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Adaptation of executive compensation in COVID-19 crisis conditions

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Abstract: Executive compensations are one of the most important mechanisms of corporate governance. Adapting executive compensation enables better global competitiveness of business organization. In order to achieve and maintain a competitive advantage, each business organization develops an executive compensation model that supports organizational strategy. After the outbreak of COVID-19 pandemic, there were a large number of job losses, and many employees in different industries had to face with reduced salaries or lost income. COVID-19 pandemic also affected the earnings at the highest, managerial level. This paper deals with the analysis of the impact of COVID-19 pandemic on executive compensations, and their adjustment to difficult business conditions and reduced profitability.

Keywords: Executive compensation, COVID-19, crisis management, risk management

1 Introduction

Executive compensation is very important mechanism of business governance. By modeling executive compensations, better competitiveness of company in the global market is achieved. The executive compensation strategy enables the realization of targeted performances. It is necessary to constantly develop compensation models and base them on targeted business performance, in accordance with the company's strategic goals. For competitiveness achieving, each company develops a specific executive compensation model, as a support tool for the strengthening of business strategy.

The business strategies of the companies faced the unpredictable and strong impact of COVID-19 pandemic, which resulted in a significant slowdown in macroeconomic activities. The contraction in macroeconomic activities was expected to overcome the 2008-2009 global economic crisis. Negative macroeconomic effects differ between national economies, depending on the measures of social distancing, and the length of its implementation. Due to the strong influence of COVID-19 pandemic, companies have faced the problem of implementing compensation strategies, especially when it comes to rewarding

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managers, as the highest hierarchical structures. The amount and structure of executive compensations are defined by contracts concluded between managers and shareholders, so any change in them is conditioned by contractual regulations.

From a long-term perspective, the changed macroeconomic conditions imply the adjustment of executive compensations, especially since the duration of COVID-19 crisis cannot be predicted. Adjustments include harmonization of short-term and long-term incentives with the achieved performances in crisis conditions, with the consent of shareholders, as well as harmonization of existing regulatory restrictions.

2 Literature review

Business owners strive to maximize the return on investment, while accepting the appropriate degree of risk, which means designing compensation models that motivate top management to make business decisions that will satisfy their interests (Firth et al. 1996). Rewarding managers should be based on the achieved business performances, in order to motivate them, while avoiding the encouragement of inadequate business performances, and encourage rational risk-taking (Eduardo, 2009). Compensation is based on the achieved business performances and may include: cash bonus, stock options, right to share purchase, share in the achieved result (Gitman, 1997). Jensen and Murphy (1990) in their studies emphasized the importance of several compensation components: stock options, bonuses based on performance, payroll amount revisions, and firing managers depending on unfulfilled targeted performances.

The relation among executive compensation and achieved targeted performances has strengthened over time. Hall and Liebman (1998) argue that this relationship doubled after 1981. According to research by Bertrand and Mullainathan (2001), companies that have a firm corporate governance structure have a deep pay-performance relation.

Recent theoretical papers do not only study the pay-performance relation, but also investigate the impact of other potential factors on executive compensation. First of all, the following factors are important: risks, human resources, managerial skills, social similarities, power, reputation, and the influence of core stakeholder groups. Subsequent research has also examined the role of risk in modeling executive compensation (Garvey – Milbourn, 2003; Conyon – Sadler, 2001). These studies have concluded that the volume and structure of managers' compensation is depending on many different factors specific to a particular company, and managers as bearers of governance with their individual characteristics.

The executive compensations trend after the global economic crisis 2008–2009 is on the ascending path again. Thus, the average monetary executive compensation increased from 6,435,000 US dollars (2009) to 12,553,000 US dollars (2019) (Bout – Wilby, 2021). The consequences of executive compensation are increasingly gaining the attention of scientific community. Current research topics are: the impact of compensation policy on management decisions (investment decisions, risk-taking, acquisition); as well as the impact on future business performance. Recent research also addresses the issue of rapidly increasing executive compensations. The authors explain this with better incentives, increased importance of general skills (Frydman, 2008; Murphy – Container, 2004), changes in communication technologies, increased power of managers (Bebchuk – Fried, 2003) and companies' growth (Gabaix – Landier, 2008).

3 Methods

The paper uses several scientific research methods, which are commonly used in the social sciences. The historical method and the comparative method were used to investigate the social phenomenon of executive compensations. The historical method starts from monitoring social phenomena and processes, taking into account the time dimension of research. The comparative method is used in the process of researching social phenomena using similarities and differences as research instruments. The paper also uses the method of content analysis, in order to determine the presence of certain ideas in the field of executive compensations.

In addition to the above, standard methods of induction and deduction, analytic and synthetic methods were used. By the inductive method, individual and special facts were connected into general conclusions. The deductive method was used to draw individual conclusions from general attitudes. The analytic method was used to extract the most important elements from the whole, and to observe the relations between them. The synthetic method served to connect individual elements into an integral whole that expressed a new whole of the paper.

