HOW TO CONTROL THE CONTROLLER – CEO COMPENSATION AND MOTIVATION

Udo C. Braendle*, John E. Katsos**

Abstract

One of the main control mechanisms that shareholders have used to rein in rogue managers is compensation. Through a combination of intrinsic and extrinsic incentives, shareholders have tried to provide the right balance to motivate senior managers to perform at their best. Shareholders have often failed in achieving this balance through compensation. In this paper, we argue that this failure is not the result of compensation packages as such, but on the focus of compensation packages on extrinsic motivators such as pay-for-performance bonuses and stock options. Instead, the focus of compensation packages should be on cultivating intrinsic motivators such as firing and prestige.

Keywords: CEO, Compensation, Motivation, Corporate Governance, Agency Theory

** Udo C. Braendle is Associate Professor of Management and Chair of the Department of Business and Economics at the American University in Dubai and External Lecturer at the University of Vienna*
E-mail: ubraendle@aud.edu
*** John E. Katsos is Professor of Business Administration at the American University of Sharjah*
E-mail: jkatsos@aus.edu

1. Introduction

The agency theory of the firm has come to dominate both the academic literature and the practical implementation of organizational control. Agency theory is premised on the ability of owners to control the actions of management to pursue the interests of shareholders and not their own self-interest. Executive contracts are supposed to provide *explicit* and *implicit* incentives that align the interests of managers with shareholders. The empirical literature has usually focused on the *sensitivity of pay* (explicit incentives) and the *dismissal* of executives (implicit incentives) to corporate performance.

The high pay of executives was justified in the 1990s and 2000s by the extraordinary gains in wealth shareholders received. Incentive pay was even characterised as one of the driving forces for the high market valuation of US corporations (Holmstrom and Kaplan, 2001). Recently, though, executive pay has increased despite stagnant macroeconomic conditions and stock prices (see Carvalhal et al., 2012). Switzerland with its successful "people's initiative against fat-cat pay" is the latest example of this trend (Economist, 2013).

All forms of control by shareholders over management involve agency costs, therefore corporate governance revolves around finding control mechanisms that reduce agency costs. To achieve this goal, monitoring refers, on the one hand, to strategies of managerial supervision and, on the other, oversight to improve performance (Braendle and Noll, 2004). This explains the existence of board systems (Kostyuk, 2006) and other external monitoring such as rating agencies and institutional investors. On the other hand high-powered incentive contracts such as shares and stock-options to remunerate directors were implemented in most companies over the last years (Armstrong et al., 2012).

One of the main control mechanisms that shareholders have used to rein in rogue managers is compensation. Through a combination of intrinsic and extrinsic incentives, shareholders have tried to provide the right balance to motivate senior managers to perform at their best. Shareholders have often failed in achieving this balance through compensation. In this paper, we argue that this failure is not the result of compensation packages as such, but on the focus of compensation packages on extrinsic motivators such as pay-for-performance bonuses and stock options. Instead, the focus of compensation packages should be on cultivating intrinsic motivators such as firing and prestige.

We begin by examining the existing literature and paradigms on agency theory and managerial compensation. Next, we examine the existing literature on employee motivation. This literature indicates that intrinsic motivation leads to higher performance in non-programmable tasks and that extrinsic motivators like pay very often "crowd-out" the effect of intrinsic motivators on the

performance of employees, leading to poorer performance in spite of higher pay. In the third section, we analyse how the employee motivation literature might inform the current agency theory debate. We find that, based on the existing literature, shareholders may obtain better performance from their managers by reducing their level of pay, but increasing extrinsic motivators through compensation packages. In the fourth and final section, we suggest some areas for further research in the field to empirically establish connections between intrinsic motivation and performance among senior managers. We also note several limitations to the current paper and how they might be addressed in future studies.

2. Agency Theory and Managerial compensation

The principal-agent model is based on economic models related to the employment relationship (Holmstrom 1979). The underlying concept is that the principal wants the agent to do *something* on her behalf and therefore must motivate the agent to do so. That motivation can come in two forms: extrinsic and intrinsic. Extrinsic motivation is what we traditionally think of in the agency theory context and it takes the form of motivators *outside* of an individual such as pay. Intrinsic motivation is *inside* of an individual and usually derives from goal identification or task involvement (Staw 1989; Fuller and Dornbusch 1988).

