

A Framework of Excessive Executive Compensation – An Obscured Breach in Corporate Governance Agency Contract

Abstract. Excessive executive compensation is tantamount to a breach of agency contract. There are two main problems with excessive executive compensation: excessive compensation is stealing from a shareholder's standpoint; excessive executive compensation is demoralizing to the other workers in the organization.

Purpose. This paper aims to provide a conceptual framework of the antecedent and postcedent of excessive executive compensation.

Approach. The paper inclines on agency theory and the attendant principal-agent contract. The paper follows a critical deconstruction approach, culminating in the development of an original conceptual framework.

Finding. Through a critical deconstruction of agency theory postulation of optimal agent's response to corporate compensation structure, it emerges that this postulation may not hold in all instances given that gargantuan compensation structure has a high propensity to nurture irresistible executive financial misdemeanours to inflate profit or share price, which are the performance index of reaping the excessive compensation. This incubates ancillary agency costs to the detriment of the principal and corporate survival.

Theoretical and practical value. The paper offers insight into corporate governance strategy for accounting and business law theory and practice in university business schools and for further research. In addition, corporate boards may draw insights from the theory developed in this paper, which portrays the antecedents and postcedents of executive excessive compensation. This theory will catalyse debate and rethinking of corporate compensation policies within the boards of directors. The paper offers an original contribution to the contentious agency cost issues by developing a conceptual framework of the antecedent and postcedent of excessive executive compensation – depicting obscured additional agency costs.

Keywords: principal-agent contract, corporate governance, agency costs, agency theory, breach of contract.

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Система надмірної винагороди керівників – невідоме порушення контракту з агентством корпоративного управління

Анотація. Надмірна винагорода керівників прирівнюється до порушення агентського контракту. Існує дві основні проблеми, пов'язані з надмірною винагородою керівників: надмірна винагорода – це крадіжка з точки зору акціонера; надмірна винагорода керівників деморалізує інших працівників компанії.

Мета дослідження. Ця стаття має на меті надати концептуальну основу попередніх і наступних випадків надмірної винагороди керівників.

Дослідницький підхід. Теоретичною основою дослідження є теорія агентства та супутнього договору принципал-агент. Стаття дотримується підходу критичної деконструкції, кульмінацією якого є розробка оригінальної концептуальної основи.

Результати. На основі критичної деконструкції постуляції агентської теорії про оптимальну реакцію агента на корпоративну структуру винагороди з'ясовано, що ця постуляція може не виконуватися у всіх випадках, враховуючи, що гігантська структура винагороди має високу схильність сприяти непереборним фінансовим зловживанням виконавчої влади з метою завищення прибутку або ціни акцій, які є індексом ефективності отримання надмірної винагороди. Це продукує допоміжні агентські витрати на шкоду принципалу та виживанню компанії.

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Теоретичне та практичне значення. Стаття пропонує розуміння стратегії корпоративного управління для теорії та практики бухгалтерського обліку та господарського права в університетських бізнес-школах, а також для подальших досліджень. Крім того, правління корпорації може почерпнути корисні знання з теорії, розробленої в цій статті, яка описує попередні та наступні випадки надмірної винагороди керівників. Ця теорія стане каталізатором дискусії та переосмислення корпоративної політики винагороди в радах директорів. Стаття пропонує оригінальний внесок у спірні питання агентських витрат, розробляючи концептуальну основу попередніх і наступних випадків надмірної винагороди керівників – із розкриттям прихованих додаткових агентських витрат.

Ключові слова: договір принципал-агент, корпоративне управління, агентські витрати, агентська теорія, порушення контракту.

1. INTRODUCTION

The author believes that a better introduction and perhaps a better summary of this discussion will be Elson's essay on the answers to excessive executive compensation:

"There are two main problems with excessive executive compensation. The first problem with excessive compensation is that it is stealing. This is a real problem from a shareholder's standpoint. Number two, excessive executive compensation demoralizes the other workers in the organization. After all, everyone else in the organization is not going to cut costs if they see the executives taking and walking off with everything that they thought they were saving" (Elson, 2007, p. 403).

The principal-agent theory has long been a notable business and economic philosophy (Ali, 2014, pp. 419-432). This theory tends to provide suggestions toward a potential resolution (to the extent possible) of the ever-expanding quagmire subsisting in the principal-agent contract and by implication to the wider spectrum of corporate governance (see example, Pandey et al., 2023). However, the many existing dilemmas in corporate governance amidst the agency theories have made scholars suggest that many ideologies of existing theories may not constitute absolute catalysts to governance problems. Instead, a pluralistic approach might provide better approaches to resolving the expanding dynamics of corporate governance complexities (Letza et al., 2014).

