



Getting the formula for CEO pay right

A value creation component is essential to better gauge the true increase in shareholder value. So too is a strong disincentive to discourage CEOs from acting unethically.

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IN his recent speech on building a culture of trust in the financial industry, Ravi Menon, managing director of the Monetary Authority of Singapore, observed that "compensation structures tend to over-emphasise profits as performance measures". We cannot agree more.

Although directors' remuneration remains a closely guarded secret known only to those who sit in boardrooms and compensation experts, it is widely known that most companies pay their directors based on the stock price and the company's level of profitability. A survey of directors' compensation by the Singapore Institute of Directors (SID) in 2010 and 2013 showed that the pay of executive directors is often fixed based on the company's financial performance.

However, the 2013 SID survey findings suggested that companies may be moving away from a profit-based metric as the sole determinant of CEO pay. In that survey, 81 per cent of the respondents cited the roles and responsibilities of the executive director as a factor in determining compensation, as compared to the second most popular factor: "results achieved" (68 per cent). Is this a sign of growing dissatisfaction with a profit-based metric for CEO pay?

The theoretical disadvantages of a profit-based metric for CEO pay are well-documented. The focus on profits may distort CEO pay through earnings management, spring-loading and back-dating of options. In addition, it may not accurately reflect the CEO's capability. An increase in the share price or the profitability of the company may not be due to the efforts of senior management alone, as wider economic factors may be at play.

Also, as Mr Menon posited in his speech, an overemphasis on sale targets and commissions has created a "trading mentality" which leads to "too much risk taking or scant regard for client interests or the sustainability of relationships". Coupled with "weaknesses in governance, risk management, and operational controls", this trading mentality has partly contributed to the spate of cases of misconduct in the global financial industry.

Many of the alternative metrics for CEO pay use some kind of "value-based" paradigm. For example, the economic value added (EVA) model seeks to derive the true economic profit of a company by deducting the full cost of capital from operating profits. CEOs would then be able to focus on developing business segments and product groups which add economic value for shareholders. Thus, CEOs are incentivised to increase shareholder value, to which their pay can be aligned with.

Companies can take a leaf out of Yahoo's books in how to reinvent a product line and increase shareholders' wealth. In 2013, Marissa Meyer, the CEO of Yahoo, began transforming the floundering technological giant into a force to be reckoned with by employing 360 mobile engineers. This bold move led to the creation of Yahoo's new mobile platform, propelling it back into the echelons of technological bigwigs, especially since 50 per cent of its users utilise the newly engineered mobile platform. In October 2014, Yahoo reported third-quarter sales of more than US\$200 million in mobile advertising revenue.

Also, the late legendary Steve Jobs famously said that "you just can't ask consumers what they want and then try to give that to them; by the time you get them built, they will want something

new". In fact, Steve Job's annual compensation was only US\$1 and he was rewarded entirely on stock options which depended on his ability to drive Apple's profits arising from product innovation in a highly competitive industry.

However, value-based models such as EVA also have their limitations. The unprecedented S\$20.52 million EVA bonus payment for 2007 by CapitaLand to its CEO remains a talking point as an example of excessive CEO compensation. Further, the EVA formulation in that case, which included one-off revaluation gains and without any maximum limit, showed up its shortcoming.

Generally speaking, as with any method of computing profits, figures for value-based models can be manipulated and tying CEO pay to value-based results may encourage CEOs to make short-term decisions which adversely affect the viability of the company in the long run.

A purely profit-based metric for CEO pay also fails to take into account incentives to act ethically. In his speech, Mr Menon advocated building a culture of trust and strong values in the financial industry while acknowledging the importance of compensation "to create incentives for the right behaviour". In his view, both high performance and high ethical standards should be driven by compensation structures. One example is the MAS requirement for a bank executive's compensation "to be aligned with not only the risks that the bank undertakes, but (also) the time horizon of those risks".

Executive compensation can also be aligned with ethical behaviour through the use of clawback provisions in directors' contracts. In a recent book, *Executive Compensation in Imperfect Financial Markets*, author Jay Cullen noted that the basic rationale of clawback provisions was that "excessive compensation which has been awarded on the basis of inaccurate financial reports ought to be recouped from senior executives culpable for those inaccuracies". In the same vein, Guideline 8.4 of the Code of Corporate Governance 2012 encourages companies to consider using contractual provisions to recoup incentive components of remuneration from CEOs in exceptional circumstances of misstatement of financial results, or of misconduct resulting in financial loss to the company.

In reality, however, clawback provisions may be difficult to enforce as, under Guideline 8.4, they are only triggered in "exceptional circumstances of misstatement" or "misconduct". Moreover, it is unclear whether the company must prove that the CEO is personally liable for the misstatement or misconduct. In particular, for misstatement of financial results, section 157C of the Companies Act may offer a defence as it permits directors to rely on reports and financial statements prepared by others so long as they act in good faith, make proper inquiry where needed and have no knowledge that such reliance is unwarranted.

Even though clawback provisions may offer only a limited form of protection for the company and its shareholders, they are still useful in signalling the relationship between ethical behaviour and CEO pay. Disappointingly, the 2013 SID survey findings revealed that 90 per cent of the companies that were surveyed did not provide for clawback provisions. Only 8 per cent of the respondents had used such clauses, while the remaining 2 per cent were considering including such clauses in the next 12 months.

It is well established that the profit-based metric distorts the CEO's incentives and fails to align pay with the CEO's performance. A value creation component such as EVA is essential to provide a more accurate gauge of the true increase in shareholder value, although it may not be easy to implement and has its limitations. Another critical component of a CEO's compensation structure is the need for a strong disincentive to discourage CEOs from acting unethically - the reluctance of companies in Singapore to use clawback provisions in agreeing on CEO pay must be overcome if we truly wish to entrench a culture of trust in any industry.

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