Managers do not necessarily maximize shareholder value (Mueller 2003). As most of them only own tiny fractions of their companies' shares (if at all), the separation between ownership and control leads to a principal-agent problem (Bebchuk et al., 2011). The stockholders (principals) want their managers (agents) to maximize the value of the company and its shares. But managers may be better off pursuing a different strategy. We can expect the utility-maximizing manager to increase those elements in an input vector that give him personal utility (Conyon 2006). In other words, she will use some of her residual income to engage in on-the-job consumption, up to a point where the marginal utility from additional discretionary expenditures is near zero. The managerial-discretion literature put forward some hypotheses concerning what it is that managers consume in excess: leisure (Edmans and Gabaix, 2009), sales (Baumol 1967), staff and emoluments (Williamson 1979), growth (Marris 1963, 1998) and income (Melis et al., 2012).

One of the key elements of agency theory is opportunism, a point stressed by Williamson (1979). If the agent has discretion which she is supposed to exercise for the benefit of another (the principal), she may exercise it to maximise her own utility instead. This is inefficient where the resulting loss to the principal exceeds the benefits to the agent. If the agent is rewarded by the principal on a basis which does not correlate her effort to the reward, the agent may not have the incentive to exercise the highest effort. The costs resulting from this agency problem includes both the loss of potential benefits and the costs of measures designed to reduce the loss of potential benefits. Jensen and Meckling (1976) identified these costs and termed them "agency costs".

Agency theory is based on the incompleteness of contracts and the separation of ownership and control. Though the resulting problems were already mentioned by Adam Smith in the 18th century, they were prominently highlighted by Berle and Means (1932). Due to the shareholders' perceived "limited liability" and the shareholders' inability in practice to control the management, the agency conflict is exacerbated. In academic circles, the shareholder and stakeholder visions of the firm have been battling for supremacy since at least the 1930s (Coase, 1937; Dodd, 1932). In general, the shareholder vision of the firm sees managers as being entrusted large amounts of ownership money and that regulation and shareholder control through Directors are the only means to stop management from abusing this trust (Muth and Donaldson, 1998; Jensen and Meckling, 1976). Again, generally, the stakeholder, or "other-regarding", vision of the firm sees managers and Directors as intermediaries among different groups with interest – beyond just financial – in the firm (Evan and Freeman, 1988). Shareholders are only liable to the company to pay up their share capital. In other words, they are sharing the company's profits, but they are not responsible for all of its losses. Limited liability, so the argument goes, shifts the risk of business failure from the company's shareholders to its creditors. Both, the companies' owners and managers therefore may have too much of an incentive to take risks, as the creditors would be the party which would suffer most in case of a bankruptcy. This could result in an inefficient use of resources (Bris and Welch, 2005)

The diversity and large number of shareholders in a typical public company cannot or will not exert effective control over the management for various reasons such as the existence of a coordination problem (Ingley et al., 2011). This includes problems of different interests of shareholders as well as bringing shareholders with the same beliefs together.

In general we refer to the collective action problem, where it might be rational for each of the shareholders not to engage in control (Braendle and Noll, 2004)

Due to the consequent danger of the inefficient use of resources there is a justification for correction. To reinforce the classical model of the company where the interests of the owners and

managers of the company are aligned, regulatory measures – mainly in the form of laws and codes – are used.

These include strengthening shareholders' voting rights, e.g. bolstering minority shareholder rights (Braendle, 2006). In addition the accountability of the management to shareholders is achieved by imposing penalties on managers when they behave wrongly (Bergstresser and Philippon, 2006). Furthermore, enforced publicity and disclosure should reduce the asymmetric information between the parties and therefore lead to better control (Braendle and Noll, 2005). All of these measures are reflected in corporate governance reforms around the world (Mallin, 2012).

Public companies are not required to have shareholders personally vote their shares because the number of shareholders is too large and their locations too diverse. As a result, shareholders instead often vote by proxy. Traditionally, access to the proxy ballot was only provided to senior management and board of directors. Recently, however, the SEC granted shareholders access to the proxy ballot in order to nominate at most one director (SEC, 2010).

So-called "say on pay" votes are a means of giving shareholders the ability to challenge management compensation packages. The recently passed Dodd-Frank Financial Reform bill (2010) requires public companies to have "say on pay" votes. These votes are advisory in that directors are not bound by the decision of shareholders with respect to executive compensation.

The major goals of allowing proxy access to shareholders and "say on pay" votes were to increase shareholder democracy and make management more responsive to the needs of others – whether these are shareholders or stakeholders (SEC, 2010, p. 331). The purpose of increasing shareholder democracy and making management more responsive is presumably to reduce the amount of excessive risk-taking and poor ethical and legal decisions made by executives of public companies over the past decade. Yet the poor decisions of company management and their excessive risk-taking seem to be more directly attributed to short-termism.

