[e] Includes $5,540,625 in restricted stock grants.

[f] Includes $3,861,000 in long-term incentive plan payouts.

[g] Includes $740,480 in long-term incentive plan payouts.

Source: www.cfo.com.