4 Results and Discussion

Factors that contribute to the executive compensation model are: company size, risk, the possibility of company growth, capital structure, managers' age and ownership structure (Polak et al. 2014). The company size is important factor of executive compensation amount and structure. The largest companies need highly skilled and experienced managers, and they expect compensation to be aligned with the responsibilities of their position. The capital structure is a significant factor of the amount of basic salary, since it is one of the most important executive compensation components. The company's ownership structure also is an important factor of basic

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salary volume. Most state-owned companies generally apply lower executive compensations, as opposed to privately owned organizations. The applied executive compensation model is also depending on the managers' age. Older executives are aiming at long-term goals; younger ones focus on goals in a short-term period. The length of engagement, the acquired skills and experience of managers, are also related to compensation expectations.

Implemented executive compensation model should promote competitiveness, compared to companies form the same industry sector. Rewarding should also be sufficiently alluring, and contain different compensation components (Marinovic-Matovic – Marinovic, 2011). Some compensation components should provide security and the standard of living, such as basic salary. Other, especially incentives, should be aimed at motivating managers to achieve the targeted goals. The structure and volume of executive compensation is not unique, and should be the best choice of every company.

The pandemic caused by COVID-19 virus has resulted in a significant slowdown in macroeconomic activity. According to the first forecasts of the International Monetary Fund (IMF, 2020a), expectations were that the decline of the global economy would amount to about 3.0% in 2020. According to Baker et al. (2020), the COVID-19 pandemic has led to enormous business unsecurity, with which historical parallels cannot be drawn. Industrial production fell by an average of about 28% in the G20 countries between February and April 2020 (OECD, 2020). The prognosis of recovery remains uncertain and depends on the final control of COVID-19 pandemic.

Following the outbreak of COVID-19 pandemic, control measures have resulted in a sharp drop of employment in all world economies, as many employees have been laid off, or their employment contracts have not been renewed. According to the International Labour Organization (2020a), in the first three months of 2020 (January-March), a loss of 5.4% of global working time was recorded, equivalent to 155 million jobs, compared to fourth quarter of 2019. Comparisons of the second quarter of 2020 and the fourth quarter of 2019 show that global working hours are down by 14%, or 400 million jobs (International Labour Organization, 2020a). The International Labour Organization estimated that global job losses in 2020 amounted to 114 million, with the share of lost working hours being highest in Europe (6.0%), the United States (2.7%), and in Arab countries (1.7%) (International Labour Organization, 2020b).

With the spread of pandemic and the closure of a large number of jobs, a part of the working-age population was left without part or all of their income. Many employees had to accept shorter working hours and / or pay reductions in various industries. According to a research study conducted in late March 2020, by Adams-Prassl et al. (2020), 11% of study participants lost their jobs due to the outbreak of COVID-19 pandemic in the United States, and 8% in the United Kingdom. In early

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April 2020, the share of the unemployed rose to 18% (USA) and 15% (UK), while in Germany 5% of respondents lost their employment at the begining of April 2020 (Adams-Prassl et al. 2020).

According to the IMF analysis (IMF, 2020b), the recovery of the global economy began in the third quarter of 2020, although the negative effects of the crisis will be present in all macroeconomic segments for a long time to come. The IMF estimates that per capita income will remain lower for several years than it was before the pandemic, which will have a negative impact on productivity (IMF, 2020b).

Regarding executive compensations in the changed macroeconomic conditions, as a result of COVID-19 pandemic, different reactions of companies have been noted. According to Glass, Lewis & Co. (2021a) survey of more than 5,000 USA and Canadian companies, only 273 reported adjustments of the amount and structure of executive compensations after the outbreak of COVID-19 pandemic. The most common was the reduction of basic salaries, followed by the reduction of other material components of executive compensation, while other changes were recorded in a smaller percentage. Figure 1 shows the adjustments of executive compensations in the conditions of COVID-19 pandemic.

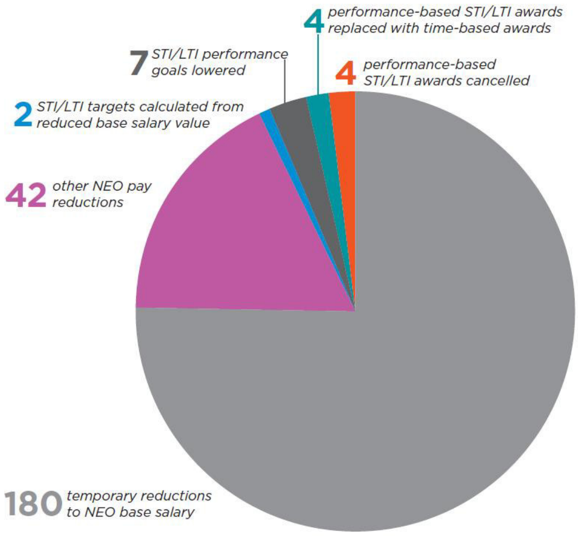

Figure 1. Adjustment of executive compensation in COVID-19 conditions
Source: Glass, Lewis & Co. (2021a) available:
https://corpgov.law.harvard.edu/2021/02/18/executive-compensation-in-the-context-of-the-covid-19-pandemic/

