Executive Compensation and Agency Problem

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Abstract. Agency problem exists in every business because of the interest conflicts between managers and shareholders. There is a need to find a balanced method to increase the business' profit and ensure managers' working efficiency. Employees can reach their potential ability under this harmonious environment that everyone can show their talents on their own stages. A compensation package is one of the solutions to maintain the balance and provide mutual benefits between those two parties. Businesses can choose different compensation applications with their stock ownership guidelines to achieve their goal because the compensation package varied in different markets. Each fields will have specific requirements for managers. The incentive plan can encourage managers' motivation and protect the shareholders' interest from overpaying or underpaying. The performance related evaluation gives the manager the opportunities to challenge themselves on earning business profit. Their performance will be compared with their colleagues which gives the company a competitive environment.

Keywords: Agency problem; executive compensation; stock ownership.

1. Introduction

Managers and shareholders have a cooperative relationship in the business. The managers are aiming at regulating a particular group or apartment in the business. Their responsibility is to organize those groups and ensure productivity. Within this position, the managers need to plan the work and distribute it to the other employees. The detailed divisions of the work will encourage efficiency and motivate the employees due to the less workload for each person. The equal distribution of work also creates a competing platform for employees because the employees' performance will be valued when they are assigned tasks that required similar effort. Secondly, staffing skill is the fundamental skill for managers. The managers are required to have an overview of employees' abilities. To prevent the situation of having people work on tasks they are not familiar with, managers need to know the employees' advantages and assign matched tasks. Thirdly, organizing the employees and establishing the relationship among employees is important. The working efficiency can be boosted in a harmonic working atmosphere. Teamwork will be achieved in this environment. In addition, managers' ability to control the employees can determine the employee's performance. The managers represent the standard of the workforce, and their evaluation of the employees has an impact on employee behavior. If the managers have the high requirement, the employees will work harder to meet the line. Otherwise, the employees may not be able to concentrate on the work. As the result, the managers have to spend most of their time in the position based on the responsibilities above. In the contrast, shareholders who own a certain number of stocks in the business have a different role in the business. Because shareholders are the owners of the company, they focus on how to maximize the business profit which is equal to their personal profit. As the result, the shareholders may not be staying in business all the time. They usually have different jobs outside the business.

Understanding the different responsibilities of shareholders and managers, it's obvious to conclude that managers and shareholders will have contradicted goals working in the business. The workload of managers determines that the managers need to spend at least 60 percent of their time in the working position. However, their personal profit earnings are related to their fixed salary and performance. If they work hard, the business's profit will increase rather than the personal profit of a manager. Therefore, the goal of the manager is to use less effort to maximize personal profit. On the contrary, the shareholders expect the managers to spend most of their time working in the position and with huge effort for creating the business profit. The conflict between personal profit and business profit leads to the question that how a balance can be created to maintain the relationship and profit earning between managers and shareholders.

An agency problem describes the phenomenon of having to contradict goals between two parties, which will affect the interest of both parties. In the question of managers and shareholders, agency problem refers to the conflict between managers and shareholders. One wants to increase the salaries with a relatively low workload, and one encourages high working efficiency and payback. It is crucial that the company can balance the interest between managers and shareholders because satisfying the managers will motivate work efficiency and quality. At the same time, the shareholders’ goal will be fulfilled with good managers. Enron could be failed example of dealing with agency problems. Enron is an energy derivative trading company, which got profited tremendously in 1985. Skilling, the CEO of the company, emphasizes the competition among the workforce. However, the market of energy trading was in a saturated state which shrank the company’s profit. For retaining the stock price and keeping shareholders, Enron made fraud in accounting practices that the company will record future earnings and losses in the current income statement. Therefore, there was an illusion of high profit earning until the exposure of this strategy [1]. The main reason for this case is that the managers and the shareholders were no consensus. The managers lied about the stock market for earning the trust of the shareholders because the considerable profit is attractive to the shareholders in this highly competitive market. This case turned out the significance of the agency problem. The aims of managers and shareholders can be fulfilled when there is a balanced contract between those two groups. An appropriate compensation contract for managers can promise both personal and business profit.

2. Executive Compensation as an Agency Problem

2.1 Compensation Philosophy

Compensation is the main part of the salary for managers which helps to solve the agency’s problem. The existence of compensation represents a monitoring effect on the managers because it builds a direct relationship between personal performance and profit. The composition of compensation varied among companies. Some offer more stock, and some offer more cash. The shareholders must consider multiple factors to determine the amount of managers' compensation. In order to get create an applicable compensation contract, the shareholders usually compare the managers’ performance and earnings in the market. Therefore, different compensation philosophies appeared in every company.

