Balooning CEOs Compensation CEOs Compensation : Burning Controversy

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Executive summary: The CEOs compensation has been a point of debate all over the world for quite long. The salaries of CEOs have been growing at a much faster rate as compared to that of other employees. The recent controversy about CEOs compensation in India surfaced due to a remark made by the Prime Minister at a conference of industries. No doubt, Indian economy is growing at a very fast pace and there are certain industries where there is a scarcity of talent at the higher levels but this has pushed the compensation paid to CEOs to a very high band. This has raised few legal, ethical and practical issues. Whether govt. should intervene in deciding the Executive's compensation? Should there be a difference between the compensation of Promoter CEOs and Professional CEOs? Why there is a difference between compensation of CEOs of public and private sectors? Should the executive compensation be linked to the profitability of the organization?

In the present study, a modest attempt has been made to dwell upon above questions and much more to get an answer to the thorny issue of CEOs compensation in a welfare State like India. For the purpose of the study we derived the data from CMIE, India as published in Business Today, Vol.16, No.13, July 1, 2007. Appropriate statistical tools have been used to test the hypotheses using Sigma Stat software. Before we move on to the analysis of data it would be pertinent to discuss certain basic concepts related to compensation.

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CEO's Compensation:

The economic approach to executive compensation is on the premise that the worth of CEO's corresponds closely to some measure of company's success, such as profitability or sales. This explanation makes sense and even possesses empirical support. Numerous studies over past 20 years have revealed that executive pay bears some relationship with the company's success.

In 2001 and 2002, executive compensation became an issue in the wake of financial and accounting scandals that involved major companies such as Enron, WorldCom, Global Crossing, Tyco Adelphia etc. American financial markets suffered a severe decline. In preparing the financial statements of these companies, accountants inflated revenue by failing to recognize that significant amount of the compensation of the top executives of some of these companies was committed to stock options. The inflated value of stock enriched them exorbitantly, when these companies faced severe financial difficulties and in some cases, entered into the illegal inflation of revenue and the huge compensation packages received by executives in these companies.

Executive compensation packages are defended by the board of directors who approve these packages, highly specialized consultants who design the packages and many others. They say that these components are needed and are useful to attract and retain management personnel of outstanding ability. This helps to encourage excellence in the performance, responsibility and accountability. They state that these awards recognize the ability, efficiency and loyalty of these executives, whose efforts contribute to the success of the organization.

Indian Story:

Expectedly, there is a story behind rising CEO salaries, and the story is one of an economy expanding at a furious pace. Indian and foreign investors are scrambling to get into new sunrise sectors such as retail, infrastructure and real estate but not finding enough CEOs to run those businesses. Says Amit Mitra, Secretary General of FICCI: "Several of the new industries are hungry for talent across management level. But there is an acute shortage of managers who can lead companies in these and other, industries." Therefore, when Reliance's Ambani embarked on his mega retail plan, he didn't mind throwing money at the professionals he wanted to win over. Thanks to Ambani, the million-dollar pay cheque became an Indian phenomenon. Some of his retail heads such as Mr. Raghu Pillai were said to be hired at fantastic salaries that touched or topped $ 1 million.

"Salary" levels have increased on account of scarcity of resources. There is a visible shortage of human capital. Fundamentally, there is a demand-supply mismatch. The shortage is particularly acute in the sectors that are just opening up. Infrastructure, for example, there are two major airports revamps happening in Delhi and Mumbai and neither of the investors has been able to find an appropriate CEO so far. Why

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should finding a CEO for an airport project be so difficult? Simply because very few CEOs in India have set up an airport from scratch, and fewer still have the unique skills that the job demands. The airside of an airport, for instance, is all engineering and technical stuff while the landside, which houses retail business, demands a good marketer.

The overall boom in business has driven up salaries down the line as well. According to the Business Today-Oman Consultants salary surveys for junior to senior managers, salaries have been rising at anything upward of 15 percent year-on-year. While the gap between the CEO's salary and a young executive's can be quite wide. Mercer data shows that a sales trainee in 2006 entered the job at Rs. 2, 66,169 a year, compared to Rs. 2, 00,966 the year before. An assistant buyer in a purchase department made 35 percent more equally better off, getting a 33 percent over 2005. At the general manager level the hike was more than 50 percent, with the total annual compensation going up from Rs. 74.70 lakhs to Rs. 1.12 crores.