Excess executive compensation is an aspect of obscured agency cost that has suffered apparent neglect or, at best, weakly discussed in the theory and practice of accounting, law, economics, and business. The lack of due attention to excess compensation may have emanated from strands of philosophical sweeping of excess compensation under the ambit of optimal contracting – in the somewhat generalized thought that excess compensation stems from surplus economic gain from exceptionally skilled CEOs. For example, according to the optimal contracting theory, compensation is a key performance incentive and a factor in luring and keeping skilled executive directors (Bebchuk et al., 2001). However, whilst this theory deserves due accolade, there is an apparent lack of ceiling where excess compensation may be said to have reached a climax and thus deserves a hiatus. Along with this reasoning, Kramm & Robeyns (2020) remind us of the advocacy by modern philosophy about the need for an upper limit to individual wealth acquisition. This is because, by nature, wealth acquisition is insatiable; accordingly, if an agent's excess compensation is left boundless, it may lead to an ultimate

sub-optimal return to the corporation, which might, therefore, corrode the very essence of agency costs. The crux of agency cost is to attempt a balance between the principal and the agent's interest; after that, the agent may provide commensurate services and return the principal's investment in the corporation. Accordingly, without a ceiling on excess compensation, it may imply that the more a company's financial performance increases, the more the CEO may acquire excess compensation.

"Excessive pay is defined as compensation that is 20% or greater than the national average CEO salary" (Whelton, 2012, p. 15).

Scholars such as Whelton (2012) argue that excessive CEO compensation has changed the relationship between CEOs and corporate stakeholders in addition to a detrimental effect on the general society. Whelton (2012) notes a cheating culture and attendant corruption, in which excessive compensation incubates corporate misconduct – which, amongst others, includes CEO corruption and attendant unethical behaviour by stakeholders. Harris & Bromiley (2007) concurs that executive compensation may exacerbate corporate financial impropriety.

It follows, therefore, that if excessive compensation is likened to cheating, if stakeholders are not happy with excessive compensation and if it breeds a ripple of corruption along the corridors of corporate governance, it is thus tantamount to an obscured breach in principal-agent contract.

Corporate law experts and accountants need additional information to assist with tracing and solving corporate misconduct.

The contemporary corporate landscape is in dire need of increased financial ethics. Hence, an obscured aspect of this phenomenon is the problem of this paper, namely the need to understand the antecedents of excess compensation and the attendant governance issues that need corporate regulatory and policy redressing. Accordingly, this paper provides a framework highlighting the drivers of excess compensation, which may assist in modelling additional regulatory checks and policies in corporate governance.

The next section of the paper provides a synopsis of principal-agent theory, this is followed by a discussion on obscured agency cost (excessive executive compensation) and a framework. The final section provides the conclusion and recommendation.

2. PROBLEM STATEMENT

Contemporary executive compensation seems to rely sweepingly on the agency theory assumption that agents would respond optimally to formulating their structure of incentives. *“A bounded rationality perspective also suggests that rewards for specific outcomes increase the probability that individuals work toward those outcomes”* (Harris & Bromiley, 2007, p. 352). However, excessive compensation may counter the agency theory's assumption regarding incentives.

In their research, Harris & Bromiley (2007) note that executive behavioural constructs may be phenomenologically profoundly entwined with incentives. An intriguing submission by Harris & Bromiley (2007) is that it is far easier to be ethical when a manager's pay is not too gigantic, but that: *“It is harder to be ethical when substantial portions of one's pay can be influenced through misrepresentation. The strong incentive power of stock options means that “the temptation to inflate stock prices artificially will also be strong”, especially when options constitute a large portion of a CEO's pay package”* (Harris & Bromiley, 2007, p. 352).

The above postulate in Harris & Bromiley (2007) had a real-life industry corroboration when a highly rated US litigator and former federal prosecutor commented that huge executive financial compensation, which existed in Enron, was a significant insignia to the existence of executive financial malpractice and its linkage to Enron's debacle. Thus, in his law article in the New York Times of 2002, Eichenwald (2002) elaborated the following regarding executive excessive compensation in Enron: *“The bonus payments and other special cash distributions include some \$320 million paid just 10 months before Enron's collapse into bankruptcy, according to company records. Legal experts said that the payments could provide strong evidence of a motive for the financial machinations that investigators think distorted the company's reported performance and ultimately led to its demise. Without those efforts, the profit and stock price levels required to obtain the money almost certainly would not have been reached”* (Eichenwald, 2002, p. 1).

3. RESEARCH OBJECTIVE

This paper aims to provide a framework for the antecedents and postcedent of excessive executive compensation. It would be very valuable for corporate attorneys and accountants in tracing and ameliorating corporate financial malfeasance.

