Executive one way to do that is

Executive compensation is yet another primary issue (especially in the UnitedStates), which is going to be explored next, as it is fundamentally concernedto the degree to which managers are compensated, in ways that align theirinterests with those of their companies’ shareholders. Besides monitoring andcontrol of CEO actions, another way of improving shareholder protection is tostructure the CEO’s compensation package, so as to align his objectives withthose of shareholders, and is generally viewed as a key internal mechanism. This is what executive compensation is supposed to achieve through a basicsalary, bonuses, stock options, and other benefits such as pension rights or” golden parachutes”. Therole of the corporate governance system is to make less severe and painful theconflict of interests that is the outcome from the mentioned earlier separationof ownership and control, but without loading the managers with unnecessaryresponsibilities related to the risk of the company. Therefore, in the absenceof monitoring a simple system is formed, in order to align their interests bygiving a reward for taking the right actions and decisions, or accordingly topenalize the wrong such.

One way to do that is by giving a compensation that issensitive to performance, or from owning stock in the firm, but the situationis complex. Although the incentives of the manager become better and strongerrelated, it becomes harder to remove or fire him/her as well, because in thecase when the executive owns more stock, he/she receives notable and importantvoting rights during the meetings which leads to the second agency problem –the conflict between, on one hand, owners who possess the majority orcontrolling interest in the firm and, on the other hand the minority

ornon-controlling owners. Tosummarize, reducing agency costs is in the interest of all participants in thecorporate governance system, and there are many mechanisms through whichcompensation policy can provide value-increasing incentives, including stockoptions or performance-based bonuses and salary revisions. Stock and OptionsExecutive'spay could be related to the performance of a company in many ways. The mostcommon method used is through bonuses based on the earnings growth. Involvingstock and options in the compensation policies gives managers good reasons andmotives to increase the attractiveness and value of the company, respectivelyto make the stock price as high as possible.

Earlystudies show that for every $1000 increase in firm value, CEO pay changed onaverage by $3. 25, of which $2 (60%) came from changes of their stock ownership– the difference of $1. 25 (40%) was driven primarily by options and bonuses. However, the authors argued this incentives were too small or insignificant, andat the end of the day it depends on the ethics and desire for optimal resultsof the executive, which remains subjective. Pay-for-Performance SensitivityThelevel of compensation and the extent of pay-for-performance for CEOs has been atopic of serious contradictions in both the business and academic spheres. Figure 1 shows the average cash pay, stock and option, bonuses and other typesof payouts over the period 1992-2013 and illustrates the substantial increasein chief executive officer pay during the last two decades. Figure1.

CEO Compensation Source: Compustat ExecuComp, by the example of DamodaranTheaverage cash pay, consisting of salary and bonuses, increased slightly andremained quite the same. Instead of that, the most

important factor whichcontributed to the increased compensation of the CEO was the rise in the valueof stock and options. The median value of options given increased from lessthan $200, 000 in 1993 to more than $1 million in 2001. Therefore, the solid useof stock and option grants in the 1990s greatly increased managers'pay-for-performance sensitivity.

Accordingly, recent evaluations show that CEO wealth increases with $25 for each change of$1000 in firm value. In contrast to that, recently companies have beendecreasing the part of stock and option grants used in CEO compensationpackages (Figure 1), stating that the level of sensitivity is too big. Yet, this was not the only problem. Sometimes options are given frequently " at themoney", which means the strike price and the current stock price are the same. Thus, the top-management has a reason and motivation to manipulate theinterpretation and release of financial forecasts, so that the bad news go outbefore options are granted (to drive the strike price down), and good news goout after options are granted. Another study proved that the practice of timingthe release of information in order to maximize the value of CEO stock optionsis very popular and frequently used. InferenceAsmentioned above, the design of performance incentives for managers incorporations is an enormously important issue. Aligning the incentives ofexecutives with those of owners is the easiest way to reduce the conflict ofinterests.

If there is no reasonable connection between CEO pay and firmperformance, it is questionable if the public corporations are being managedefficiently. Shareholders want CEOs to take specific actions – for example, deciding which problem to solve, which project to pursue or drop – whenever itis in

the owners’ interest. But most of the times, the CEO takes intoconsideration only his private gain and cost from pursuing a particularactivity. That is why a compensation policy which ties the CEO’s welfare toshareholder wealth helps to align the private and social costs and benefits ofalternative actions and thus, provides incentives for CEOs to take the correctdecisions. Nevertheless, shareholder wealth is affected by many factors in addition to the CEO, including actions of other executives and employees, demand and supplyconditions, and public policy. It is appropriate, however, to pay CEOs on thebasis of shareholder wealth since that is the most important aim, consideringthe shareholders’ goal and perspective.

Up till now, the central agency problem in large corporations around the world was focused onirresponsible professional managers, who are not loyal to the shareholders’interests, but a conflict of interests between the minority, and controlling shareholders (who own more than 20% of the shares) mayarise as well – a topic, which is going to be discussed in my next article.