CHAPTER 5

Executive Compensation—Unsound and Unjustifiable Practice: A Driving Force behind Short-Sightedness

Compensation Basics

Basically, a good compensation system is fair and equitable, and it motivates people to perform well to the best of their abilities. Ideally, people should be compensated appropriately in relation to their qualifications (education, training, skills, experience, etc.), authorities, and responsibilities.

At the time of hiring, salary, severance package, fringe benefits, and other incentives should be based on what the individual brings to the organization in personal strengths and what he/she is expected to contribute to the organization immediately as well as in the long run. The organizational and job market realities should dictate the overall starting compensation package.

The retention, promotion, and separation (retirement and firing) compensation policies should reflect the application of fair, equitable, and objective performance-measurement criteria that accurately measure the individual contribution for the financial and nonfinancial merit considerations. The periodic evaluations for merit raises and promotions have to be prompt and realistic, and they should provide adequate incentives and motivations to excel at work. Not only must the compensation policies and practices facilitate the human productive efforts, but they must also relate to the individual contribution toward the achievement of the organization’s specific objectives in the past as well as in the future.

Leadership Compensation: Individual Responsibilities Versus Contribution

To understand the effectiveness of executive compensation practices, let us review once again the corporate management’s fiduciary duty and contribution
toward the firm’s overall business success and failure as an ongoing entity. (See chapters 3 and 4 for details.)

The corporate CEO and other top managers have the fiduciary responsibilities and obligations to preserve the organization’s financial well-being and promote its long-term business interests. These highly educated and experienced corporate “professional” managers are expected to ensure and secure the organization’s survival and growth through careful strategic planning and management. The shareholders expect their corporate managers to provide a reasonable return year after year on their investments while not jeopardizing their capital investments and financial interests; any managerial accomplishments better than or as good as the rest in the industry or elsewhere are preferred in the long run. Other corporate stakeholders—customers, employees, suppliers, distributors, creditors, and the community at large—also expect corporate managers to perform well to enhance everyone’s best interests and well-being.

The authority and discretionary power given to the corporate managers empower them to acquire and develop the corporate resources (capital, technology, plant, equipment, facilities, human, etc.). These resources are to be deployed to enhance the firm’s long-term security, profitability, and growth. Thus, the corporate CEO and his/her top lieutenants have obligations to use their best knowledge and skills in managing these resources. They have to formulate and implement effective business strategies, policies, and plans. Their decisions and actions should be aimed toward the accomplishment of the organization’s goals and objectives that would benefit the shareholders and other stakeholders one way or another in the long run. In return, the corporate managers should be compensated fairly and appropriately.

Executive compensations should depend on the management’s real contribution toward the firm’s progress on the long path to its ultimate destined goals. For their specific achievements in fulfilling the stakeholders’ long-term expectations, the CEO and other individuals at the top receive compensations in the form of basic salaries, bonuses, fringe benefits and perks, and severance payments. As long as the people at the top perform effectively, their positions should remain secured and they should be rewarded in both financial and nonfinancial terms. Their compensations should be in line with and justifiable in relation to others in the organization and elsewhere, in terms of each individual’s actual importance and contribution toward the firm’s competitive success and progress in the very dynamic global marketplace.

Corporate managers continue to work, lead, and run the organization at the pleasure of their organization’s owners, the stockholders who are represented by the corporate board of directors. The corporate directors speak for the shareholders and other stakeholders.

The board of directors, elected periodically by the corporate shareholders, supervises and guides the corporate top managers. It is the board’s primary responsibility to provide effective governance to ensure that the organization continues to move forward toward its destined goals through very careful management policies, strategies, and practices. The board has to provide watchful eyes