Corporate Governance (22E00500)
Group report: Fair executive compensation

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1. Introduction

1.1 Introduction to the topic of executive compensation

Even though the public in America is not aware of the actual compensation levels of CEOs, they tend to believe that corporate leaders make too much money. This is based on the results of a new survey on the public's perception of CEO pay conducted by the Rock Center for Corporate Governance, a joint venture of Stanford Graduate School of Business and Stanford Law School. The survey polled 1,200 Americans about the salaries of CEOs, how they should be compensated for performance, and whether the government should be involved.

Overall, respondents believed that most CEOs earned less than a tenth of what they actually did — on average, they believed CEOs earned nearly $1 million, whereas the true average is around $10 million. Nonetheless, 74% believe those CEOs are overpaid. Furthermore, CEO pay has risen dramatically in recent decades. CEOs can now earn between 210 and 300 times what their employees do. According to the Economic Policy Institute, they used to make 20 times the pay of their workers back in 1965, i.e. the difference has increased quite radically.

The institute discovered this finding by surveying years between 1978 and 2014. According to the institute, even when adjusted for inflation, the CEO pay increased by 997% from 1978 to 2014. Generally, companies use high salaries to attract top talent in a competitive field or to reward leaders who add value to the company. According to Stanford GSB lecturer and researcher Nick Donatiello, another survey shows that Americans are either skeptical that

CEOs create additional value or do not believe they should be compensated for it. For example, when survey respondents were asked how much a CEO should be paid if he or she increased the value of a company by $100 million in a year, the median answer was $500,000, while the mean response was $3.2 million.

The finding should be a red flag for many companies that set the level of CEO pay and additionally must justify it to the general public. "Clearly, companies have failed to communicate how much value their CEO can or will create, and how much compensation is required to attract, retain, and motivate the right people," Donatiello says.

Interestingly, academic studies on this topic have yielded mixed results. It would seem that some studies agree with the public opinion that CEOs are being overcompensated and blame it on the "managerial power" for example, which is a form of hypothesis that US CEOs set their own pay levels. On the contrary, other papers disagree, claiming that the compensation of CEOs is fair considering some factors such as the increase in firms' size and complexity, ownership and board's structure as well as the causal effect between CEOs compensation and firm performance.

Understanding the complexity of the matter, this paper sets out to examine both perspectives, and synthesizes the findings to derive a final conclusion regarding the remuneration of CEOs. The question to be solved is whether or not the level of executive compensation is fair or excessive as indicated by the public opinion. We will approach the topic mainly from the perspective of effective markets and agency theory. However, it should be noted that there are also many other compensation theories which may lead to different results. In the next chapter we will briefly cover the most common forms of compensation theories in the light of executive compensation.

1.2 Compensation theories - the basis of our approach

The topic of executive compensation has been generally approached in the academic literature through one of the following theories: i) behavior reinforcement and expectancy theory, ii) equity theory or iii) agency theory. In short, compensation can be defined as the remuneration given to employees for the work they do for a company. This can be seen to consist of tangible assets such as monetary benefits in the form of base salary, stock options and bonuses but also intangible factors e.g. workplace culture, compliments and employee's responsibilities have an impact.

Based on previous studies and publicly available information, it is common knowledge that labor costs can be one of the largest expenses for an organization depending on the line of business it carries. Thus, companies objective is to mitigate these costs through compensation management i.e. systems implemented to ensure that money is spent to secure the highest level of employee productivity from the perspective of cost optimization. Aim is to pay employees well enough for them to stay motivated and do their best, and stay within the organization while also making sure that no money is wasted in terms of excessive compensation. Compensation theories can be used as a basis to establish an efficient compensation management and a way to find the optimal compensation level.

Due to limited time and space constraints our paper only focuses on the most common and widely accepted form of compensation theory, i.e. the agency theory. However, it should be noted that there are also other theories which have gained additional attention during the last decade. Most common of these are behavior reinforcement theory and equity theory. According to behavior reinforcement theory, reward-earning behavior is likely to be repeated in the future, i.e. an employee is likely to perform in a similar way if he or she has been acknowledged for it in the past or if it will likely be followed by a definite reward or outcome. Thus, it is important to pay attention to which kind of behavior is encouraged in terms of remuneration. For example, the key performance indicators used for incentive systems may reinforce certain types of behavior.