The debate over executive compensation is hardly new. With new industries and business taking off, the war for top management talents has pushed CEO salaries to record levels. In the U.S.A, it has been on for decades, and was reignited recently when it emerged that Home Depot's unsuccessful CEO, Bob Nardelli would be walking out with $ 210 million as part of his golden handshake. Synergy Consultants conducted a survey on "Best Compensation Management Strategies" and came out with interesting findings.

The information technology companies have their strategy to be amongst the top 25% paymaster in their region of operation. This is primarily because of the fact that skilled professionals form the crux of this knowledge-intensive industry. Same is the case in the telecom sector. The compensation, offered to fresh MBAs, as compared to fresh engineers is much higher, except in the IT sector where engineers get better pay packages than MBAs. The highest compensation for all three levels, i.e. junior management level, middle management level (5-10 years of experience) and senior management level are distributed in FMCG,IT, Telecom, Engineering and Durables industries.

Controversy about CEO's Compensation:

Top management's remuneration has ballooned sharply raising the key question whether the shareholders and companies have been adequately rewarded with increase in pay of CEO? There have been controversies in USA, where some top executives in corporations appears to be exceeding the few million-dollar mark. If we compare the top executive's total compensation with performance, we get mixed results, some high paid executives performed better than other. If we take a past case of Lee Iacocca, his contribution in rebuilding of the Chrysler Corporation, and saving it from bankruptcy was a tremendous feat. New Chrysler Corporation has justified every penny he had earned. Louis Gerstner's, who retired as CEO of IBM grossed $ 127 million-- which works out to about Rs. 600 crores -- more than the turnover of some of India's bigger firms.

TOP DRAWERS OF GROSS ANNUAL SALARY (INDIA) 2001 2002

Executive	Annual Salary (in Rs. Crore)
Vivek Paul, WIPRO	4.6
M.S.Banga, HLL	1.6
P.S.Pal, WIPRO	1.5
K.W.Kamath, ICICI	1.5
Lalita D.Gupta, ICICI	1.3

In India, the situation is nowhere as obscene. Yet, the fact that government thinks CEO pay may be out of control puts the subject at centre stage. On May 24, 2007 when Prime Minister of India, Dr. ManMohan Singh arrived at industry association CII's conference in Delhi to "share his thoughts" on Inclusive Growth-Challenges for Corporate India. It was a virtual rap on the knuckles that he delivered to the who's who of India Inc. gathered there to hear his speech. Delivered with earnestness, the speech set out to talk about a 10-point social charter for inclusive growth that could be the result of a "**new partnership**" with industry. After dwelling on issues such as caring for workers, corporate social responsibility and employment for the less privileged he urged the industry to resist, *"excessive remuneration to promoters and senior executives and discourage conspicuous consumption. In a country with extreme poverty, industry needs to be moderate in the emolument level it adapts. Rising income and wealth inequalities, if not matched by a corresponding rise (in) income across the nation, can lead to social unrest. - An area of great concern is the level of ostentatious expenditure on wedding and other family events. Such vulgarity insults the poverty of the less privileged; it is a social wastage and it plants seeds of resentment in the minds of the have-nots."*

The Prime Minister's advice to industry does not make a case for greater governmental control over executive pay, feels the Ministry of Corporate Affairs, which is revamping India's company law. Instead, the ministry plans to scrap the existing cap on managerial remuneration and leave decisions regarding pay hike to shareholders. This would mean that shareholders could decide on a higher managerial remuneration than what is possibly today, if they feel that the candidate deserves. Currently, government's approval is needed for any public company to raise the remuneration of a director to above 5% of the company's net profit and for all directors, 11% of the net profit. The new company law is likely to remove this cap as well as the need for government approval and leave it to a special resolution of the shareholders to decide managerial remuneration. This has been proposed to retain and attract talent at higher managerial level.

