Executive Compensation and Agency problems

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In most of the publicly traded companies, shareholders do not engage in the day-to-day running of the corporation. Instead, the executive managers and directors do the role of running the corporation on a day-to-day basis. Nyberg et al., (2010) observe that shareholders of a corporation delegate decision-making authority to the managers and directors, in what in finance and economics literature is referred to agency relationship. This separation of powers seeks to enhance corporate governance structures through separating ownership from management. Shareholders delegate decision-making authority to management expecting the management to act in shareholders' interests of maximizing shareholders' wealth.

However, this may not be the case as the management may pursue self-interest, which does not maximize shareholders' wealth, consequently giving rise to agency problems. Some of the ways that management may abuse their power include empire building, awarding themselves long-term employment contracts, severance agreements and other personal enrichment plans that do not add economic value to shareholders. When managers seek self-interest at the expense of shareholders' wealth, a corporation falls because of eroded value. Therefore, there is a need for executive managers and directors to pursue shareholders' interests in order to maximize shareholders' wealth and build a strong corporation. Extensive research on ways to solve agency problem proposes that executive compensation plans converge the interests of shareholders and manager, and hence it is an effective way to mitigate the costly consequences of the separation of ownership and control. This report seeks to discuss critically how managerial compensation can be used to solve agency problems.

Agency Powers and Agency Problem

Geiler and Renneboog (2011) explain that agency theory propose that agency is a relationship between a principal and an agent; the agent represents the principal in transactions with a third party, therefore any decision that an agent makes on behalf of the principal impacts on principal's welfare. Agency relationship, at the beginning of the twentieth century was introduced in the running of large companies. Ross, Westerfield and Jaffe (2005) observe that the corporate structure of separation of powers between the management and owners of a corporation has resulted in the growth of corporations in the developed countries. However, the success of agency relationship has been with problems due to conflict of interest between the management and shareholders. For instance, managers may be willing to pursue short-term interests while shareholders may be looking to pursue long-term interests to maximize the shareholders' wealth in the long-term. Thus, a need to resolve such kind of conflicting interests between the parties. Bebchuk and Fried (2003) citing Jensen and Meckling (1976), who were the first scholars to research on agency problems, asserts that conflicting of interest between management and shareholders can be solved through managerial monitoring and incentivization. Kim and Nofsinger (2004) term the cost that shareholders' incur to resolve conflicting interests between shareholders and management as agency costs. Agency costs include the sum of expenditure that shareholders spend to monitor managers, cost of managerial incentives to maximize shareholders' wealth and residual loss to the firm's value. Thus, agency costs can be viewed, as real transaction costs determined by corporate structures of a firm and borne by shareholders of a firm to ensure that managers engage in activities that maximize shareholders' wealth. Early financial economists argued that managerial compensation is a tool that the owners of a firm can use to ensure that managers pursue shareholders' interests. However, Bebchuk and

Fried (2003) hold contrary views stating that executive compensation is an agency problem because managers may use their powers to dictate their compensation, which may not be tied to wealth maximization objectives of shareholders.

Ross et al., (2005) observe that prolonged agency problems that manifest as conflict of interest between shareholders and management lead to a reduction in the value of a firm because of ownership dilution. The scholars explain that conflict of interest between owners and managers of a firm is because of four major reasons. The first reason is that managers prefer to invest in projects with short-term horizons while shareholders prefer long-term investment horizon. The second reason is that managers are risk averse and seek less risky investments with low financial leverage unlike shareholders who have a high-risk appetite. The third reason is that managers prefer engaging in activities that do not decrease their remuneration levels and firms' value, thus the engage in less intensive tasks of high consumption levels. The fourth reason is that managers dislike changes in control of a company because it results in reduction in employment levels. In addition, Bebchuk and Fried (2004) opine that managers may engage in value expansion activities through increasing the size of a firm, though it may be against shareholders' interest and wealth maximization goals. The desire of managers to build business empires, which may be against the interests of shareholders, is to serve personal interests through gaining prestige and greater remuneration. Therefore, solving conflicts of interests between shareholders and managers can be resolved through providing managers with incentives to align their interests with the interests of shareholders that maximize wealth. Managerial compensation influences managers and directors to be aggressive, and to take up risky long-term investments to increase shareholders' wealth.