Short-termism is the "the obsession with short-term results by investors, asset management firms and corporate managers" (Krehmeyer et al., 2006). Theorists of multiple persuasions see short-termism as a major problem that might be fixed through changing executive compensation structure, likely via "say on pay" and proxy access rule changes (along with other proposals). Theorists traditionally associated with the shareholder (Fuller and Jensen, 2002) and stakeholder (Evan and Freeman, 1988) visions agree not only that short-termism is a problem, but that it must urgently be fixed. Though law and management theorists have come up with a variety of proposals to solve short-termism, most relate, in some way, to simply adjusting the criteria by which senior management is incentivized (Bebchuk et al., 2011).

Though executive compensation is certainly not the only facet of corporate governance, it is easier to measure compensation of executives than, the relative power or prestige of being the CEO of one company or another. So it is not surprising that much of the literature which has tested for the effects of managerial discretion has looked at managerial compensation. Executive compensation in the USA has risen continuously since 1970, with the bulk of the increase stemming from granted option plans (Conyon and Murphy 2000).

2.1 Base Salary

The base salaries for executive officers are in most cases determined by benchmarks based on industry salary surveys. These surveys typically adjust for company size, reinforces the observed relation between compensation and firm size. Even though base salaries only make up a declining percentage of the total compensation, they are key component of executive employment contracts. As these salaries are fixed, risk-averse executives will naturally prefer a dollar increase in the base salary than in the variable bonus compensation.

2.2 Bonus

Almost any company offers an annual bonus plan based on performance over the year, covering all of its top executives. Despite heterogeneity across industries and companies, executive bonus plans can be categorized in terms of three basic components: performance measure, performance standards, and the structure of the pay-performance relation (Murphy 1999). Usually no bonus is paid until a minimum performance hurdle is reached – commonly 80% of a budgeted target. Exceeding this hurdle, the manager receives a bonus, which increases as performance mounts. Target bonuses are paid for achieving the performance standard, and there is usually a "cap" on bonuses paid – 120% of the target is common. The value between the minimum hurdle bonus and the cap is named the "incentive zone". The target is normally somewhere in the middle of this incentive zone.

Companies normally use accounting elements like revenues, net income, EBIT, etc., to measure the performance. The most common non-financial performance measures used in annual incentive plans is to quantify the deviation from ex ante specified objectives, customer satisfaction or plant security.

As long as the managers believe they can make the minimum hurdle, they will naturally try to

increase performance – by legitimate means or, if push comes to shove, by illegitimate ones. According to the point on the pay line, they will either by pushing expenses into the future or shifting profits from present to the future.

Some companies even went further. The Swiss bank UBS implemented in 2008 the bonus-malus plan to remunerate its top executives (UBS, 2013). The main characteristic of the plan is that the bonus pay out is spread over several periods and that - in the case underperformance - a delayed pay out can be reduced or even set to zero. Underperformance is mostly based on the profit and loss results of the bank.

2.3 Stock options

Stock options are contracts which give the management the right to buy a share of stock at a pre-specified exercise price for a per-specified term. Stock options are a form of deferred compensation, i.e. an arrangement in which a portion of an employee's income is paid out at a date after which that income is actually earned.

These options normally become "vested", i.e. exercisable, over time: for example, 20% might become vested in each of the five years following grant. These options are non-tradable, and the exercise price is often "indexed" to the industry or markets. The mechanical explanation for the explosion in stock options, although unsatisfactory to economists, is rooted in institutional details on granting practices and exacerbated by the bull markets at the end of the end 90's and beginning of 21st century. Therefore stock option which are not indexed to the relevant industry are in the line of fire, as managers can free ride on the positive temper on stock markets and profit from an environment where their own performance does not matter. Or the managers will try to increase the stock price in short term to cash in instead of implementing a long-term strategy.

Agents can game the competition system when they have multiple instruments at their control. This incentive problem has become known as multitasking (Holmstrom and Milgrom 1990; Baker 1992), where compensation on any subset of tasks will result in a reallocation of activities toward those that are directly compensated and away from the uncompensated activities. Using ratios like sales margin or return on assets as performance measure is dangerous, as it motivates gaming. That is because managers can increase the measure in two ways: either increasing the numerator or decreasing the denominator.

As we can see, both schemes are not incentive compatible and therefore lead to manipulations. The only way to solve the problem is according to Jensen (2001) to remove all the kinks from the pay-for performance line shown above. His solutions are linear incentives and he convicts nonlinear, especially convex incentives as those will increase the variability.