Equity theory approaches remuneration from the perspective of uniformity and fairness. According to this theory, employees' actions will be based on their perception of how they are compensated in comparison to their coworkers and similar positions. Ultimately, there should be some sort of equity or uniformity in the compensation as if the employees feel to be undercompensated for the amount of work it should result in lower productivity, increased turnover and higher absenteeism. Vice versa, if the employees feel overcompensated they should in theory work harder to retain their current position.

Agency theory can be seen as the most common and most-widely accepted form of compensation theories. Thus, we have decided to include agency theory also as the main subject of our analysis in terms of the topic of executive compensation. In essence, agency theory can be defined as a conflict of interests between the shareholders of a company and the actual

employees who run the daily operations and business activities on the behalf of shareholders. The theory states that both the shareholders and employees can be regarded as stakeholders of the company, and the remuneration paid to the employees is a mandatory cost (agency cost) to mitigate the issues caused by conflicting interests. Ultimately, the employees will try to get as high of a compensation as possible for the minimal amount of work while the shareholders would like to get the opposite, i.e. maximum work input and efficiency for as little money as possible.

Agency theory represents a nexus of contracts between the shareholders and executives (along with other employees) and can be seen as a principle that aims to explain and resolve issues in the relationship between these two parties. Often the objective is to reduce so called agency loss which can be seen as costs incurred due to the difference in priorities and interests. In our opinion the level and structure of executive compensation is an important factor in this regard and can be seen as key to mitigate these agency losses. From the perspective of efficient markets it would be reasonable to presume that the level and structure of executive compensation would be set at an optimal level to sufficiently reduce the agency costs. In chapters two and three we will discuss arguments for and against this perception in more detail.

Most often the areas of dispute in terms of agency theory are due to two key areas: i) difference in the goals and ii) risk aversion between the shareholders and executives. As an example, company executives may desire to pursue short-term profitability to gain additional bonuses while the shareholders would prefer to aim for long term strategic goals and value growth. There are multiple different instruments to try to mitigate these differences such as the structure of overall compensation (base salary, bonuses and stock options) and cultural aspects. Risk aversion related differences are more difficult to mitigate as these can be due to governmental factors (e.g. the safety nets provided by society in a form of different benefits) and individual preferences. On a general level, however, executives can be seen as more risk-averse than the shareholders as they have an option to diversify their shareholdings between different companies while executives may rely on a single source of income. Thus, the executives may be too risk averse and avoid riskier investments that would be beneficial for the shareholders and value maximization.

Overall, the level and structure of executive compensation can be seen as an important topic from the perspective of all above-mentioned compensation theories. In the next chapter we will

focus in more detail on the arguments against high executive compensation, i.e. that the level of compensation would be excessive in terms of agency theory and thus resulting in redundant costs for the company. Similarly, in chapter three we will discuss arguments supporting the current level of executive compensation and lastly we will conclude our findings and present our reasoning in the light of agency theory.

2. Arguments against high executive compensation

Scholars and the general public have various arguments against high executive compensation. These points argue that the current level of compensation cannot be justified in all situations. In this section we will address some of the more common arguments and critique against high executive compensation to give some weight to the public outcry.

2.1. Critique on Performance-based pay

Performance-based pay is often used as an explaining factor for higher executive pay. According to the Agency theory (Jensen & Meckling 1976) the management and shareholders interests differ from each other by nature. However, there are different remedies to this problem, one of which is the performance based pay. In essence performance based pay incentives managers to work harder and towards common goals.

