

Research on the correlation between corporate compensation and CEO from a new perspective

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Abstract: This essay focuses on the ideal salary contract the companies should make if the amount of reward does not actually increase. This essay utilizes a lot of secondary resources as the base for research to learn about the ways that Tesla runs and how it corporates with its CEO. It will discuss the preference of CEOs and companies, and make a conclusion about how this contract might encourage CEOs to work harder and bring more profits to the company. This essay will discuss the reason for the high salary phenomenon for CEOs and thus analyze the way that might motivate CEOs to spend more effort on the work. Theoretically, the conclusion of this essay might provide a rationale for developing new corporation method. It can also provide more suggestion for the companies in real practice.

1. Introduction

CEOs are essential for the company's development since they are usually asked to design the way the company is going to work and help the company to earn as much profits as possible. In 1930, a company called Kodak had about 75% of the whole market for cameras, but as the better equipment occurred, Kodak finally broke up. The shrinking market was not the only factor that caused its failure—the CEO's bad decision also brought troubles to the company. Thus, it is essential for the company to choose a perfect CEO that can lead the company to flourishing. However, CEOs require benefits to join the companies.

CEO's salary has been always increasing in these years. If people rank CEOs by talent, and replace the top CEO by CEO number 250, the value of his firm will decrease by only 0.016%. However, these very small talent differences translate into considerable compensation differentials, as they are magnified by firm size. The same calibration delivers that CEO number 1 is paid over 500% more than CEO number 250. The use of discretionary accruals to manipulate reported earnings is more pronounced at firms where the CEO's potential total compensation is more closely tied to the value of stock and option holdings. In addition, during years of high accruals, CEOs exercise unusually large amounts of options and CEOs and other insiders sell large quantities of shares [1].

CEO's contract usually contains salary, bonus, and stocks. Sometimes, there might be some shared profit based on the performance of the company. These kinds of contracts make up of the main part of CEO's income. They usually reflect the profit brought by the investment of human resource of CEOs. This kind of investment can be risky because they must invest on one particular company for a relatively long period of time. Because of these risks, CEOs can ask the company to pay them with more profits [2].

The essay is based on the theories that CEOs are not always willing to take risks, so while discussing about their salaries, it becomes essential for us to discuss if the salaries should contain more monetary or more stocks as rewards, and to figure out if the company should provide the CEOs with more short-term salaries or long-term salaries. The long-term salaries are believed to be riskier and might not be fully gained if the CEOs do not achieve their goals during that period. Long term salary contracts can usually make sure that CEOs will be less willing to quit the job, but also means that they become less willing to work at the company because of the possible risks during their working time might cause a

huge decrease in their salaries. Some companies might use valuation adjustment mechanism with their CEOs, and if the CEOs do not achieve the goal, the money they finally get will be really low, and they might even have to pay the company some compensation because of the low benefits provided to the company which makes it to be unhappy with [3].

2. Data and method

2.1 Data

The evaluation and data of this essay is based on Tesla. Tesla's battery energy storage business is booming, while the solar branch is showing signs of improvement.

In Q4 of 2020, Tesla Energy revenues amounted to \$752 million (new record), while the cost of revenues stands at \$787 million. It, unfortunately, means a negative \$35 million result and a gross margin of negative 4.7%, but if the company is expanding the business, we assume it's under control. Tesla Energy accounted for 7.0% of the total revenues in the quarter. The CEO of Tesla, Elon Musk, owns 21% of Tesla but has pledged more than half his stake as collateral for loans; Forbes has discounted his stake to take the loans into account [4]. This essay is basically based on the salary contract of Elon Musk with Tesla, to show a successful example of the benefits of a perfect salary plan which can earn a lot of profits for both the company and the CEO.

2.2 Method

In this essay, we analyze the type of compensation plan of the company with Musk and make further explain and develop it. Based on this compensation plan, this essay is going to analyze the best way for a company to make a contract with its CEOs so both the company and CEO will get their profit maximized. The essay discusses about the benefits and troubles that might be brought by certain kind of salary contracts, so it can provide an efficient and profitable way for the companies to make their own contracts with their CEOs.