But it is not easy to make a switch to adopt a linear compensation system. Target-based bonuses are deeply ingrained in minds of managers. For incentive compensation to work, corporate boards must choose both the right measures and the right levels of performance. In principle stock options employ the right measure of performance for corporate executives, but they do not set the right level. Shareholders expect boards to reward management for achieving superior returns – that is, for returns equal or better than those earned by the company's peer group or by broader market indexes. Stock options are often not indexed and therefore do not provide this possibility.

In the early 90s it was the consensus view in the literature that the sensitivity of pay to performance in the United States was too low (Jensen and Murphy 1999). According to these studies executives did not receive enough cash after good corporate performance and did not incur sufficient losses, through dismissal, after poor performance. The same result was observed in other countries like Japan (Kaplan 1994). The change in executive wealth normalised by the change in firm value appears small and falls by a factor with firm size, but the value of the CEO's equity stake is large and increases with firm size. But the probability of dismissal remained unchanged between 1970 and 1995 (Murphy 1999).The use of equity based compensation and pay-performance sensitivity has risen in other countries as well, and in the UK the percentage of companies with an option plan has risen from 10% in 1979 to over 90% in 1985 (Main 1999).

It is hard to see just how changing executive compensation requirements to be more closely linked to actual performance through "say on pay" votes (Bebchuk et al., 2011) will have any effect on the "vicious cycle" created by short-termism (Lipton et al., 2009).

It is also hard to see why boards, shareholders, and legal theorists alike have largely ignored the rather large body of social psychology research that suggests that monetary rewards for performing a task (e.g. achieving the highest quarterly profit for a firm) actually *decreases* the effort put into a job that requires the accomplishment of multiple tasks by a performer - e.g. a CEO (Deci et al., 1999). If we accept the agency theory of the firm, that is, that management is simply the agent to its principals (Jensen and Meckling, 1976), i.e. shareholders, then we would also, by extension apply the research that relates to compensation of other employees in agency relationships. Social science research has also produced fairly convincing evidence that rewarding non-manual workers with explicit rewards for explicit tasks *decreases* performance

for any non-rewarded task (Baker, 1992 as well as Holmström and Milgrom, 1990). Furthermore, incentive-based contracts for agents specifically reduce an agent's motivation to succeed in fulfilling his contract (Sliwka, 2003). It shouldn't be surprising then that when management is paid largely in accordance with the success or failure of a company's stock price would do so to the detriment of other important needs such as long-term shareholder wealth maximization and the interests of stakeholders.

This research thus suggests that management and law scholars might be focusing on fixing a system that is unable to actually capture what actually motivates senior management to act in the best interests of shareholders or stakeholders. Employees who are intrinsically motivated to do their jobs well do not need extrinsic motivators to succeed in their jobs. They simply need sufficient pay. During the 1950s and 1960s, senior management pay at public companies was substantially less linked to performance than it is today, yet firm growth was substantially stronger then than now (Frydman and Saks, 2007). If we take all of the research in this context seriously, we could easily come to a conclusion that is directly opposite from existing proposals to re-focus senior management on "better" priorities – eliminate pay for performance entirely and simply provide pay that is commensurate with the job.

3. Employee Motivation

Research on motivation within the psychology and social science literature has been pursued since at least the 1940s (Maslow, 1947; Fuller and Dornbusch, 1988). The prevailing view regarding motivation is that incentives are often a great motivator (Van Herpen et al., 2005). Motivators themselves fall into two categories. Extrinsic motivation is that which comes from outside an individual. Extrinsic motivation has been found to sharpen focus on individuals and allow them to accomplish manual tasks substantially faster than without incentives targeting extrinsic motivation (Deci, 1980). The most common incentive in the principal-agent relationship is an external motivator, namely, salary. In fact, all most of the executive compensation and economics literature focuses on extrinsic motivators. Only recently have economists and agency theorists had their attention drawn to the potential power of intrinsic motivation, the second category of motivation (Falk and Fehr, 2002). Intrinsic motivation is most often based on social norms, like reciprocity and fairness, that drive individuals to achieve some goal or task internal to themselves, even if the perceived benefits are to one's community or society (O'Reilly and Main, 2010; Fehr et al., 2007).

A robust set of research in psychology and behavioral economics indicates that extrinsic motivation (i.e. pay-for-performance) is counter-productive to success of a non-manual (i.e. thinking) task (e.g. Titmuss, 1972; Deci, 1980; Ariely et al., 2009; Camerer et al. 1997). A linked finding is that intrinsic and extrinsic motivation "crowd" one another out individuals only have a certain "pool" of motivation that they can draw from and too much of one type of motivation will force out the other. In other words, too much extrinsic motivation, like pay, will reduce the likelihood that individuals will be motivated intrinsically, for instance by a desire to reciprocate goodwill.

