Incentive Alignment in Corporation

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Introduction

One of the important components of agency theory is the decision making under risk. It has been stressed in recent literature that risk is also one of the least developed topics in agency theory, and that independent risk-concerning stream of investigation has been still not exploited enough and is able to bring benefits for agency theory. As Wiseman and Gomez-Mejia (1998) point out in their review of corporate governance research, "The challenge of corporate governance is to set up supervisory and incentive alignment mechanisms that alter the risk orientation of agents to align them with the interests of principals" (p. 133). A question arises, Are the incentive plans used in practice efficient in their role? There is a considerable amount of literature (e.g. Westphal & Zajac 1994; Zajac & Westphal 1994; Wiseman & Gomez-Mejia 1998; Ofek & Yermack 2000), which provides a criticism on general adoption of incentive plans and concerns the issue of efficacy of corporate governance mechanisms. This study may be accredited to very this line of management research.

The separation of decision-making and ownership in large corporations has been predicted by several influential scholars to be very beneficial (Berle & Means 1932; Jensen & Meckling 1976). The separation of decision-making skills and capital property makes it easier to find parties which possess these necessary affairs, because it does not require both of them from the same individual. As a consequence of the separation, investors care only about their wealth. However, this separation brings out an agency problem of aligning the objective of decision-maker to owners' goal of wealth maximization (Fama & Jensen 1983). This problem is being solved in practice by monitoring the behavior and offering incentive compensation plans for CEO and other top managers (see for example Murphy 1999). However, these plans force the CEO to be an owner of the corporation and to bear both systematic and unsystematic risk, which may affect her decision-making in both favorable and hostile way. This paper is to show that the owners have another and better possibility how to warrant their wealth maximization.

Yet, it contributes to the corporate governance investigation by exploring decision-making using a neglected view on risk and incorporating it into agency-theory based corporate governance discussion. Using an ex-post model introduced later in the text, this paper also supplements the observation that agency theory alone is not capable to solve and explain the actual solution of incentive alignment problem between CEO and owners because of existence of CEO power and institutional motives in the adoption of compensation schemes. Finally, as the existent discussion on market- versus accounting-based measures in CEO pay is addressed, I point out a problem of implicit assumptions in arguments of most influential scholars, which dim the recognizable superiority of market-oriented compensation, used in the frame of relative overperformance of competitors.

Theoretical Framework

1 Owners as Investors

The purpose of investing capital in a corporation is to increase the wealth of investor.[1] Due to the possibility of diversification of the investment risk, investors are in general considered to be risk-neutral. By the act of investing, investors become owners of the corporation, and so the objective of the company is inducted by the goal of investors. Thus, the role of Chief Executive Officer (further on, CEO), as the foremost manager, is to maximize market value of the company. Indeed, this behavior is equivalent to the maximization of investors' wealth under the assumption that she can influence the wealth of investors exclusively by the means of company value.

It has been recently documented (Morgenson 1998, as it is cited in Ofek & Yermack 2000; The Economist, October 11th 2003) that, on average, about 13-15 per cent of the shares of U.S. largest companies is owned by (or reserved to) their managers and the proportion has grown during the last decade imposingly. This is an enormous proportion which apparently causes that the above-mentioned assumption is not conformed in practice. Since CEO is a particular investor and decision-maker of the

[1] Family-managed and other peculiar corporations, whose investors may have different goals (such as altruism or self-esteem), are excluded from the discussion.

company, she behaves in a way that maximizes her personal property; i.e. not necessarily the company market value. She tries to get higher benefits than it is appropriate from her share on the investment in the company.

2 Control of CEO

It is argued in scientific literature that the control of CEO's behavior is a necessary and inevitable component of the solution of the principal-agent problem which arises between corporate CEO and the owners of the company (cf. Wiseman & Gomez-Mejia 1998). Basically, there are two schemes for doing so: (1) monitoring manager's everyday behavior, or (2) motivating manager by incentive plans.

Everyday monitoring of CEO's behavior is a productive control system leading to rather absolute supervision of manager's decision-making and it is very likely to guarantee desired outcomes. In general, this way of control is very complicated and costly to employ, causing that it is preferred in small and noncomplex firms (Zajac & Westphal 1994), where the owner and the manager is the same person or where there exists another way of diminishing monitoring cost (e.g. when it is possible to rely on trust and reputation of CEO), and in the firms with very low or very high idiosyncratic risk (Miller et al. 2002). Particularly, it has been shown in several studies (e.g. Zajac & Westphal 1994, Gray & Cannella 1997, Bloom & Milkovich 1998, Miller et al. 2002), that firms which possess very high or very low unsystematic risk tend not to use incentive plans, and implementation of incentive pay in such companies is negatively related to firm performance. It is believed that it is because CEO is not really able to powerfully influence the company outcomes which serve as a basis for her incentive remuneration.