Executive Compensation Plans

Kim and Nofsinger (2004) explain that managerial compensation through stock options and stocks link managerial performance to the firm's value, thus aligning shareholders' interests of maximizing wealth with managerial performance. Dow and Raposo (2005, p.2701) assert that executive compensation influences the strategies that managers and directors take on running a firm. Therefore, executive compensation plays a critical role in aligning managerial interests with shareholders' interests. Anson et al., (2004) recommend that a good executive compensation plan should reward managers and directors based on performance. Therefore, the management of a corporation will align their interests with that of shareholders and in the process enhance corporate governance structures in the firm. The authors continue to state that a good executive compensation plan should be based on the following broad principles. The first principle postulated by Anson et al., (2004) is that an executive compensation plan should be designed to ensure that shareholders' long-term interests are aligned with management interests to avoid conflict of interest between the two stakeholders in a firm. The second principle of a good executive compensation plan is that managerial compensation should be a hybrid of cash and equity based incentives. The third principle states that executive compensation should be transparent. Nevertheless, Bebchuk and Fried (2003) argue that the executive compensation program may not be effective in aligning long-term shareholders' interests with management interest because the compensation plan is vulnerable to abuse because shareholders of a public traded corporation do not bargain at arm's length with executive management, thus managers are able to influence their pay, creating agency problems.

Anson et al., (2004) reckon that managers setting their own pay are an agency problem that may hinder alignment of shareholders' interests with those of shareholders and thus propose that corporations set guidelines to be adhered by executive management and shareholders in bargaining and setting compensation for the executive management. Anson et al., (2004) continue to assert that, for a compensation policy to reduce the agency problem, it should include a mix of long-term incentives, equity ownership, bonuses and base salary. The compensation plan should identify drivers of bonus and other compensation incentives. Anson et al., (2004) enumerate that drivers of incentives and bonus pay could be return on equity, stock price, return on assets or return on capital employed. The compensation policy should explain how equity is distributed, which include warrants, rights, options, stocks and other equity based grants are to be exercised as they dilute ownership. Lastly, a compensation policy should outline how managers are to be awarded severance packages such as golden parachutes and exit perquisite. Due to the imperative nature of executive compensation and maximization of shareholders' wealth, Anson et al., (2004) reveal that the institutional investors such as CaIPERS and investor activists developed a model to evaluate whether levels of executive compensation in public traded corporations were justified. The CaIPERS compensation model is based on compensation metrics, financial metrics and scoring methodology to give a relative score on performance against compensation.

Figure 1. A change in executive compensation against S&P 500 index.

Exhibit 1: S&P 500 Executive Compensation

Compensation Category	2001	2002
Median Salary	10.1%	4.2%
Median Bonus	-17.6%	8.8%
Stock Options	43.6%	-18.6%
Restricted Stock	-21.0%	1.3%
Overall Compensation	26.7%	-10.9%
S&P 500 Total Return	**-11.90%**	**-22.00%**

Source: Anson et al., (2004). *Aligning the interests of agents and owners: an empirical examination of executive compensation*. IVEY Business Journal.

Managerial Compensation, a Solution to Agency Problem

Following the recent economic recession CEO scandals and government bailouts, executive compensation, particularly in the United States of America has gained immense media coverage. The United States federal government in the process has been involved in scrutinizing executive compensation, which includes base salary, bonuses, equity options and equity ownership, as they demand accountability and transparency in the corporation they rescued from collapse. One of the causes of the near collapse of financial institutions and other corporations in the United States of America was executive managers' powers to pursue strategies that were aimed at value addition and not maximizing shareholders' wealth. For example, mortgage companies in the United States of America issued mortgage loans, subprime loans, to households with high default probability, thus growing business and eroding shareholders' value. Following the bubble, mortgage companies that were trading in subprime loans were left holding worthless assets on their books, eroding shareholders' wealth. Therefore, there is a need to ensure that executive