Certain issues, which came out of the recent controversy, are

- **Whether govt. should intervene in deciding the executive compensation?**

- **Why there is a huge gap between the compensation of top executives of Public and Private sector organizations?**
- **Why there is a huge gap between the compensation of promoter and non-promoter CEO's?**
- **Should the executive compensation be linked to the profitability of the organization?**

Data Analysis :

For the purpose of analysis null hypothesis has been formulated, which is tested using z-test, correlation & regression analysis, and t-test.

Ho1) There is no significant difference between compensation paid to Promoter-CEOs and Professional-CEOs.

Ho2) There is no linkage between profit and compensation of CEO of company.

Ho3) There is no significant difference between compensation paid to CEOs of Public and Private sector organizations.

Results of hypothesis Ho1, Ho2, and Ho3 are being presented in the Table-1, Table-2, and Table-3 respectively.

Table-1

Ho1 - There is no significant difference between compensation paid to Promoter-CEOs and Professional-CEOs.

Sr. No.	Promoter CEOs	Salary (in Rs. crore)	Professional CEOs	Salary (in Rs. crore)
1.	Mukesh Ambani	24.52	D.Bhattacharya	4.69
2.	Brijmohan Lall Munjal	15.58	Douglas Baillie	4.59
3.	Sajjan Jindal	13.25	Martial G.Rolland	4.36
4.	Sunil Bharti Mittal	12.67	A.M.Naik	3.98
5.	Y.K.Hamid	7.88	Raymond Bickson	2.96
6.	Malvinder Mohan Singh	6.57	Y.C.Deveshwar	2.87
7.	Kumar Mangalam Birla	6.41	Deepak Parekh	2.48
8.	Narattom Sakhsaria	4.63	K.V.Kamath	2.47
9.	Rahul Bajaj	3.83	S.Ramadorai	2.44
10.	Azim Premji	2.52	Ravi Uppal	2.17
11.	K.Anji Reddy	2.49	B.Muthuraman	2.20
12.	Anil Ambani	2.02	Aditya Puri	1.79
13.	Anand Mahindra	2.01	Sanjeev Aga	1.79
14.	Ratan Tata	1.75	Ravi Kant	1.69
15.	Uday Kotak	1.34	Pravin Kadle	1.62
16.	Glenn Saldanha	1.09	Jagdish Khattar	1.47
17.	Atul Punj	0.57	P.R.Menon	1.33
18.	Ramalinga Raju	0.52	Bhaskar Bhat	1.00
19.	Narayana Murthy	0.41	P.T.Siganporia	0.99
20.	Shishir Bajaj	0.30	J.Schubert	0.98
	Total	110.36	Total	47.87

Note: Only CEOs of BSE 100 companies were considered.

Mean	5.518	2.394
Standard deviation	6.412	1.189
No. of items	20	20

Calculated value of Z = 9.581

At 1% level of significance, if the calculated value of Z is within $\pm 2.576\ \sigma$, then hypothesis is accepted otherwise rejected. Since the calculated value lies beyond the specified range hence the hypothesis is rejected. This means there is a significant difference between the salaries of Promoter-CEOs and Professional-CEOs.

Table-2

Ho2 There is no linkage between profit and compensation of CEO of company.