3. Results and discussion

3.1 The research background

CEOs usually require a huge amount of benefits as the awards of their work, and it might cost a huge amount of money. The company wants CEOs to work harder and bring more profits to the company. As a result, CEO's salary and how it is paid is always what the companies care the most. If the salary was too high, the company might lose profits, while a low salary is not enough to motivate the CEOs to work hard. According to the research from Lois Schafer Mahoney and Linda Thorn, the higher the salary of CEO is, the more they are willing to work for the company's development, improve the company's reputation and make decisions that are better for the stakeholders [5]. The CEO usually have a relatively high salary then other people, and the motivation mechanism for them can be divided into monetary and non-monetary. Non-monetary motivation includes improvement in reputation and increase in the term of office, while monetary motivation includes real money and stocks. Non-monetary motivation can help motivate CEOs to work harder, but monetary motivation will be much more effective [6]. In the short term, salaries will be a more direct motivation for the CEOs, while stocks can work better in the long term. As a result, this essay will mainly discuss about the monetary motivation for the CEOs.

Most companies decide to use both salary and stocks as rewards for the CEOs, so they are more willing to work in the company for either short terms or long terms. Mostly, the CEOs get more stocks as salaries instead of real money, and that's because the companies want these CEOs who are talented to stay for a longer time in the companies. As the CEOs get the stocks and they work harder, the companies will gain more profit, which is shared by the CEOs, thus motivate them to work harder and longer so they can earn more profits. Besides, if the CEO is going to leave, the company must take a lot of time to look for another CEO and to deal with the problems left by the previous CEO. All these

troubles will cause a great loss to the company, so most companies tend to avoid this situation and try to keep them at the company as long as possible.

3.2 Operation mechanism

Different companies have different ways to deal with the salaries. Some companies tend to pay the salary every month or every year, while others might prefer to pay less often. Most of the CEOs salaries are given depended on their performance. The less often the companies give salaries, the harder usually CEOs will tend to work. People found out that about 90% of CEOs are overconfidence [7]. These CEOs always think they are better than other people in the team, and are too optimistic about the situation. Overconfidence might bring a huge lost to the company since CEOs are directly related to the company's income. However, in a longer term, the CEOs tend to become less confident since they are not sure about the situation in few years later. Investment is significantly more sensitive to cash flow among this group of CEOs than among their peers. This measure conflicts with an interpretation of the findings based on stock liquidity. In addition, by relating personal portfolio decisions to corporate investment decisions in disjoint time periods, it provides further evidence that signaling and inside information cannot explain the findings. As a result, a contract that give CEOs salaries less frequently can usually bring more profits to the company [8]. For these kind of contracts, valuation adjustment mechanism is a more special example. These contracts make people gain no money if they did not reach the goal, and even give compensation to the company if the difference between the result and the goal is too big. Elon Musk, the CEO of Tesla, made a contract with the company that, he will not get any money in ten years for his work, unless he raised the market value of the company to 650 billion dollars. If he reached the goal successfully, he would gain stocks which worth 55.8 billion dollars. This seemed to be a risk-taking decision, since any accident might take away all the rewards, but it was a way to motivate the CEOs to work harder. CEOs will not get any base salary, so the final award is really meaningful to them, and they have to work hard or they might lose the job opportunity and all the salary. Since a small accident might decrease the market value greatly, for example the outbreak of Covid-19 in 2020, the CEOs tend to work harder, try to earn more than the goal required.

Usually, people do not have the incentives to try something hard, because these things are not necessary for them. They can get all the things they need by doing something easier and safer. However, with a contract like this, people will be motivated to spend more time on their works and try to be as successful as possible in the project, because they have nothing to choose but to work harder and achieve the goal. It reduces the possibility that people want to give up in the middle, because in this contrast, they will not get any money during the ten years, and if they just give up, all the energy they spent is going to lose for no returns. Eventually, people will just try harder and harder to gain the reward. After earning it, the satisfaction brought by the reward can let these people forget about all the pain, enjoy the reward, and continue to work on the second goal. Take XinJiang Torch company as an example, it made a valuation adjustment mechanism with a few other companies that, from 2013-2017, the profit earned by this company should not be lower than 50 million, 60 million, 70 million, 70 million, 70 million yuan relatively. If the company did not reach 85% of the goal, it had to pay 5 million yuan back to those companies as compensation. Instead, if it reached the goal successfully, those companies that invested would give XinJiang Torch a reward of 5 million yuan. The valuation adjustment mechanism motivated the company to earn more profits and work harder. And as the result, the profit of the company in those 5 years was 60.07, 80.56, 99.03, 116.60, 85.26 million yuan relatively, which was much higher than the goals made before and better support the theories [9].

