Research Article

Executive Compensation as a Corporate Governance Problem

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Abstract

For many years, executive compensation, with the forms of base salary, bonus, stock options, stock grants, pension and other benefits (car, healthcare etc.) was deemed as a complex and controversial subject that has attracted the attention of regulators, media and academics for further investigation. Initially, the objective of a properly designed executive pay was to attract, retain and motivate the senior management and solve agency problems. However, this incentive took a different turn where senior management took advantage to satisfy its personal needs resulting in the collapse of well-known companies such as Enron, WorldCom and converting executive compensation as corporate governance (hereafter, CG) problem.

Keywords: Executive Compensation, Corporate Governance

Introduction

As a highly controversial topic, executive remuneration has attracted the attention of regulators, media and academics. Their criticisms took many forms of concerns relating to "the level of executive pay, its relationship with company performance and the failure of executive pay setting (e.g. board of directors, compensation committees)" (Clarke and Branson, 2012, p.470) to stop this managerial excess. The popularity of research in corporate governance and executive remuneration is self-evident (see e.g. Bebchuk and Fried, 2003, 2004; Devers et al, 2007; Keasey and Wright, 1997 etc.). Some kind of curiosity about the

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pay packages top executives are receiving is developing worldwide. Additionally, it is considered as a motivation by those who take offense at the very large rewards to voice their dissatisfaction. For example, Clarke and Schor (2008 cited by *The Guardian,7th October, 2008, para. 6*) reflect the discontent regarding the remuneration of bankers during the financial crisis period presenting California representative Henry Waxman who reports to Lehman Brothers chief Executive Richard Fuld that "your Company is bankrupt, you keep $480m. Is that fair?". Moreover, public interest on CG naturally grows due to the high profile corporate failures, especially those that have devastating impacts. Although executive remuneration as a CG mechanism has been used to solve agency problems, it has become a problem itself. Through this essay, a brief description of executive remuneration's history will be given including its theoretical perspectives. The relationship between executive compensation and company performance will be provided. Furthermore, whether executive remuneration is considered as a problematic mechanism or a solution will be discussed by assessing related case studies. Lastly, some key points will be reflected.

Agency Theory and Executive Compensation

In a large firm, agency problems are likely to exist where a separation of ownership and control takes place (see Jensen and Meckling, 1976) between three parties: the shareholders/owners, the board of directors and executives/managers of the company. The shareholders own the company, the board of directors have the responsibility to control the decision-making process on behalf of shareholders/owners and executives are responsible to check the daily decision making process. However, there is a possibility that managers can use company's assets to enhance their own lifestyles. In other words, they take advantage of their control power to satisfy their personal needs such as living a luxury life with expensive cars and personal trips (see Kim et al, 2010; Revell et al, 2003) while "leaving the cost to fall on the shareholders" (Kim et al, 2010, p.13). In this light, one way to avoid this conflict of the breach of trust by managers is to act with transparency and be accountable to the shareholders and other stakeholders. Transparency and accountability are very important pillars of CG. As "the availability of firm-specific information to those outside publicly traded firms" (Bushman et al, 2004, p.207), transparency helps companies to provide clear and

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accessible information about remuneration and other company information to enable shareholders and other stakeholders to scrutinise and challenge where appropriate. In addition, being accountable, it means that someone has the responsibility or "the duty to provide an account or reckoning of those actions for which one is held responsible" (Gray et al., 1996, p.38). Without accountability and transparency, the agency problem would be hard to defeat. With these two pillars of CG, the confidence of stakeholders is increased and they are keys to economic prosperity. Thus, principal-agent theory is considered as the cornerstone of executive compensation and CG practices.

Executive pay as positive perspective

From the first years of its implementation as a CG mechanism, it was believed that executive pay, composed of the financial compensation and other non-financial awards received by executives for their services to the company, could solve the agency problems. Donaldson et al (2009, p.1) argued that "optimal contracts may induce the self-interested manager to adopt investment policies that may increase the shareholders' wealth" linking executive compensation with firm's share prices and performance using earnings per share (EPS) or return on capital employed (ROCE). "The most powerful link between shareholder wealth and executive wealth is direct ownership of shares by the CEO" (Jensen and Murphy, 1990b, p.3). Loderer and Martin (1997, p.224) also added that "researchers have found that the simplest way to resolve this conundrum is to have a significant ownership commitment from corporate managers". Williams and Rao (2006) reported that as naturally risk-averse, executives took the incentive to include stock options in compensation rewards in order to achieve increased rates of return in periods of positive effects.