A wide palette of various incentive plans are commonly used in corporations attempting to control the manager by motivating her behavior via monetary incentives (cash- and stock-based). This direction is the one followed by the majority of corporation practitioners, and so provides a fruitful playground for researchers. It has been investigated (e.g. Narayanan 1996) how efficient the incentive plans are in the motivating effect. The results are controversial, although showing a positive relationship between adoption of incentive plans and firm performance in some

companies. Yet it is not clear from the research whether incentive plans are in their role in fact efficient (Wiseman & Gomez-Mejia 1998; Abowd & Kaplan 1999).

3 Aversion against Significant Negative Impacts

There is a marvellous amount of research activity concerning risk aversion. It has been believed for a long time that people are risk-averse. However, a lot of publications reveal that risk aversion does not work in the same line for both gains and losses, and depends on framing of problems and decision-maker's reference point (cf. Wiseman & Gomez-Mejia 1998 and references therein). Rather, some suggest that there exists loss aversion in the society (e.g. Kahneman & Tversky 1979). That is, people behave as risk-averse when talking about positive outcomes, and as risk-seekers when considering negative outcomes. The loss aversion is one of the approaches, that arisen because of the existence of many counterexamples for the suitableness of risk aversion assumption, for example a well-known Allais' paradox, which exhibits a certainty effect.

In the decision problems in practice, the lotteries are not either positive or negative. Rather, the decision-maker encounters both benefits and losses at the same time. The simplest example of this in business area is to decide whether to undertake a project of a possible gain and a possible loss. I believe that all actual decision problems are of such nature: there is never a possibility of choosing among options which all lead to positive outcomes even under the worst possible circumstances. The same holds for negative-outcomes election. Otherwise, there existed a "benefit machine", which we all would appreciate very much.

Another fact which runs counter to both risk aversion model and loss aversion model is that people do not perceive small losses in the same manner as large losses. For example, I conducted a small survey among 12 students from different fields for the purposes of this study. They had to choose between two possibilities: (1) to loose X for sure, or (2) to flip a coin and face a loss of either $2X$ or 0. If X was told to them to be 1 euro, ten of them decided to go for the risky alternative, one was indifferent and one would choose loosing one euro for sure. On the contrary, when X was fixed to 5’000 euro, they became worrying more about the possible loss of 10’000 euro and

the answers were significantly different: five going for the risky alternative, one indifferent, and six preferring the certain loss of 5’000 euro. The change in the preferences was driven by the wealth level of individuals: the higher wealth, the higher tendency to prefer risky alternative even for 5’000 euro.

Some researchers use as a measure of risk the variance reflecting overall uncertainty; other scholars (mainly from the fields of management and psychology) consider probability of loss (Wiseman et al. 2000). I argue that decision makers do not consider only probabilities, but often rather the maximum possible loss. Those are the values to worry about: when a possible loss would bring an individual into serious troubles, despite the fact that the possibility is not very probable, one tends to avoid that alternative at all. So, one chooses another option though incurring other costs, which are not too high and so choosing an "irrational" alternative, regardless of whether it is less risky or more risky, or whether it has a lower mean value. As it has been shown in the survey of students, the decisions vary according to the strength and significance of the negative impact of the worst alternative on their lives. In more complicated decisions with greater number of possible options, perhaps, one would also take into account the other alternatives with negative impact on the decision-maker.

It is also possible to see this kind of judgments from a broader view. Many decisions are taken in order to prevent the possibilities which affect gravely not only the decision-maker, but also other people or things she cares about. The typical cases of this behavior would be the propaganda against nuclear power-plants (in Austria, for example), or decision-making in family firms, where the owner avoids decisions which could have a negative impact on the next generations of her family.

Now a question arises: Are investors averse against significant negative impacts? I claim that diversification of investment is not only the cause of risk-neutrality in classical meaning, but also similarly contributes to neutrality for significant negative impacts. An investor may just incur a loss which is limited to her investment (limited liability rule), which is never significant under the assumption of diversification. And, as the investor cares only about her wealth maximization, she is indifferent among options which could lead to significant negative impact on other parties.