3.3 Influence Factor

Many companies will not make a valuation adjustment mechanism with their CEOs even with such appealing benefits. The problem is that such mechanism is too risky for people that are not totally confident with their abilities. The CEOs usually require a high salary for their living, but with such mechanism, it might turn out that they get nothing after their work, even if they just have a tiny difference between the result and the goal. For Tesla's CEO Elon Musk, he made a contract that last over 10 years, which was too risky. It is true that they will gain both properties and reputation, but they

have to face the situation that they might lose everything and owe the company a huge amount of compensation that they are not affordable at all. In one case, company A bought all stocks of company B at the price of 4.75 billion yuan, to lower the cost, they made a contract that company B should earn enough money in the next few years. Company B did not reach the goal and finally gave company A a compensation of 1.68 billion yuan. In this case, company B did not success probably because the goal it promised was too high, even if that industry was flourishing in those years, company B was not able to reach the goal. Besides, company B did not have the whole control of the company, which led to its failure. People can learn from the failed use of valuation adjustment mechanism and utilize it for the CEOs [10].

3.4 The solution

For most companies, it would be perfect if they utilized the valuation adjustment mechanism and added some base salary for the CEOs. The base salaries would better be at least twice as much as the salaries of the employees, so CEOs have the motivation to finish their daily work that is much harder than those of normal employees. For most CEOs, which are not willing to take risks, they require a base salary to ensure their life qualities. However, the bonus for the valuation adjustment mechanism would better be at least 5 times as the basic salary they will get during that period. That's because if the bonus was too low, the CEOs will never be motivated to work really hard to get the little amount of bonus. They will just be willing to work until they reached the lowest limit for not getting punished. The base salary can be reduced by increasing the bonus, so it can still attract CEOs that are confident with themselves. The low base salary and high bonus will be more useful for the companies that want to find the CEOs that are really talented no matter how long it takes. The CEOs can gain more profits through the contract and the profits brought by them will benefit the company greater, so it is a win-win solution. However, if the company does not have enough time to look for one talented CEO, they should probably increase the base salary, or the normal CEOs who do not have the ability or willingness to take the challenge will not take this job opportunity.

4. Conclusion

The CEOs do not wish to take risks, but they have greater desire to get more profits when they are confident of themselves. As a result, the company should provide CEOs with a salary contract that contains both short-term awards as the basic salary to reduce the risks and long-term awards as motivation for CEOs to work harder and stay for a longer time in a company. If there is no base salary, some CEOs who are not totally confident and are afraid of meeting some accidents might just quit because they do not want to get a relatively low reward after working for several years which is totally not enough to support their daily lives. If there are no long-term awards, CEOs will become less willing to work hard. They are able to get the base salaries no matter how they do in their daily works, so they will try to spend minimum energy to achieve the basic requirement. The basic salary should be relatively low, or CEOs will become less willing to reach the goal and get the extra awards since it might require a lot of energy and they do not feel like the awards worth it. The compensation plan of Tesla is a special example that Elon Musk gets totally no basic salary and even a valuation adjustment contract. The benefits brought by this kind of contract is very clear that CEOs will be always try their best to solve the troubles and bring as much profit as possible to the company since they do not want to take the risk and they are sure that they can do so. However, the problem is just that the companies might spend a lot of time to look for CEOs that are confident and able to achieve the goal.

The salary plan should contain some stocks as awards or salary, not just monetary rewards, because this might motivate CEOs to work hard. Elon Musk's contract contains no monetary salary, which means that he will get more profits as the company earns profits since he holds about 21% of Tesla's stocks. Nevertheless, monetary awards might also help CEOs, since actual money usually seems to be more attractive, and people usually enjoy the feeling of owning money in their bank account instead of stocks with a huge worth. So for most companies, it should provide CEOs monetary awards as salary or long-term rewards, but not as all of the salary. By doing so, the company can maximize the

profits of itself, while providing CEOs with an appealing salary and award at the same time. As a result, both company and CEO will be willing to make a long-time contract with each other, and thus avoid the problems of spending too much time on finding another person to take the job for the company and the ones of having troubles finding another job opportunity which might provide an even worse salary treat. As a conclusion, it will be a win-win solution for the company to include stocks as well as money as awards for CEOs in both shorter term and longer term.

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