

Overview of Executive Compensation

In general, managers who are in the second level of a company earn about two-thirds of a CEO's salary (i.e. manager at second level earn \$66,000 if the CEO earn \$100,000).

In 1980, CEOs received about 42 times the average pay of lower-level workers (i.e. if a CEO earns \$100,000, the low-level workers earn approximately \$2500). Now top executives are paid 475 times the pay of the average factory worker (i.e. if a CEO earns \$100,000, the low-level workers earn approximately \$200). As a point of reference, the corresponding differential in Japan is under 20 (i.e. if a CEO earns \$100,000, the low-level workers earn approximately \$5000).

Components of an Executive Compensation Package

There are five basic elements of most executive compensation packages:

(1) Base salary: Although formalized job evaluation still plays an occasional role in determining executive base pay, other sources are much more important. Particularly important is the opinion of a compensation committee, composed usually of the company's board of directors or a subset of the board. Frequently the compensation committee will take over some of the data analysis tasks previously performed by the chief personnel officer, even going so far as to analyze salary survey data and performance records for executives of comparably-sized firms. One empirical study suggests the most common approach (60 percent of the cases) of executive compensation committees is to identify major competitors and set the CEO's compensation at a level between the best and worst of these comparison groups.

(2) Short-term (annual) incentives or bonuses: Annual bonuses often play a major role in executive compensation and are primarily designed to motivate better performance. Most striking is the rapid rise in popularity of this type of compensation. Only 20 years ago just 36 percent of companies gave annual bonuses. Today bonuses are given to 90 percent of executives.

(3) Long-term incentives and capital appreciation plans: Long-term incentives now account for over one-half of total executive compensation, up from 28 percent a decade ago. By far the most common long-term incentive remains the executive stock option. A stock option is the right (not obligation) to purchase a stated quantity of stock at a stipulated price (strike price) over a given period of time (exercise period) following certain eligibility (vesting) requirements. Because many of the highest-reported executive pay packages can be traced to stock options, critics have focused on their use and abuse.

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Exhibit below identifies some of the **Long-Term Incentives for Executives**

Type	Description	Comments
Incentive stock options	Purchase of stock at a stipulated price, conforming with Internal Revenue Code (Section 422A).	No taxes at grant. Company may not deduct as expense.
Nonqualified stock options	Purchase of stock at a stipulated price, not conforming with Internal Revenue Code.	Excess over fair market value taxed as ordinary income. Company may deduct.
Phantom stock plans	Cash or stock award determined by increase in stock price at a fixed future date.	Taxed as ordinary income. Does not require executive financing.
Stock appreciation rights	Cash or stock award determined by increase in stock price during any time chosen (by the executive) in the option period.	Taxed as ordinary income. Does not require executive financing.
Restricted stock plans	Grant of stock at a reduced price with the condition that it may not be sold before a specified date.	Excess over fair market value taxed as ordinary income.
Performance share/ unit plans	Cash or stock award earned through achieving specific goals.	Taxed as ordinary income. Does not require executive financing.

* B. Ellig, *The Complete Guide to Executive Compensation*

(4) Executive benefits: Since many benefits are tied to income level (e.g., life insurance, disability insurance, pension plans), executives typically receive higher benefits than most other exempt employees. Beyond the typical benefits, many executives also receive additional life insurance, exclusions from deductibles for health-related costs, and supplementary pension income exceeding the maximum limits

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permissible under ERISA guidelines for qualified (eligible for tax deductions) pension plans.

(5) Perquisites (Perks): Perquisites, or “perks,” probably have the same genesis as the expression “rank has its privileges.” Indeed, life at the top has its rewards, designed to satisfy several types of executive needs.

- One type of perk can be classified as internal, providing a little something extra while the executive is inside the company: a luxury office, an executive dining room, special parking.
- A second category comprises perks that are also company-related but are designed for business conducted externally: company-paid membership in clubs/associations and payment of hotel, resort, airplane, and auto expenses.
- The final category of perquisites should be totally isolated from the first two because of its different tax status. This category, called *personal perks*, includes such things as lowcost loans, personal and legal counseling, free home repairs and improvements, personal use of company property, and expenses for vacation homes. Since 1978, various tax and regulatory agency rulings have slowly been requiring companies to place a value on perks.

Because of the changing nature of tax legislation, each Components of an Executive Compensation Package at one time or another has received considerable attention in designing executive compensation packages.

Exhibit below traces the trend in these components over time.

Breakdown of Executive Compensation Components

Compensation Component	1970s	1980s	1990s	Today
Base salary	60%	40%	33%	16%
Short-term (annual) incentives or bonuses	25%	20%	27%	16%

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long-term incentives and capital appreciation plans	15%	20%	40%	68%
employee benefits	Not Reported	15%	Not Reported	Not Reported
perquisites	Not Reported	5%	Not Reported	Not Reported

- Sources: IOMA, *Pay for Performance Report*

Reference: Milkovich–Newman. (2004). *Compensation*. The McGraw–Hill Companies

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