Businesses in the same field tend to have similar compensation philosophies. Business principles, strategic framework, and performance assessment are the general compensation assessments in banks such as JPMorgan Chase & Co, Bank of America, and Citigroup. In JPMorgan Chase & Co, the business principle and strategic framework are connected. They emphasize exceptional client service, operational excellence, fairness and responsibility, and teamwork. Chase targets the global market and is aiming at understanding the customers from their angles as well as providing long-term profit for them. For achieving better services for different groups of people from varied geographic locations, the company will send managers to the local market to get closer information about the customers’ needs [2]. Besides, the operation policy focuses on maintaining a respectful working environment and providing a safety-first culture. The employees should protect the business resources and work for sustainability. A reasonable division of workload and equal treatment to every employee. A leaner work process is expected in the business with a thoughtful act. Chase encourages the contribution of everyone with their ability, leading to cooperation among employees. In Chase’s compensation philosophy, the compensation will be paid aligning with the managers’ performance and the shareholders’ interest [3]. Using the performance assessment, the shareholders can compare the managers and offer them the correlated amount of compensation. At the same time, the talents and advantages of the managers can be shown which helps the business to assign the work. Besides, the compensation provides a fair platform because it is straightforward without any extra benefits.

Managers will earn what they deserve. Similar to Bank of America, the managers will be paid for performance. The rewards are only based on the actual results without any modifications [4]. The purpose of having a compensation philosophy is to prevent any fraud and inequities. The business assigns the compensation with a fixed rule which gets the consensuses among the shareholders. An equal competitive environment motivates managers to evaluate each other and increase their working efficiency.

2.2 Compensation Cases

The components of compensation include various options depending on the business decision. The most common compensations are cash, long-term incentives, stock units, and insurance. The business will offer an income package that includes a fixed salary and variable incentives. Each component has a different proportion in the compensation. Usually, a fixed salary is the lowest amount for managers due to the property of performance-based evaluation. Over 50 % of the income is incentive-based and the managers can be offered the stock unit or additional cash. DSU (Deferred Share Unit) and RSU (Restricted Stock Unit) are two options for a stock unit provided by the business. Some businesses only give one of those two types of stock units to the managers and some other businesses allow the managers to choose what they want. The former represents the unreceived share units that managers can get after meeting certain requirements. The latter has a certain vesting schedule basing the performance goal or employment, which grants the manager company shares. The additional compensation is usually presented in the form of insurance or a traveling subsidy. The company will cover the major costs for the managers who got assigned to do some research in another city, such as flight tickets or travel costs. PSUs (Performance share unit Programs) represent the evaluation of managers' performance.

For example, JPM has a compensation plan of a fixed salary plus a 15% of cash incentive, 0% of RSUs, and 85% of PSUs. This cash incentive will be vested immediately, and PSUs have a vesting schedule of the combined period over 5 years. In the first three years, award cliff vests will be offered. The last two years will be the ultimate amount and holding post-vesting. JPM offers each non-employee director an annual cash retainer of $ 100,000. The directors will be granted $250,000 as DSU on the annual performance year equity awarding if they are still on the board. However, DSU will be distributed into the company's common stock in the year of retirement. Besides, the directors can choose to defer part of their cash compensation each year. The deferred cash compensation has the chance to be converted into DSU which will be distributed later as stock units. Same to the DSU distribution way, the deferred cash compensation will be distributed in the year of retirement [5]. According to JPM's directors compensation table in 20121, all the directors got stock awards of $250,000. Each director got different cash compensation because of the different positions. Certain committees can get the extra retainer depending on their position. The Lead Independent Director can get a $30,000 bonus. The audit and Risk Committee chair can get $25,000 and all the other audit and risk committee members can get$15,000. Ban Board's chair retainer is $25,000. J.P. Morgan Securities plc Board retainer is $110,000. All other committees' chair retainer is $15,000. Stephen B. Burke, who is the Lead Independent Director since 2021, got $145,000 as a cash retainer including $30,000 as the lead independent director, $100,000 as an annual cash retainer, and $15,000 as the nominating committee [4, 5]. In addition, all the directors can get the meeting attendance fee of $2,500 when the directors attend the specific purpose committee. If directors are asked to serve on one or more specific purpose committees periodically by the Board, they can get the compensation paid in cash. Timothy P. Flynn, chair of the audit committee, got paid most in the section of "Other fees earned or paid in cash", which he attended 50 meetings in 2021. The average for this section paid is around $37,222 that every director attends 15 meetings on average [4]. With the adds up of those incentives, the directors can get a considerable income. The more they contribute to the company, the higher payback they will get.