Most studies would agree that executive compensation is correlated with firm performance (Kaplan 2012). This however raises the question of which factor actually causes which outcome. High executive compensation could be due to the ability to simply pay more, or the better pay could have incentivised the CEO to work harder thus improving the performance. Most would agree that on a general level performance based pay works as an incentive to improve one's productivity. For example, there is a lot of evidence from the sales industry of performance based pay increasing productivity. However, the nature of the job and tasks of a CEO is completely different from that of a salesperson. It could be argued that additional hours dedicated to the job do not necessarily improve productivity considering the high hours CEOs have to work no matter what. Additionally, the utility function of the increased pay is not linear as it may be in lower paying jobs. Consistent with this, Mishra et. al. (2000) find that CEOs'

performance based pay is positively related to firm performance but has diminishing returns or can be even counterproductive when managers are risk averse. Similarly, Jensen & Murphy (1990) find only a small relation with CEO wealth and shareholder wealth. Furthermore, Tosi et. al (2000) states that only 4% of the variance in CEO pay is due to firm performance.

Performance based pay is troublesome also due to the inflexibility of the pay. CEOs will commonly benefit from windfalls and economic trends without having any effect on the outcome. However subjectivity is often used in favor of the CEO if unpredictable negative events affecting performance have occurred. Moreover, performance based pay has other adverse effects such as gameplaying, but we will not address these issues in this paper.

It can be concluded that aggressive performance based pay schemes might not improve the firm performance, but may rather serve as simply a value destroying expense. This would be the case when the marginal cost of performance based pay is higher than the value it adds. This is not to say that performance based pay has no other benefits, but it could be argued that its efficiency improving nature is overstated at least on excessive compensation levels. It should also be noted that when studying performance based pay the results vary greatly depending on how things are measured. For example, different results can occur whether one chooses to assess performance based pay on when it is given or when the final cash flow is received.

2.2. Attracting talented individuals

Another classic argument for high executive pay is that it attracts talented individuals to the firm. Most studies use firm size as a proxy for CEO talent, assuming more sizable firms are complex and require more talented CEOs to manage it (Edmans & Gabaix, 2016). Talented CEOs know their worth and seek the best opportunities for their career. Furthermore Falato, Li & Milbourn (2015) show in their study that CEO credentials such as education and career affect positively on pay and performance especially in larger firms. It can be said that there is some evidence in larger firms that bigger pay attracts more talented CEOs. However it could be argued that there is not enough evidence of this in smaller firms.

Gabaix & Landier (2008) find in their study that there are very small differences in CEO talent which still cause substantial differences in their pay. The underlying assumption is that the best CEOs manage the largest firms. However the differences in talent between the best CEOs in

large firms are insignificant whereas the pay differences are not. Therefore it can be argued that many firms overstate the correlation between the talent and pay when trying to attract talented executives. Adding to this Fernandes et al. (2013) find that CEO characteristics such as education, past experience or tenure have no significant effect on differences in pay. Furthermore Dicks (2012) argues in his paper that bad governance may result in overpaying CEOs. This then pressures other firms to match the salaries to compete in the labor market. This means that especially smaller firms that do not have resources for proper governance may be unable to assess CEO talent accurately thus overpaying them regarding their talent. This could then inflate the overall CEO compensation levels which would then also reflect to larger firms with good governance.

Therefore it is more likely that the correlation between talent and compensation is mostly relevant when comparing smaller and more complex larger firms. However the differences between same sized companies are insignificant. Bigger firms have to pay more to CEOs than smaller firms due to the complexity of the business which requires more experienced CEOs. The argument of attracting capable individuals therefore works only for bigger firms but even between the seemingly best executives the difference between talent does not match the difference in pay as shown by Gabaix & Landier (2008). For executive pay to be considered "fair" the company should get value for their money. In situations where the compensation levels are inflated due to bad practices and the talent is overvalued this is not the case.

2.3 CEO and Board dynamics

One of the board's tasks is to choose the optimal compensation level and structure for the CEO. There are a lot of things that go into determining compensation packages. Most CEO compensation packages comprice of base salary, short-term incentives and long-term incentives. Determining the optimal level and structure of pay is not easy. On one hand it needs to be effort inducing and cost efficient and on the other hand it needs to be competitive. The CEO and the board have different preferences for the compensation. Therefore their dynamics play an important role in determining the CEO compensation.