managers engage in activities that managers do not engage in activities that maximize personal interests at the expense of shareholders' interests. Empirical studies suggest that executive compensation influences executive managers to pursue strategies or engage in activities that maximize shareholders' wealth, which is the long-term objective of enterprises. Dow and Raposo (2005, p. 2718) elucidate that executive compensation tied to performance creates an incentive for the management to pursue strategies that are of interest to shareholders since they are in charge of strategy formulation and implementation in a firm. Executive compensation should be tied to long-term investment value of a corporation. This is to encourage managers to take up investments with a long-term horizon, which will not add value to corporate stakeholders but to the society in general. One way of providing incentives to executive managers to pursue investments with long-term horizon is to award executive managers stocks, options and warrants that will vest in the future. The executive managers that include top management team will pursue activities and goals that will maximize shareholders' value in the future. As a result, align shareholder's interest, which is wealth maximization with management interests. This view is upheld financial economists and scholars studying the relationship between executive compensation and agency problems. For example, according to Ross et al., (2005) equity and other equity based ownership arrangement for executive manager's controls consumption by managers and their preference for short-term investment horizons. The scholars argue that as managers increase ownership level in a firm, they tend to be more prudent and cautious in their investment as undertaking overly ambitious investment will lower their wealth, which is tied to the stocks they hold in the corporation. Similarly, the voting right based on share ownership by the managers is a means to curb agency problems. Deferred compensation is another executive compensation plan linked to performance. Under the deferred compensation plan, the retirement

and the exit package for executive managers is linked to long-term performance of a corporation. Therefore, encouraging executive managers to engage in projects with positive net present value that will increase both the value of the firm and retirement package for the executive managers. Bebchuk and Fried (2003) argue that equity ownership by executive management is a form of risk sharing because under a fixed compensation scheme, managers will be less be encouraged to seek profitable projects since residual risk is borne by shareholders only. However, compensation linked to performance results to optimal risk sharing and returns between management and shareholders.

Murphy (2002) observes that besides long-term financial performance and enterprise value, some corporations also pursue short-term goals and objectives. Lo, Ghosh and Lafoitaine (2011) observe that short-term performance metrics are commonly used in evaluating sales and marketing executive managers, using periodical sales and profits. However, this system is ineffective as it suffers from timing problems and exogenous shocks. Executive managers under compensation linked to current performance may undertake projects that yield short-term gains but with long term costs, resulting in negative present value in the future. For example, executive managers may forego future investments to increase dividends, increasing stock price in the short term and bonuses to go up. Foregoing future investments will result to long-term value problems for the firm. Similarly, managers could be discouraged to invest in projects with high short-term costs but long-term gains, affecting a firm's long-term value. Business environment is susceptible to exogenous shocks, factors beyond management control. In cases where compensation is linked to current performance, exogenous shocks have adverse effects on compensation to executive managers, thus discouraging management effort. Compensation

linked to current performance has been criticized by scholars because it goes against the main objective of a firm. Ross et al., (2005) assert that the main objective of a firm is to increase enterprise value in the long term. Compensation tied to future firm performance and deferred compensation, therefore help a firm achieve corporation's main objective of maximizing long-term enterprise value and in the process increase shareholders' wealth. Executive compensation aligns shareholder's interests with management interest, enhancing corporate governance and accountability in a firm. The mechanism is that executive compensation that is linked to performance acts as a check and balance against the performance of executive managers. Manager's contribution to the long-term value of the firm is measured and rewarded accordingly. Due to performance metrics, managers create effective relationship among themselves and external stakeholders in order to enhance performance and increase incentives.

Conclusion

The growth of corporation at the turn of the twentieth century is because of separation between ownership and management in what is termed as agency theory in finance and economics literature. Managers act as agents for shareholders who are principals. Thus, any transaction that managers enter on behalf of shareholders affects shareholders' welfare. It is therefore prudent to ensure that managers act in the interest of shareholders because managers may enter into transactions that advance their personal interests at the expense of shareholders' interests, resulting on agency problem. Problems that are a result of conflicting interests between shareholders and managers can be resolved through managerial compensation and monitoring. Managers are incentivized to align their interests with shareholders' interest, therefore increasing shareholders' wealth. Empirical studies suggest that managerial compensation should be linked to long term performance of the firm to ensure that executive managers pursue investments that

are not overly risky and increase enterprise value in the future together with shareholders' wealth. A compensation plan that includes offering stocks, options, warrants and other equity based ownership plans that vests in the future checks that executive managers invest in projects with a long term horizon to increase enterprise value, which is the main objective of a firm.

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