4. THEORETICAL BACKGROUND

Agency Theory in Corporate Governance – A Synopsis

Agency theory describes the relationship between a principal and the agent; whilst the principal provides the capital, the agent is hired to run the business on behalf of the principal. By so doing, the principal delegates authority to the agent and in return, the agent is expected to run the business efficiently to provide financial returns to the principal. This, therefore, represents the contract or

the agreement that subsists between the agent and the principal; however, given that the agent runs the business on a day-to-day basis, the agent develops an apparent monopoly of the business information more than the principal (Mishra, Heide, & Cort, 1998).

This information imbalance creates information asymmetry, which results in corporate governance problems because ceteris paribus businessmen and women are economically rational people and would place their personal financial benefit first before thinking about the principal. Accordingly, possessing abundant privileged information may influence the extent to which the agent could abuse their power by using corporate information to their personal advantage at the expense of shareholders (Haugen & Senbet, 1979; Macher et al., 2011). These and more create problems for the principal who initiates approaches for monitoring the activities of the agent; these include, among other things, regular preparation of financial reports and external auditing of the financial reports, which gives rise to agency costs in the principal-agent contract, which includes amongst others monitoring costs, bonding costs and residual loss (Florackis, 2008).

5. RESEARCH RESULTS

The Obscured Agency Cost in Corporate Governance – Toward a Framework of Excess Compensation Cost

Scholars of economics and law uphold that ideological penchant may be related to the economic genres of institutions and choice (Kalt & Zupan, 1990). Therefore, instilling ideological characteristics into the analysis of agency costs usher complexities, including, among other things, the measurement problem and approach to the measurement. Hence, Fama & Jensen (1983) opine that a significant factor in corporate survival is the approach and success in controlling agency problems.

Fama & Jensen (1983) opine that the root of agency problems lies in the cost implication of writing and enforcing contracts between the agent and the principal. These expensive characteristics of the principal agency relationship result in different agency costs, such as monitoring costs, structuring costs, bonding costs, and residual costs (or residual loss). Albeit the agency costs are meant to neutralise and/or reduce the agent's excesses or contravention of the contracts, there is still no guarantee that the principal is assured of positive benefit from the business entrusted to the care of the agent. There is the possibility that in some principal agency relationships, the total costs of contract enforcement may exceed the benefits. The excess costs over the benefits of the agency relationship are the residual loss (or residual costs) (Fama & Jensen, 1983).

Two opposing perspectives on excess pay result in opposing predictions about how governance structures and excess compensation might be related. On the one hand, excessive pay might be an agency expense (Bebchuk et al., 2001). According to the managerial power hypothesis, executive directors have significant control over their own pay, making it difficult to deter

them from securing a lucrative contract that is not always related to their performance (Bebchuk & Fried, 2003). This theory says excess compensation worsens agency issues by hurting business performance. Accordingly, the agency cost view would expect governance structures to function as a limitation against excessive compensation of executives; this function is thus anticipated to reduce agency costs.

On the other hand, according to Fama (1980), excessive compensation may be a way to increase senior directors' drive to boost businesses' financial performance. According to the optimal contracting hypothesis, pay is a key performance incentive as well as a factor in luring and keeping skilled executive directors (Bebchuk et al., 2001). Therefore, if a company agrees with this viewpoint, the company should try to pay more than the opportunity costs of executive directors in order to have them achieve more desirable results (Bebchuk et al., 2001). According to Shleifer & Vishny (1997), governance arrangements are generally interested in a company's ability to maximize its profits. The governance structures are, therefore, anticipated to promote excess remuneration to maximize company performance, according to the performance motivator view of excess compensation.

This paper's framework is developed with reliance on the critical literature argument that excessive executive compensation, in addition to constituting extraordinary cost burden to the principal, may contain other ancillary costs (directly or indirectly), which, put together, may jeopardise the interest of the principal and other stakeholders, with an additional potential threat to corporate survival at the long or short.

This framework corroborates scholarly arguments in the empirical literature, which questions the value of excessive executive compensation (Walker, 2012): *“Extracting excessive executive pay is likely to have other adverse consequences beyond transferring funds from shareholders, other investors, and workers to executives. The managerial power view of the executive compensation setting process implies that the design of executive pay packages will be distorted from the most efficient design to camouflage executive pay and deflect outrage. To the extent that it is transparent, excessive executive pay may adversely affect worker morale at lower organizational levels”*.

Whilst buttressing the argument that excessive executive compensation may entice executives to financial malpractices that could tumble the corporate existence, Eichenwald (2002) quoted Stephen Meagher – a US white collar case expert, a litigator and a former US prosecutor, as follows: *“A strong financial motive is probably the best evidence a prosecutor can get to promote or establish criminal intent,” said Stephen Meagher, a former federal prosecutor who handled white-collar cases and now represents whistle-blowers. “The levels of compensation that we are talking about here would certainly seem to be a powerful incentive for anyone to do anything.” (quoted in New York Times by Eichenwald, 2002, p. 1).*

Based on the preceding discussions, this paper contributes a framework in Figure 1 for understanding the dynamics and further discussion of excessive executive compensation.