As an evidence of agency costs' reduction, Hall and Murphy (2002, p.4) presented that "during the fiscal year 1999, 94% of S&P 500 companies granted options to their executives, compared to 82% in 1992", confirming the accuracy and success of executive compensations to bridge the principle-agent gap; in other words, the gap existed between the best interests of the principal and the agent. Through these results, it can be considered to motivate, reward and discipline executives who had poor performance. An article related to the speech by SEC Staff about executive remuneration

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written by Spatt (2004, para. 6) mentioned that "high compensation is necessary to attract talented individuals, who typically possess outstanding alternative opportunities". Considering agency theory, it is worth to point out that these awards are only 'prizes' that are typically allocated to the most successful executives with high performance in the company. Thus, this argument is related to pay for performance relationship where Snyder (2007, para. 5) pointed out that risk and reward go together where "their livelihood are tied to the market in a way that most of the rest of us would find chillingly risky". Therefore, viewing the above opinions and evidences from several surveys, executive pay was considered as the rescue from agency problems hoping for a better economy and to mitigate the principal-agent gap.

Executive Remuneration and Company Performance

The most executive compensation packages include some requirements regarding the company performance and its relationship with the amount of executive pay received by company's executives. Several research studies took place to demonstrate if there is actually a relationship between company performance and executive pay, if this relationship is positive or negative and how this affects the company as an economic entity and its viability in the current market (see Junarsin, 2011; Van deer Laan et al, 2010; Devers et al, 2007; Gomez-Mejia and Wiseman, 1997; Lin et al, 2011 etc.) Mallin (2010, p.195) stated that there are three types of performance measures: market-based, accounting-based and individual-based measures. According to Junarsin (2011, p.163) and Mallin (2010, p.195), performance is measured using various indicators such as "return on assets (ROA), market-to-book ratio, earnings per share (EPS) and return on capital employed (ROCE), shareholder return and individual director performance". However, negative relationships between executive pay and company performance are taken place ascertaining agency problems and the fact that executives continue to take advantages of their position and act fraudulently to achieve high executive compensations (see Main et al., 1996; Benito and Conyon, 1999 etc.). Additionally, "a spate of unexpected company failures, financial scandals and examples of 'corporate excesses', such as high pay awards to the executives of poorly performing companies threatened to undermine investor confidence" (Keasey and Wright, 1997, p.62). Thus, the executive compensation from a good CG mechanism becomes problematic.

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Criticisms on Executive Compensation

Apocalypse of negative signs

Accounting scandals of well-known companies, such as Enron, WorldCom, Fannie Mae, General Electric, Royal Bank of Scotland (hereafter, RBS), revealed the problematic side of executive remuneration. Lessons have been taken regarding shareholders as principals and executives as agents where "there is no alignment between their interests and as a result, the performance-based pay for executives exacerbates agency problems instead of decreasing them" (Thomas and Hill, 2012, p.213). Executive remuneration increases the focus of executives only on their personal interests, ignoring the shareholders' interests and resulting vast turmoil on company's viability and general economy. The use of executive pay schemes as a solution to align agent-principal's interests was "an illusion" (ibid, p.213). Additionally, Bebchuk and Fried (2003, p.72) argued that "executive compensation is viewed not only as a potential instrument for addressing the agency problem but also as part of the agency problem itself".

Weak accounting-based incentives

Some weaknesses are also reflected through accounting-based incentives where accounting profits are used as performance indicator (Kim et al, 2010, p.18). First, "executives can increase the research and development into higher costs to make the company look more profitable in future than in present aiming to increase accounting profits" (ibid, p.18). Furthermore, the possibility of earnings manipulation by executives, specifically CFOs, plays a significant role in the 'true and fair view' of company's financial statements (Millstein, 2005). By so-called cooking the books, executives change the numbers of financial statements in terms of their own preferences to show higher profits and at the end, to get higher executive compensation (Millstein, 2005). "In 2004, Bernie Ebbers, founder and former chief executive officer (CEO) of WorldCom, was sentenced to 25 years in prison for his involvement in WorldCom's $11 billion accounting fraud" (Kim et al., 2010, p.23). According to Wearing (2005, p.92), "Scott Sullivan, former CFO shifted some expenses from profit and loss account to the balance sheet showing improved earnings to delay WorldCom's bankruptcy".

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Equity stakes & Bonus

Bonus is defined as "an annual, short-term incentive that usually involves targets considered to be under the fairly immediate control of executives" (Bruce et al, 2007, p.281). "Having less transparency and more complicated bonus schemes, it leads to higher bonus for executives but such complexity of shareholder value is not been associated with" (ibid, p.282). Berkeley Group plc reveals the case where there is not information disclosed relating the bonus performance targets in the annual report and doubts were reflected questioning if it was related to transparency or camouflage issue (ibid, p.289). As a famous case for its bankruptcy in 2001, Enron received criticisms regarding the reasons of its collapse and the people that were involved (Ackman, 2002; Wearing, 2005; Eichenwald, 2002). Enron was accused for earnings manipulation having as benefit to executives a huge amount of share bonuses.

