

# EXECUTIVE COMPENSATION

Kevin J. Sigler - **Intro**

University of Nebraska, 1989

Adviser: Keith Broman

The purpose of this dissertation is to investigate executive compensation plans which base awards on common stock performance as a method of reducing agency problems in the firm.

Conflicting interests between managers and shareholders may lead to a suboptimal allocation of resources within the organization. These conflicts are known as agency problems.

The term agency is derived from the fact that corporate decisions are delegated to agents (management) who perform on the shareholders' behalf. Agency problems occur when the manager consumes more perquisites than he does as 100 percent owner of the firm's common stock.

Costs from agency problems may also be incurred if the manager's time horizon is less than that of the shareholder. Since the manager is interested in his perception in the business community, it may be in the manager's best interest to invest in projects with early large payoffs instead of projects with the largest net present value.

A manager is less diversified and susceptible to more risks than company shareholders since his human capital is tied up on the firm. In addition, when a manager is paid a straight salary he is in a position comparable to the firm's bondholders. He will risk not receiving his wages only if the firm goes bankrupt. In either case agency costs may result since the manager, who is assumed to be risk averse, may not accept risky positive present value projects in order to protect his wages or curb part of his added risks.

There are two fundamental behavioral assumptions on which the modeling of these agency problems is based. First, it is assumed that all individuals choose actions that maximize their own personal welfare. The agents or managers in the above cases are in decision making positions. The decisions on the amount of perquisites consumed or the investments taken are made in order to maximize the managers' utility. These decisions may diverge from the interests of the owners or shareholders.

Second, individuals are assumed to be rational and capable of forming unbiased expectations. These individuals, who are modeled as the shareholders in the above cases (assuming 100 percent equity financing), form these unbiased expectations regarding the impact of agency problems and the associated future value of their wealth. Therefore, shareholders understand the self-interest motivation of the agent or manager and take this into account when valuing the equity of the firm. This results in lowering the value of the firm's equity when the manager is not 100 percent owner.

One way of avoiding these agency costs may be by linking the compensation of the manager to the price movement of the company common stock. This allows the wealth of both the manager and shareholder to fluctuate together, resulting in the convergence of their interests.

This dissertation reviews the literature on the effectiveness of stock performance based executive compensation in reducing agency costs. In addition, it makes a contribution by empirically testing if agency costs are reduced by tying a portion of executive pay to the price movement of the firm's common stock.