4. Current intrinsic motivator: takeover threats

Managers may behave opportunistically as we have seen above. In addition, agents in agent-principal relationships, including corporate executives, are often only motivated with extrinsic incentives, such as salary and stock options. Within current executive pay contracts, however, there does exist one major intrinsic motivational tool to encourage executives to do their best work: takeovers.

In a zero transaction costs world even a slight deviation of a company's market value from its potential maximum would lead someone to purchase a controlling interest in it and remove the management, alter its policies, and claim the wealth gain from bringing the company to its maximum value (Mueller 2003). This threat of a takeover was the chief constraint on managerial pursuit of growth, but sufficiently loose to allow managers to deviate significantly from shareholders'-wealth-maximising policies (Marris 1963). The term "market for corporate control" was introduced later on to describe this process, and it was argued that this "market" did provide sufficient discipline to constrain managers effectively.

When Marris discussed this process, one of the most radical mechanisms for disciplining managers, hostile takeovers (Becht et al. 2002), were sufficiently rare. This mechanism is highly disruptive and costly and therefore seldom used. On this issue, the analysis by Scharfstein (1988) stands out. Building on insights of Grossman and Hart (1986) he considers the ex-ante financial contracting problem between a financier and a manager. This contract specifies a state-contingent compensation scheme for the manager to induce optimal effort provision. In addition the contract allows for ex-post takeovers. The important observation made by Scharfstein is that even if the firm can commit to an ex-ante optimal contract, this contract is generally inefficient and will induce too few hostile takeovers on average.

If hostile takeovers are a disciplining device for management, they should predominantly affect poorly performing firms. But this prediction is not borne out by the empirical literature. Successful US takeover targets are smaller than other companies, but that's the only difference from their peers (Comment and Schwert 1995). Furthermore, if hostile takeovers should correct managerial failure and enhance the efficiency, the value of the bidder and the target under joint control should be larger than the value of the bidder and the target separately. The empirical literature neither supports this prediction (Andrade et al. 2001; Burkart 1999).

Therefore takeovers do not seem to be an efficient measure to guarantee behaviour of the management in the sense of the shareholders.

5. Well-balanced packages

Agency theory predicts that incentive pay and takeover threats are substitutes (Kole 1997). This finding matches the findings of motivation theory which suggest that intrinsic and extrinsic motivators "crowd" one another out. Moreover agency theory predicts that incentive pay should be tied to performance relative to comparable firms, not to absolute performance. Early studies found that changes in the CEO cash compensation were negatively related to market performance, but positively related to firm performance (Gibbson and Murphy 1990). Equity-based compensation, in contrast, is most of the time not corrected for market stock index movements, consequently leading to a solid rejection of the relative performance evaluation hypothesis in all recent surveys due to accounting problems, tax considerations, difficulties in obtaining performance date from competitors (Abowd and Kaplan 1999; Bebchuk, Fried et al. 2001; Murphy 1999).

Agency theory can be used to determine the optimal exercise price of granted options. The options with an exercise price equal to the company's stock price, which are very common in practice, are a clear contradiction of the predictions of this theory (Bebchuk et al. 2001:69). Theory also predicts that incentive schemes and the adoption of the latter should result in an increase in shareholder wealth. The latest empirical literature generally rejects this prediction, whereas earlier event studies generally support it (Habib and Ljungqvist, 2001).

Furthermore, firms subject to blockholder monitoring are less likely to implement stock option plans (Kole 1997), because more discipline substitutes for more sensitivity of pay. Managements protected by anti-takeover laws or anti-takeover amendments provide more incentive pay to compensate for less discipline from hostile takeovers, while in the UK takeover threats are higher while incentive pay and the level of pay are lower than in the US (Conyon and Murphy 2000). However, this theory is not consistent with what we observe. Companies in industries with more disciplining takeovers should therefore pay less, while in fact they pay more.

In addition to these explicit incentives, implicit incentives take the form of executive dismissal or post-retirement board services. In the US, this latter point seems to be true, as 75% of the CEOs are holding at least one directorship after retirement. This is a point which is opposed by many corporate governance codes.

6. Conclusion of these measures

It has become difficult to maintain the widely held view of the 90s that US pay practices provide explicit and implicit incentives for aligning the interests of managers with those of the shareholders. On contrary, it seems that the managers have got the possibility and the power to set their own wage at the expense of shareholders (Bebchuk et al. 2001). Long-standing debates all over the world show that the opinions are controversial.

We suggest a new approach with the help of penalties for the management. Instead of designing a "standard" contract with a base salary and a bonus if a certain given project is successfully enforced, the shareholder can think about a contract with a higher bonus for a successful project and a penalty for failure.

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