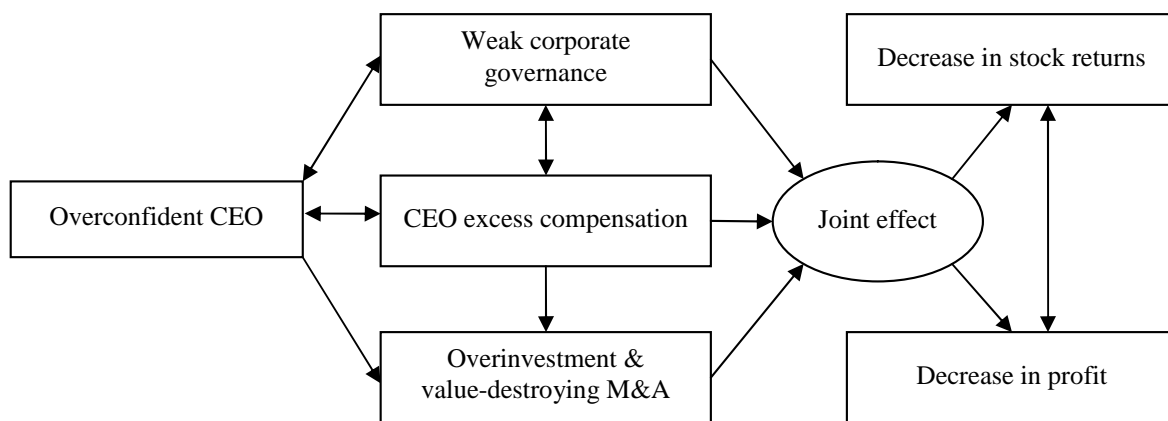


Figure 1. Framework of Excess Executive Compensation – Ancillaries and Ripples

Source: Author's Model (with insights from the literature).

6. THEORETICAL AND PRACTICAL VALUE

This paper possesses practical and academic theoretical significance. Corporate boards may draw insights from the theory developed in this paper, which portrays the antecedents and postcedents of excessive executive compensation. This theory will catalyse debate and rethinking of corporate compensation policies within the boards of directors. This paper's conceptual framework would engender further discussions, debates and research that would apply the conceptual framework

to critical and empirical research. Additionally, the issues raised in this paper provide a good discussion paper for business schools in corporate governance and business law classes.

The paper contributes a new debate on the corollaries and ripples of excessive executive compensation by developing a new conceptual framework, which brings new insight and deconstruction to the principal-agent contract and the attendant agency costs.

7. CONCLUSION

This paper was motivated by the apparent obscurity of the dynamics of additional agency cost implicit in excessive executive compensation. Accordingly, there exists a corporate governance problem which draws from an apparent sweeping belief that excessive executive compensation inclines on the agency theory assumption that agents would respond optimally to executive compensation structure. Thus, most executive compensation structures have been tailored toward unlimited executive compensation perks in so far as there is evidence of improved profit or share price performance, albeit the apparent existence of unethical financial practices that beget the profit or share price performance. This obscured agency costs further obfuscate accounting and legal apparatuses that could be applied to curb related malfeasance. Therefore, this paper engaged in a critical deconstruction of excessive executive compensation and provides a maiden conceptual framework to guide practical and theoretical understanding and further developmental debates around excessive executive compensation (EEC). This framework highlights the intertwined antecedents to excessive executive compensation and the postcedents of excessive executive compensation.

Overall, the significance and value of the paper are encapsulated within the additional agency costs

orchestrated by the EEC. This cost could cause a potential corporate liquidation to the detriment of the shareholders whose interest the agent should protect. Therefore, the paper provides clues toward formulating additional legal and accounting strategies to curb excessive executive compensation and/or to ameliorate the devastating effects of EEC that may threaten corporate survival. The paper's opinion is that executive compensation, which relies solely on the agency's assumption of the agent's optimal response to compensation, may be overrated and that the overrating and apparent penchant for the belief that financial returns from excessive executive compensation cause negative ripples that may infest corporate structures and other corporate stakeholders with unethical operational and financial practices. After all, eminent empirical research by corporate governance experts found that the best-paid CEOs are not necessarily running the financially best-performing companies.

The discourse in this paper is of timeous importance given growing corporate governance issues and that additional information provides valid evidence that may be vital for both legal and accounting intervention in maintaining efficient and effective corporate governance. Further research is encouraged to apply this paper's framework in future empirical research and strive to expand the framework.

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