In some cases, investors would not behave in risk-neutral way, but rather as risk-seeking. This switch in their risk state happens as a function of new projects under consideration. When a project may lead to a large negative value in some of the possible states of nature and may so affect the assets of other stakeholders (e.g. debt holders), the limited liability of owners is motivating them to behave as risk-seeking, because very this acting would maximize their wealth. This holds analogously for the neutrality towards significant negative impacts and seeking such impacts.

4 CEO as an Investor

One of the crucial points of the problem is that managers are, as it is generally agreed, risk-averse. That is because their human capital investment and income are both tied to one firm, which lessens the possibility of effective diversification (Zajac & Westphal 1994). Therefore, the aim of investors is to make CEOs to behave as risk-neutral, and in the situations explained above, to behave in a risk-seeking way. This is a very important point for the present criticism of incentive plans. It will be argued that incentive alignment, as it is routinely taken up, does not lead to the expected change in risk aversion of manager, especially in the meaning of aversion against significant negative impacts. And in turn, incentive alignment does not lead to desired behavior of maximizing the wealth of the outside investors,[2] the original owners of the company.

Maximization of the wealth of the outside investors is equivalent to the maximization of market value of the company. However, if inside investors are taken into account, this may clearly not be the case. Some of the "insiders" may be better-off when the market value is lower; for example employees-shareholders often prefer less wage-less stress alternative to higher wage-more stress option, especially when the level of stress is already considerably high. It is because high stress in the job may

[2] Whenever it is referred to outside investors, we do not include CEO and other stakeholders, who are required to hold shares regardless of their propensity to invest in the company, or who may benefit from the company in some ways different from making profits by buying and selling shares and receiving dividends. To such investors we refer as to inside investors.

affect negatively the private life of employee and may for instance lead to family problems, and because of effort aversion of the employees, to put some of the possible explanations.

The CEO's objective may be substantially different from the one of outside investors. Her utility maximization may include other variables, such as variety of psychological issues broadly pointed in the scientific literature. Those include power-seeking, a tendency to create an empire, executing her self-esteem intentions, goodwill and reputation, or even learning and gathering information (which may be used for other purposes, such as scholar activity or some illegal operations).

Moreover, even if CEO's objective is to maximize her wealth, it does not necessary mean that it is done by maximization of market value of company. For the CEO, her wealth includes all possible future cash flows, not only the ones from the company she is currently running. Thus, if maximization of the current company's market value could lead to the consequences which negatively affect her long-term life, CEO will prefer not to sacrifice herself and ergo, will not heed the objective of outside investors. Such situation occurs, for instance, when CEO's reputation is in the bank. This provides support for the claim that CEO does not generally decide in risk-neutral way, even if she enjoys incentive alignment plans. A CEO (with or without incentive plans) is always averse against significant negative impacts, even if she is not risk-averse.

If one of the inside investors is CEO – who is the top decision-maker – her personal goal fully replaces the original goal of outside investors. Therefore, it is apparent that when CEO owns a substantial part of shares, which is indeed true in the current market, outside investors become "outsiders", regardless of how they attempt to capture CEO's behavior.

5 Accounting-Based Outcomes in Incentive Plans

There is no theory-based reason why outside investors should care about accounting-based outcomes of the company. Some would argue that it reflects the actual state of the company. A lot of evidence of the possibilities to influence these results by CEO makes this argument very weak. Other would reason that it provides

information for investors about how well the company is managed, so better accounting numbers indicate that investors are better off. However, all accounting results are reflected in the market value of the company, as it can be seen in the market when these numbers are announced. Therefore, there is no direct way how company's accounting-based outcomes can make an investor surpassing and higher market value is the only way how the outside investors can indeed become better off.
The accounting-based outcomes, however, may be for CEO an easy means how to increase her wealth, if she has a typical incentive-oriented reward scheme. They are much more predictable than market-based outcomes and also, CEO can influence them easier (Wiseman & Gomez-Mejia 1998). As a consequence, CEOs often tend to keep the numbers more or less stable over time. In particular, better results may be impossible to maintain over longer time period and so, CEO's reputation and owners' satisfaction with "her results" might be hurt. This is another illustration of how the aversion against significant negative impacts plays an unneglectible role in her everyday decision-making.