Thomas (2002, cited in Arnold and Lange, 2004, p.754) reported that "Jeffrey Skilling, Former Enron's CEO, have received bonuses that had no ceiling, permitting the traders to 'eat what they killed'". By proceeding to illegal insider trading to manipulate earnings and to use "heavy stock option awards linked to short term stock price" (Healy and Palepu, 2003, p.13), they aimed to achieve rapid growth in Wall Street and to gain high levels of bonuses. Andrew Fastow, Former Enron's CFO, prepared different financial statements and reports to communicate with management and other ones for Enron's owners, employees and stakeholders. Thus, Enron failed to be transparent and to disclosure the actual financial information. Executives have hidden the company's real financial condition by presenting fake results, cheating the interested parties including Enron's owners (Wearing, 2005). Their role as theatre actors is seemed through an Interview of Skilling by PBS's Frontline (2001) where he mentioned: "We are the good guys. We are on the side of angels" knowing that this statement does not stand.

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Weak Stock Options & Excessive Risk

Stock options have faced difficulties on the alignment of managerial incentives with shareholders goals. Kim et al (2010, pp.18-19) stated that "due to the combination of stock price appreciation and dividends on shareholder returns, CEO increases dividends in favour of using the cash aiming to increase the stock price". By increasing stock price, CEO gains higher share of dividends at the end of the year. Thus, CEO tends to take risky projects and follow risky business strategy to have higher chances to get stock options award. In this case, CEO takes advantage of his/her position by acting and taking decisions without thinking the possible consequences. Executive risks can be regarded as additional cause of executive pay limitations. According to Firth et al (1999, p.618), "executives work very hard to meet the expectations and to maintain company's share price". "Because of shareholders' pressure, companies generate high financial returns at levels that were not sustainable, with management's compensation" (Lipton et al, 2009, p.2). In several cases of financial failures, it can be noticed how executives are able to use creative accounting to manipulate figures in financial statements. In the case of Lehman Brothers' collapse, executives were accused of "using Repo 105 method for off balance sheet activities" to deceive investors and shareholders about company's true financial condition (Guerrera and Sender, 2010). In the case of Enron, Ackman (2002) argued that executives used "dubious, even criminal, accounting tricks" to meet the performance requirements of board of directors ignoring significant profitability measures. Even before the total failure, executives continue to receive compensation rewards, known as "midnight bonuses" (BBC News, 2006).

Lack of Connection between Performance & Compensation

In general, stock prices are affected by company performance and by external factors as world economy. When there is prosperity in the economy, the stock prices increase. All companies, regardless of their financial condition and success, take the advantage of it. Therefore, executives of poorly run companies are being enhanced by receiving richly compensation, without having worked sufficiently and fairly. On the other hand, when there are economic difficulties in the company due to stock price fall, executives should be awarded but they are not, due to decreased options. However, there is the case with Stanley O'Neal, Merrill Lynch CEO, which seems to act

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differently in a market fall. According to Kim et al (2010, p.20), "he was CEO of Merrill Lynch during the 2007 financial crisis who was seen playing golf while his company was facing financial problems and losing a significant amount of money". It reported that O'Neal has received an extremely large pay package after his departure from the company that was measured according his performance in the company (Tse, 2007). He did not work sufficiently and fairly in order to get this remuneration, but he stepped down leaving his company in crisis where 'pay for no performance' existed. This is not the profile of CEO that a shareholder wants to see in charge (see Rogers, 2014; Boesler, 2012; DeCarlo, 2012).

Jensen and Murphy (1990a), Bebchuk and Fried (2004) and Jensen and Murphy (2004) criticized the performance-based pay arguing that the executive remuneration' problem was not the high levels of compensations received by CEOs, but the fact that their compensation was not related to companies' performance. According to BBC (2012), Kar-Gupta (2012) and Treanor (2011), Stephen Hester, RBS' CEO and the remaining RBS's top executives received similar criticisms regarding the huge amount of benefits. Mass media and newspapers (e.g. BBC, Reuters, The Telegraph etc.) have reflected the public's global dissatisfaction towards bank executives' compensations during recession. According to Kar-Gupta (2012, para. 11), Matthew Oakeshott, the Liberal Democrat lawmaker, argued that it is "totally unacceptable reward for failure" when Hester did not accomplish his role correctly in RBS by making inefficient decision making and pay for no performance is reflected. As executives choose only risky projects to invest company's money satisfying their hubris, the results will be dramatic for the economy. Thus, some recommendations for immediate actions to be taken are provided by Liberal Democrat minister Jeremy Browne stating "should turn down the bonus" and Conservative Mayor of London Boris Johnson stating "the government should step in and sort it out" but Dr Ruth Bender from Cranfield School of Management had an opposite opinion that "the bonus was reasonable" (BBC, 2012). According to Sparkes (2012, para. 3), "Prime Minister David Cameron reported that new measures will be taken to allow shareholders to a company bosses' reject a wage or bonus by giving to shareholders a binding 'vote on top pay packages' and on payment for failure."