Sr. No.	COMPANY	CHAIRMAN/CEO	SALARY (2005-06)	PROFIT (2005-06)
1.	Dabur	V.C.Burman	0.90	189.29
2.	Financial Technologies	Jignesh Shah	3.17	42.47
3.	Cummins	Anant Talaulicar	0.37	175.70
4.	Bajaj Auto	Rahul Bajaj	3.83	1123.27
5.	Crompton Greaves	Gautam Thapar	0.94	163.05
6.	Ranbaxy Labs#.	Malvinder M. Singh	6.57	395.13
7.	ABB*	Ravi Uppal	2.17	340.31
8.	Kotak Mahindra	Uday Kotak	1.34	118.23
9.	L & T	A.M.Naik	3.98	1011.60
10.	Bharti Airtel	Sunil Mittal	12.67	2012.08
11.	Reliance Industries	Mukesh Ambani	24.52	9069.34
12.	Siemens^	J.Schubert	0.98	360.11
13.	JSW Steel*	Sajjan Jindal	13.25	1292.00
14.	UTI Bank*	P.J.Nayak	0.94	659.03
15.	Sun Pharma	Dilip Shanghvi	0.84	461.29
16.	Infosys Technologies	Nandan Nilekani	0.41	2421.00
17.	Mahindra & Mahindra	Anand Mahindra	2.01	857.10
18.	VSNL	N.Srinath	0.73	479.36
19.	ITC	Y.C.Deveshwar	2.87	2235.35
20.	Tata Chemicals	P.R.Menon	1.33	353.03
21.	Tata steel	B.Muthuraman	2.20	3506.38
22.	Maruti Udyog	Jagdish khattar	1.47	1189.10
23.	ICICI Bank	K.V.Kamath	2.47	2540.07
24.	Cipla	Y.K.Hamied	7.88	607.64
25.	Wipro	Azim Premji	2.52	2020.48
26.	HDFC Bank*	Aditya Puri	1.79	1141.45
27.	Hero Honda	B.L.Munjal	15.58	971.34
28.	India Cements	N.Srinivasan	0.78	45.31

Carl Pearson's co-efficient of correlation between salary and profit = 0.664

P-value = 0.00006

Regression equation

Salary (Y) = 1.585 + 0.00211 * Profit (X)

Since the co-efficient of correlation is positive and P-value is less than 0.05, hence both salary and profit tend to move together in the same direction. Therefore, the null hypothesis is rejected. There is a linkage between salary of CEO and profit of company. There is a trend of performance-based compensation.

Table-3

Ho3 There is no significant difference between compensation paid to CEOs of Public and Private sector organizations.

Sr. No.	PUBLIC SECTOR CEO	Salary (in Rs. Crore)	PRIVATE SECTOR CEO	Salary (in R. crore)
1.	Vivek Saraogi	1.94	Mukesh Ambani	24.52
2.	Jagdish Khattar	1.47	Brijmohan Lall Munjal	15.58
3.	N.Srinath	0.73	D.Bhattacharya	4.69
4.	C.P.Jain	0.21	Martial G.Rolland	4.36
5.	C.Venkataramana	0.17	A.M.Naik	3.98
6.	Ashok Puri	0.12	Raymond Bickson	2.96
7.	Ashok Sinha	0.11	Y.C.Deveshwar	2.87
8.	S.Behuria	0.11	Deepak Parekh	2.48
9.	Mahesh Lal	0.1	K.V.Kamath	2.47
10.	Proshanto Banerjee	0.1	S.Ramadorai	2.44
11.	Y.Gopala Rao	0.1	Ravi Uppal	2.17
12.	R.S.Sharma	0.08	B.Muthuraman	2.2
13.	A.K.Khandelwal	0.05	Aditya Puri	1.79
14.	A.K.Purwar	0.05	Sanjeev Aga	1.79
15.	M.B.N.Rao	0.05	Ravi Kant	1.69

Mean	0.359	5.066
Standard deviation	0.578	6.38
No. of items	15	15

Calculated value of Student's 't'=2.846
Table value of 't'=2.467

(Degree of Freedom = 28 and 1% level of significance)

Since the calculated value of 't' is greater than the table value hence the hypothesis is rejected. Therefore, there is a significant difference in the salary of CEOs of Public and Private sector organizations.

Findings and Conclusion:

The analysis reveals the following important findings about the compensation of CEOs in India.

1. Promoter CEOs are getting more compensation as compared to Professional CEOs. The average annual salary of twenty Promoter CEOs is Rs. 5.52 crores as compared to Rs. 2.39 crores for Professional CEOs. The main reason for such a stark difference could be attributed to the fact that Promoter CEOs are getting a major component of their compensation (approx 80%) in the form of commission, which is linked to the profit of the company. The fact of ownership plays an important role for this situation.

2. The compensation of CEOs is related with the profitability of the organization. A high degree of correlation (0.664) substantiates this fact.