As Wiseman & Gomez-Mejia (1998) identify, the typical argument for not relying only on accounting outcomes is that market-based measures may increase the risk borne by CEO, since they measure firm performance largely outside the manager's control. On the other hand, some claim that market-based criteria increase the likelihood that CEO will exhibit behavior consistent with interest of investors. However, the main criticism here is that both sides assume that market-based criterion must be the absolute stock price in the market. Both groups of scholars neglect other possibilities, for example that relative market-based norms can be included in compensation schemes.

6 Ex-Post Remuneration Model

Typically, an incentive rewarding scheme consists of a variety of components. All combinations of short- and long-term compensation based on accounting and market outcomes compose the main part of total compensation (cf. Murphy 1999). Moreover, base salary, forgiven loans, huge severance packages, and other advantages are also often present in rewarding models. I will show that the ex-post model

presented in this section is similar to, and to some extent better than the typical remuneration scheme of today's CEO (called the ex-ante model in further analysis).

Based on the previous discussion, I introduce a very simple and naive compensation model. I propose that the CEO be rewarded based only on the market value of the company. Moreover, what is taken into account is only the change in the market value, confronting with those changes in similar-size companies in the same industry. The change is measured by comparing today's market value with the market value "long" time ago, say ten years[3] (ten years is a modal term of option plans in current CEO remuneration; Murphy 1999). If the value change is higher than the change in benchmark, current CEO and all the antecedents at CEO position are rewarded distributing among them part of this difference, say five per cent,[4] based on the fact how each of them has accounted for the change in the market price. If the value is lower than the benchmark, no reward is allocated. There are no other ways of monetary remuneration and CEO cannot be severed from her position.

The ex-ante model appeared as a consequence of several agency problems with CEO behavior. Since the control of CEO's behavior cannot be efficiently done by actual monitoring of her decision-making, incentives have been offered her in order to align her objective with the one of the owners of the company. The objective of investors is to increase their wealth in the long-term. It is generally agreed that the agency costs of incentive alignment between investors and CEO are minimized when CEO compensation is related to firm performance or other types of information regarding actions taken by executives (Tosi & Gomez-Mejia 1989). Moreover, the

[3] The length of this span may vary depending on the industry. For example, in more innovative and R&D intensive businesses should be longer than in more conservative manufacturing. The length of this period for a given sector can be deduced from short- or long-term orientation of the present-day's compensation schemes.

[4] Five per cent reward would probably not be far from the current ratio of changes in CEO's wealth and owners' wealth. Absolute sensitivity of CEO wealth to the wealth of investors in large corporations was estimated to be about 1.1 per cent in the years 1997 and 1998 (Bebchuk et al. 2002), which is more than three times greater than in the period 1974-1986 (Jensen & Murphy 1990). In this model we are taking into account only positive changes in owners’ wealth, and rewarding all previous CEOs which have accounted for the change.

efficiency of an agency contract can be improved by incorporation of the information about the performance of other agents facing similar business risk, because the influence of systematic risk is reduced (Antle & Smith 1986, Kerr & Kren 1992).

As a consequence, CEOs are to be motivated by tying their rewards to company results. For the short-term, annual (or shorter-period) accounting numbers have been used for bonuses. However, investors realized that this does not necessary lead to the maximization of their wealth in the long run; so it looks as a clear solution that CEO be forced to become one of the owners, i.e. to possess a significant amount of company shares. Hence, stock options and restricted stock were put into the compensation system in order to transfer partially the risk-bearing function to the manager. It is taken for granted in the theoretical models that the CEO cannot hedge the risk, however, recent evidence is contradictory (Ofek & Yermack 2000). Moreover, some researchers argue that cash contracts induce managers to underinvest in the long term and that stock contracts induce overinvestment in the long term (see Narayanan 1996).

It has become very common in practice that exercise price of stock options is changed when the market value of company changes so that it does not function as a motivator anymore. Murphy (1999) discovered that in the sample of 1000 largest U.S. companies, 15% of stock option grants were replaced or reloaded in fiscal year 1992. Usually, current market value is used as the exercise price of new option (95% of new option grants; Murphy 1999). Pollock, Fischer & Wade (2002) present, that CEO power significantly affects the repricing of her stock options. Moreover, many corporations adopt, however, not actually use stock options in the CEO's remuneration (Westphal & Zajac 1994). There are several possible explanations for these facts, including CEO's power, impression management, and institutional theory. The announcement of the adoption of long-term incentive plans also raises market value of the company (Murphy 1999), so the adoption itself may increase CEO's current reward, if market price has been incorporated in the remuneration system.