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Executive pay as executives' greed

Viewing the 'two sides of coin', Junarsin (2011, p.164) stated that "if it is used appropriately without any excess or fraudulent actions, executive compensation can bond executives to owners so as to enhance shareholder wealth". On the other hand, "the misused or dysfunction of this corporate governance mechanism can impoverish managerial entrenchment and moral hazard" (ibid, p.164). Levitt (2005, p.41) mentioned on Bebchuk and Fried (2004)'s findings that confirm the statement "a breakdown in corporate governance and a build-up in greed". The huge amounts of executive pays drive the corporate governance to erosion sending the message that boards of directors spend shareholders' money lavishly and without the appropriate supervision. As former senior partner of Goldman Sachs, Gus Levy used to say that everybody in the company are "greedy, but long-term greedy" (Endlich, 1999, p.18), confirming the above statement.

Corporate Loans

In WorldCom case, CEO Bernard Ebbers obtained unsecured loans with interest payable lower than borrowing from external parties such as banks (Wearing, 2005, p.88). According to Wearing (2005, p.88), one possible reason for this action may be to resolve his personal financial problems, but this could negatively influence company's share price. If the CEO's investments might fail, the company will have significant losses. When WorldCom entered into bankruptcy, the share price decreased dramatically and thus, Ebbers was not able to settle the loan by selling his shares, as he had supposed to fulfil. Lublin and Young (2002, para. 14) present some criticisms that the practice of WorldCom to give loans to its CEO was a bad idea, referring to the statements of William Rollnick, director and compensation-committee member at Mattel Inc "such lending should not be part of the general pay scheme or perks for executives" and the toy maker in El Segundo, Calif, "it should not be done for large amounts". Therefore, compensation committee did not follow the appropriate legislations to provide a secured loan to CEO, characterizing this decision as hurried movement without thinking the possible consequences. If the compensation committee had secured the loans, Ebber's shares might have been seized for sale to cover the loan when the stock prices were still high enough to do so.

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Golden Goodbyes' consequences

After their retirement, executives receive compensation, characterized as "Gratuitous Goodbye Payments" (Bebchuk and Fried, 2003, p.81). As in cases of FleetBoston and IBM, CEOs live a luxury life by receiving retirement packages with huge amount of money and free access to corporate jets, apartments and other benefits (Kim et al, 2010; Revell et al, 2003). The case of Fannie Mae was an example of a poor and conflicting executive pay management where several problems with compensation arrangements existed. According to Bebchuk and Fried (2005, p.1), CEO Franklin Raines and CFO Timothy Howard have resigned classifying their acts "as 'retirements' and obtaining their retirement packages where after it was discovered that company's earnings were inflated over the previous years". As earnings increase, the level of executive compensation is growing but in this case the two executives act fraudulently to secure their future bonuses. "This is unacceptable and must change immediately" and "it's inexcusable that anyone would think it's OK to hand out these bonuses" (Chadbourn, 2011, para. 14) were some of the bonuses' criticisms. According to Bebchuk and Fried (2005), there was no relationship between executive pay and company performance characterizing it as 'camouflage' where executives have hidden their overall retirement rewards and no sign of transparency existed.

"The strong desire to camouflage may result to inefficient compensation structures that affect negatively the managerial incentives and company's performance" (Bebchuk and Fried, 2003, p.76). Thus, weaknesses of pay arrangements show the necessity of reforms in current compensation practices.

Conclusion

A significant interest in executive compensation and corporate governance can be observed due to the prevailing financial climate, the financial collapses of well-known firms and the accusation of rewards for failure and a lack of accountability. Criticisms from different backgrounds reflect the problematic side of executive remuneration, as it cannot fully be handled to the related practices as a corporate governance mechanism. Using whatever form of executive compensation, executives

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are never happy and satisfied and they ask for more, showing their hubris (see Brennan and Conroy, 2013; Hiller and Hambrick, 2005). However, there are those arguments who try to defend and to argue that this kind of rewards are deserved for executives and if there is a proper management with the help of related legislation and corporate governance codes, both parties, principal and agent, could be winners of the case without eroding any principal-agent concept and the company's financial condition. Unfortunately, this greed element exists where executives act without thinking the consequences and the parties that can be influenced. In the case of Enron, the victims were the employees that have lost their jobs, pensions and in one day, their dreams were collapsed. Therefore, calls for immediate legislations and reforms have been presented through these years in order to find out the possible solution that may stop this devastating situation with executive pay. In the beginning, executive pay seemed to be the solution where the scene suddenly changed and the consequences are followed one by one.

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