According to Bout and Wilby (2021), the salaries of managers in 2020 were potentially reduced by 3% to 4% due to a decline in the amount of bonuses in many companies, that reported worse business results after the outbreak of COVID-19 pandemic. It was expected that the average amount of executive compensations would be slightly increased at the beginning of 2021, because some companies would provide "supplemental grants"for their managers, in order to compensate for non-payment of obligations from 2020. In 2021, a potential increase of stock options is expected, due to the harmonization of long-term plans of companies, after a year of working in crisis conditions coused by COVID-19 pandemic (Bout – Wilby, 2021).

Despite the strong impact of COVID-19 pandemic on business results, in the near future companies may be restricted to apply the changes in the amount and structure of executive compensation, due to the restrictions of contracts concluded with their top managers (KPMG, 2021). As an alternative, companies have the option of reducing the basic salary or targets for achieving incentives (KPMG, 2021). Changes to these compensation components are generally not regulated by contract, and do not require the approval of managers or shareholders. Table 1 shows the possible short-term adjustments of the structure and volume of executive compensations, as well as the advantages and disadvantages of the measures taken.

Table 1. Short-term adjustment of executive compensation in COVID-19 conditions

1. Approach	2. Advantages	3. Disadvantages
4. Cut base salary	• Can align executives with broader employee actions • Immediate cash flow savings	• Shareholders generally do not give much credit • Can backfire when salaries are restored and companies report pay increases • Risks angering executives
5. Cut/eliminate annual incentives	• Longer-term cash flow savings • Immediate accounting impact/expense savings	• Potentially demotivating to team; particularly if performance improves at an accelerated pace • Removes (if eliminated) tool for CEO to galvanize team and drive behaviors

Source: KPMG. (2021)

Available: https://home.kpmg/xx/en/home/insights/2020/07/covid-19-executive-compensation.html

From a long-term perspective, companies need to adjust executive compensations to changed business conditions, depending on the duration of COVID-19 crisis. First of all, the adjustment of short-term and long-term incentives is necessary, which requires the consent of shareholders, as well as compliance with various regulatory restrictions (KPMG, 2021).

The adjustment of the volume and structure of executive compensations should be explained, regarding the impact of pandemic on the achieved business performances. It is necessary to explain both the causes that lead to the adjustment of compensation, and the consequences that may occur if executive compensation is amended, in terms of retaining managers, maintaining their engagement at a high level, or achieving business performances in difficult business conditions (Glass, Lewis & Co, 2021b).

The crisis caused by COVID-19 pandemic has led to a consideration of business performance which should be linked to compensation, with the aim of high motivation of managers. When adjusting executive compensation, companies need to decide whether to reward managers for unforeseen risks, or to take on greater risks in difficult business conditions (Zattoni – Pugliese, 2021).

Conclusion

Achieving and maintaining competitiveness and long-term success of the company requires top quality managers. Attracting and retaining quality managers requires adequate executive compensation models. Executive compensation models, and the management of these models in order to improve business performance, have been the subject of research interest for nearly a century. The research of executive compensation is directed towards adequate motivation of managers, as well as concerns for equality and fairness.

Although the global economic system has shown a satisfactory level of resilience to the effect of COVID-19 crisis, the predicted loss of the global economic production by 2025 is up to 28 trillion US dollars, while 120 million jobs will be lost permanently in the tourism sector alone. The latest macroeconomic indicators have implied an economic recovery, although the duration of the COVID-19 crisis is difficult to predict. Macroeconomic recovery in Europe and the United States has slowed due to the emergence of new variants of COVID-19 virus, latest movement restrictions, and declining of social and economic activity. Updated forecasts point to a longer-term negative impact of the pandemic on global macroeconomic indicators, with a slower rate of economic growth over the next few years.

Regarding executive compensation in the changed macroeconomic conditions, as a result of COVID-19 pandemic, different corporate strategies have been implemented. The most common is the reduction of basic salaries of managers, followed by the decrease of other material components of compensation, while other changes were applied in a smaller percentage. From a long-term perspective, companies need to adjust executive compensations to changed business conditions, especially depending on the lasting impact of COVID-19 crisis.

Executive compensation adaptation measures can’t be universally applied in all companies whose business is affected by COVID-19 pandemic. The volume and structure of compensation should be adjusted according to agreement between all stakeholders, and possible solutions should be harmonized with current microeconomic trends. The adaptation of executive compensation should be coordinated with the measures applied to other employees in company, since COVID-19 pandemic has led to a reduction in number of employees, salary cuts, and decrease of working hours in many companies.

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