Companies in the same field will take different compensation packages to attract managers with a similar number of rewards. For example, BOA offers $100,000 as a cash award with incremental awards if the directors have other positions. The Lead Independent Director can get $50,000, the audit& enterprise risk committee chairs can get $40,000 and the compensation and human capital can get $30,000. Also, the directors can get RSU for $250,000 which means the directors can get the stock awards while they are still in the position. However, the total amount of the offered compensation is the same as JPM [6]. By calculating the incentive-based compensation fraction, JPM offers 95.7 % incentive compensation and BOA offers 92.6%. The data is similar because both companies are in the same competitive market with an equivalent level.

2.3 Profit Changes with the Compensation Changes

The proportion of the compensation changes with time followed by the increase in the company's annual profit. The alteration by the shareholders and managers improves both personal interest and common profit. In general, the fraction of compensation increased from a few years ago with the growth in profit. In 2015, JPM offers a cash retainer of $75,000, which is $25,000 different than now. Also, the DSUs increased $25,000 with the change of distribution of PSUs. The cash bonus was 20% of the compensation and the PSUs were 80%. In those five years, JPM increased its PSUs and decreased the Cash Bonus. According to the proxy statement report of JPM from 2015 and 2021, the earnings per share increased $9.36 which means the company has a raise in profit from the share price [5, 7]. Therefore, it's able to conclude that the increase in compensation policy has a relationship with increased earnings per share. The compensation in 2021 relies on PSUs more than in 2015, the manager's behaviors are valued in a bigger portion turns out that performance-based compensation can raise both the shareholder's and managers' interests. BOA also experienced an increase in net income and changes in compensation. The net income increased $16.1 billion in those years. The main change made in those six years was the RSUs. The directors in BOA got $50,000 increase in RSUs in 2021 [8]. Although the variable pay mix didn't have an obvious change in the ratio, the director's compensation and the company's profit are higher than in 2015.

3. Stock Ownership

Due to the huge amount of stock distribution to the managers, the business needs a stock ownership guideline to protect the business profit and shareholder's interests. In the case of JPM compensation distribution, the stock units are valued the most. If the company does not have an appropriate stock ownership guideline, people can have the stock transaction depending on their feelings. As the result, the price in the stock market will be unstable and causes the loss of potential customers. Also, some companies will have specific requirements for managers to keep in place. JPM required each member to accumulate at least 200,000 shares. Besides, at least $10 million of the fixed dollar value of shares is needed to obtain to remain in the position. Before those requirements got fulfilled, the directors need to keep 75% of net shares. After those requirements are met, the directors are only required to keep 50% of the net share for the duration of their services [5]. BOA requires its chief executive officers to have 500,000 shares and keeps 50% of the net shares until a year after their retirements. Other officers need to keep 300,000 shares with the same retention as chief executive officers [9]. The contrary of the bank company, the technology company has different stock ownership guidelines. For example, Intel requires its officers to hold the Intel common stock based on the multiple of their base salary in five years. Robert H. Swan is the CEO of Intel Corporation whose requirement for the stock is ten times his base salary and has the deadline for the stock on Feb 2024 [10]. Businesses adjust the stock ownership guideline depending on market changes. Some companies have stricter stock ownership guidelines because these companies are in markets with better margins. For keeping the stocks from losing, the companies must take some strategies to maintain the amount of stock held by the managers.

4. Conclusion

Agency problems can be solved by the compensation package because personal interests are tied to their performance and business profit. PSUs got applied in the majority of businesses to evaluate the directors' working efficiency. Sometimes the employees will be compared with other employees from the same business or different business. Shareholders use the comparison as the analysis for compensation preventing overpaid and underpaid compensation. Also, compensation philosophy represents the principal or the structure of a company. What the company values most will be used as the criteria for managers, creating a positive working atmosphere. Manager's talent and ability will be tested with the consideration of compensation alteration. In this competitive environment, managers will also be motivated because a fixed salary is a small portion of their salary. The incentive compensation is a major part of the salary. DSUs, RSUs, and PSUs are variable payments depending on the personal ability which promises the equity. At the same time, the stock ownership guideline sets the fundamental requirement for managers because the number of share units owned by them represents their right in the business. The compensation decision should be taken carefully because some error values are existing in the policy. The compensation policy will keep improving to achieve higher profits in the future.

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