   However, it has also been found that the CEOs salaries are not linked to the profits and performance of the company. Far too many CEOs get paid large sums even when they don't perform. CEOs should be well paid when they do perform, but there is no justification for paying for non-performance. Due to this shareholders are demanding the *right to approve pay packages of top executives*. Following the tradition of British companies, "say on pay proposals", such demands are gaining momentum in the U.S. However, by not paying CEOs based on company performance, boards are failing to execute their responsibilities.

If this were to happen, who would determine these complex compensation packages? The Courts? The Securities and Exchange Board of India? External Governance gurus, who have no responsibility for the corporation's performance? None of these alternatives make sense. In fact, they threaten the very foundation of our system of governance. The real problem is paying enormous sums to CEOs who fail to perform. Our compensation system should be of taking risks and being rewarded for success, not on guaranteeing huge payouts to CEOs who destroy shareholders value.

3. There is a huge gap in the compensation being paid to the CEOs of Public sector and Private sector companies, which is reflected in their average annual package of Rs. 0.36 crores and Rs. 5.07 crores respectively. A possible reason for this is due to the fact that salaries of Government CEOs are guided by legislation and is subject to a high level of public scrutiny through the medium of Parliament and CAG audit.

4. The instrument through which the Government of India has traditionally controlled the executive compensation is the Companies Act 1956. Between 1969 and 1974, the Government had fixed a cap on the annual package of the executive director. Appointment of the directors also needed to be approved by the Government. Over the years Government has made several concessions to the rules and has allowed companies to appoint directors without its prior approval. However, broad limits on managerial remunerations still remain and are guided by Sections 198, 349, and 350 of the Act.

   So, what is the way out to compensate our powerful and aspiring business leaders in the wake of current economic scenario? Do we need to exercise restraint? How should boards manage the compensation of their executives or CEOs? I would like to suggest following guidelines, which could be helpful in resolving this controversial issue of compensating the executives.

- **Link compensation with the performance**: There is a general saying that wealth creation should precede wealth distribution. Growth in CEO pays sends a signal that rewards does follow hard work; it is also a powerful motivator for aspiring managers and business leaders. The pay could be linked to measures such as revenue growth, Economic Value Added, etc. Executive compensation should be tied up with the company's long-term objectives and based on the firm's economic value, not its stock price. Internal equity should also be given equal weightage between CEOs and their subordinates. They should be rewarded for the company's success.

- **Guaranteed salary should be paid less:** It is ironic that by guaranteeing CEO compensation, boards put their CEOs at minimal risk while putting employees at far greater risk. When CEOs in these firms fail, it is the employees who lose their jobs and their income, while CEOs pocket their guaranteed pay. The underlying cause of this problem is the failure of boards to develop their future CEOs internally, often yielding to investor pressures to hire a corporate savior.

CEOs in USA earn less than twenty percent of their compensation as guaranteed salary, and rest is "at risk" salary earned through bonuses. In India, the proportion of pay at risk is much lower, though this number has been growing. the band width of the salary should be broadened more.

- **ESOPs to be compulsory part of compensation:** To ensure commitment and accountability on the part of CEOs, Employee Stock Option Plan (ESOPs) should be a compulsory part of their compensation package and suitable guidelines should be put in place for this purpose.
- **Better transparency and disclosure practices:** Certain aspects of CEOs pay are rarely computed while arriving at total pay. Proper norms should be set keeping in view the disclosure practices being followed throughout the world. Boards and Remuneration committees need to play an important role in this regard as well as in ensuring the affordability of pay package.

Epilogue:

The Indian economy has grown at an unprecedented rate in the last few years, and corporate India has played a big role in job creation, infrastructure development and raising income levels. Shouldn't CEOs who drive this development and social reform be entitled to a fair share of the economic rewards? It becomes an imperative to analyze that are executives solely responsible for the profitability of organizations.

In India, where CEO's pay in general is not clearly out of control, any new legislation aimed at restricting executive's salaries will end up disrupting market dynamics. Salaries are a factor of the market. India is operating in an International environment today. If companies want the best talent, they will have to pay the market rate. External equity can't be ignored so easily.

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