Less investigated, but more important are the problems with restricted stock given to CEO (or purchased by her when exercising options), almost all restricted stock of a CEO is sold after the CEO leaves the company, or at least, the position. There is some evidence that restricted stock is relatively inefficient in inducing risk-averse CEOs to accept risky projects (Bryan et al. 2000). A lot of speculation is then

being seen, because CEO tries to sell her shares at the point when the market overvalues the company most (cf. Fluck 1999). For that, she often uses the internal information, using either personal connections to top managers, or information she possesses from the time she was at CEO position. Consequently, when a bigger amount of shares is supplied and assuming by the market that this action happens only when the company is overvalued, the stock price of the company falls down significantly. This is not what the investors are looking for.

We can see that the proposed ex-post model relates CEO's compensation to firm performance, as it is recommended by agency theory. However, it does not lead to deflections as described in previous paragraphs, which may hurt the wealth of investors. Both models transfer some amount of company-specific risk to CEO, so unsystematic-risk-bearing arguments account in a similar way for either of them. Systematic (market) risk is borne only in the ex-ante model. Nevertheless, in the ex-ante model, CEO's reward from stocks and stock options does not depend only on her own past decisions. Considering that it is usually received when CEO is already down from the position, her successors' decisions account noteworthy for the actual market value of the company. Hence, a CEO bears not only the risk of her decisions, which she may be able to diminish, but also the uncertainty about the future decision-makers (the board of directors' ability to select a competent CEO) and their decision-making. This gamble is not something which CEO could be able to influence. In the ex-post model, CEO does not take this risk to such high degree, because CEO is accounted for her own decisions, whether at the moment when they are undertaken, or in the long run.

I am to claim that ex-post model minimizes the aversion against significant negative consequences and restricts it only to nonmonetary ones (such as reputation or future employment possibilities). Wiseman et al. (2000) observed that "If there is only a potential for gains but no pay penalty contingent on lower values of the performance indicators pay may not be seen as risky by decision makers". Since CEO is not penalized for high negative impacts on market value more than for low negative impacts in this model, her aversion is limited only to nonmonetary issues. However, this is not true for ex-ante model, where CEO is punished more for more negative impacts owing to her possession of shares and stock options.

There has been a pregnant and very critical public discussion about excessive pay of CEOs and never-ending effects of its rise (as a reference, see a special report on executive pay in The Economist, October 11th 2003). There are some reasons why executives' pay should (or could) grow over time. For example, as the total CEO pay is and can be linked to the size of company, if the largest corporations today are larger than the largest corporations in the past, there is clearly a room for the same growth in CEOs' rewards. However, the current growth rate of executive pay is much higher. I believe that it should be accounted to what is known as the Lake Wobegon effect. "No board [of directors] wants to pay the average for the job. The above-average candidate which directors have just selected as CEO, they invariably reason, deserves more." (The Economist, October 11th 2003, p. 13). And so, the board offers to new CEO a reward without asking her whether she demands such a colossal pay, assuming that she will behave as above-average. In my model, only above-average CEO would be willing to sign the contract. Moreover, the contracting scheme does not change when a new CEO is taking the position. Thus, it is up to her to show whether she indeed is above-average manager or is not.

Why should not be CEO severed from the position? This restriction is in order to overcome information asymmetry in the market, because it is difficult for outsiders to distinguish unfortunate circumstances from poor decisions (Wiseman & Gomez-Mejia 1998). It is often not true that the market price of company reflects absolutely all the existent information; rather, only the information available to (current and possible) investors is displayed in the market value. Therefore, if the change in market value is under-average some year, it does not necessary mean that the CEO has made wrong decisions. It is fairly possible that just market is not aware of the true value of the decisions and is undervaluing them. But CEO may have some internal information which is not available to public and she may know that it will come out later on. At that time she will be rewarded for the decisions. If CEO knows that her decisions were really unsatisfactory, she will not wait for next periods and will try to avoid negative consequences on her future life by leaving the firm as soon as possible. This condition thus yields an effective natural selection of CEOs: good stays, poor leaves.

I have been manifesting that there exists a motivating model for CEO compensation which is at least as good (from the point of view of investors) as the typical today's CEO remuneration model. We could ask: How costly is it to maintain

this model? Due to the existence of stock exchange, it is very easy to gather all the information about the market value of the company and benchmarking corporations. However, for some industries, it might be difficult to find a benchmark; maybe there is no similar-size company, or other kind of problems may arise. Probably the most difficult task is to allocate the accountability for overperforming the benchmark among CEOs. Yet, there have been a similar challenge in the remuneration models which are used today. Boards of directors face the complex and difficult task of attributing responsibility for organizational results to management or to environmental factors beyond CEO's control (Kerr & Kren 1992). For example, many boards of directors make changes in the compensation plans (e.g. repricing stock options) when they realize that the reality is different from what they were expecting. I believe that consultancy firms are so well-developed today, that providing this kind of recommendations would not be a problem for them.

The following note should be made here. Other costs may arise when investors decide to implement this model. The adoption costs are probably very high because CEOs usually have a significant power over the board of directors (Finkelstein & Hambrick 1996; Westphal & Zajac 1994; Yermack 1997), and on the other hand, when investors are dispersed, they may not have control over the board which would be enough to enforce the change in the pay system. Moreover, as ex-ante incentive plans are generally recommended by both researchers and consultants, the adoption of that pay scheme has a value in the society and so offers an institutional premium for both company and CEO (Westphal & Zajac 1994).

It is possible to find kind of ex-post remuneration models in the market, however, not very often in manager positions. For example, payments after showing a competence are realized for researchers or insurance agents. The most similar to the model presented here are the rewards of proprietors. They have to show that they are able to overperform competing firms in the long run and only in that case they can get a benefit, which is a fraction of the total firm profit. Exactly as in the ex-post model, they cannot be severed; only the proprietor herself can resign from her position.

Conclusion

The purpose of this paper was to extend the agency-based corporate governance literature and provide some theoretical explanations why current solutions to agency problems may not work efficiently. Particularly, the focus was on showing that today's incentive plans are not efficient because of underdeveloped knowledge about risk aversion and risk itself in decision making and because of evidence supporting managerial and institutional theories. I incorporated different and less often used definition of risk aversion in order to help to explain some contradictory results in recent literature.

The agency theory is developed under the assumption that CEO cannot influence owners' wealth by other means than by the market value of the company. Nevertheless, this assumption is gone kaput as soon as the manager enters the family of investors. In addition, the assumption may not be valid anymore in the case when CEO's reward is tied to the corporation outcomes, regardless of whether the measures are market-based (external) or accounting-based (internal). This is truer for accounting-based outcomes, which may not be correlated very much with the increase in the wealth of investors, which is their ultimate goal.

By presenting the ex-post compensation model, which is argued to be at least as good as current rewarding system in practice, this paper adds to the evidence, that agency theory alone cannot explain today's methods in corporate governance, and other psychological and/or sociological theories must be considered. In particular, if typical compensation schemes were not advantageous for managers, companies would prefer the ex-post model proposed in this study. Thus, existence of institutional premium for the company and CEO, and existence of CEO power over her compensation mix is supported by this theoretical study.

However, the model is still not perfect and neglects some important issues. For example, it assumes that the goal of investors is to maximize their wealth given that they have invested capital into the company. It may not be definitely true, because to get the market value of $1’001, it matters whether an investor had to invest $1’000 or $1. Nevertheless, I think that the model can be adjusted even to this kind of criticism by its deeper exploration.

The arguments presented here should be tested in the market. I think that it will be very difficult to find a sample of companies, which use a compensation system similar to the ex-post model introduced in this study. Moreover, I doubt whether there exist at least one such company, to begin at least with a case study, which could yield some support for the claims presented here. Furthermore, more precise investigation concerning aversion against significant negative impacts must be done. More especially, this aversion should be faced the practical decision-making in corporations.

This paper shows up several important problems to be addressed in future research activity. First, better understanding of risk is needed in order to be more powerful in explaining current practices in CEO compensation by agency theory. Second, the analysis in this article shows an importance of compensation based on benchmarking, i.e. rewarding schemes relative to the firms similar in size and risk. Finally, the aversion against significant negative impact on reputation has been shown to be the most important issue to deal with. Hence, reputation and the trust based on it will be very important issues linked to the control of CEO's behavior, and so more interest should be drawn on these topics in the future investigation as well.

Summary

The paper provides a criticism on the incentive plans used widely in corporations in order to align behavior of Chief Executive Officer (CEO) to the shareholders' interest of maximizing their wealth. It further develops the ongoing debate about risk aversion and highlights how it affects decision-making in companies. An alternative model of CEO's remuneration is presented in the paper and it is argued that this ex-post model results in better consequences for owners than the common incentive models used in the practice do. The new model is less costly, however, not very frequent in application, thus supporting presence of institutional motives and managerial power in CEO compensation schemes in large corporations.

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