Core & Guay (2010) argue that weak corporate governance is the root for problems in CEO compensation. Pay-setting processes may be flawed to begin with due to bad corporate governance, which means that it is likely that the compensation level and structure is flawed as

well. This is consistent with Dicks (2012) and Hermalin & Weisbach (2003) who argue that smaller firms that have weaker governance are likely to overpay CEOs. Shin (2016) highlights an issue in his paper of CEOs using their power over boards to affect their own compensation. If CEOs are undercompensated they are more likely to push benchmarking their compensation on industry standards. However if their pay is above the industry they abstain from doing so. The effectiveness of this depends on the power dynamics between the CEO and the board. Factors such as tenure, social standing and additional board positions affect the power that the CEO has. Benchmarking one's pay is problematic since it can justify pay increases even though it is not in line with performance. It can be argued that benchmarking pay is easier when increasing pay because this is usually pushed by the CEO. This could lead to inflated compensation in the whole industry, because CEO driven benchmarking is usually done on the best paying firms (Shin, 2016).

Relating to the benchmarking problem is non-US companies justifying the adoption of US type of compensation. Fernandes et al. 2013 found in their paper that so-called "Americanized" firms tend to adopt US type of compensation models. These kinds of non-US companies can have for example considerable sales in the US, US competitors or are exposed to US capital markets. US companies are known to emphasize performance based pay which in turn increases the overall compensation level. Adopting a US style of compensation has become increasingly popular due to businesses becoming even more global. However a question arises whether non-US companies have actual legitimate reasons for doing so or if this is used as an excuse for excessive compensation. The latter can be argued in the case where CEOs use their power over the board. Gerakos et al. (2013) present a possibility that non-US CEOs could undertake US market activities forcing the board to adopt the higher US pay-practices. While adopting possibly higher paying performance based pay might not necessarily be a bad thing, considering in this case the CEO power, it is likely that the target setting of which the performance based pay is measured from will be also heavily influenced by the CEO.

Influencing the compensation can also go in the other direction. Tosi et. al (2000) find that firm size rather than performance works as a better predictor for CEO compensation in management-controlled firms. Interpreting this, CEOs that have power over boards push for less performance based pay and higher base salaries as they are risk averse. Overall it can be concluded that CEOs can exercise power over weak boards and therefore affect their own compensation structure and size. What makes resisting hard for boards is that the changes in

compensation can be convincingly masked with seemingly legitimate motives. Boards can even purposely allow this to happen in order to possibly affect their own compensation in the future. This can especially be the case with so-called interlocking boards where board member of company "A" is the CEO of company "B" and board member of company "B" is CEO of company "A". (Hermalin & Weisbach, 2003)

2.4 Summary

Previously mentioned points in this section are most commonly used by the public to argue against excessive executive compensation. First we argue that while performance based pay may be useful in general, it isn't without its drawbacks. Its effort inducing effects are diminishing at high compensation levels, and can even be counterproductive in some cases. We also highlight that the managerial talent as a basis for higher compensation can mostly be justified only for larger firms. According to multiple studies CEO characteristics play a very small role in their compensation. Therefore it stands to reason that variance in CEO talent is often overstated. This might be mostly due to the difficultness of assessing CEO talent. This is not to say that there are no differences in CEO talent, but rather that the differences are not observed effectively by the boards who determine their compensation. Lastly we raise the issue of managerial power. CEOs can have considerable power over the boards which allows them to influence their own compensation in many ways. CEOs tend to benchmark their pay on peers when they feel they are undercompensated. CEOs may also even push the boards to adopt a different compensation structure. The leverage of a CEO can be based on merit, but it can also be achieved by less justifiable social means.

A common factor determining the severity of these observed adverse effects is the strength of the boards. We argue that weaker, less experienced and less independent boards are likely to implement a poor compensation package in terms of structure of pay. These boards are not able to assess CEO talent objectively which may result in overpaying bad CEOs. It is also likely that these boards give in to the CEO more easily resulting in benchmarking top paying firms. While these problems start from bad governance possibly in smaller firms the effects spread to all firms in terms of inflated compensation levels.

Smaller family firms may be an extreme example of this. Often the board and the CEO are insiders and have strong social bonds with each other. Possible outsider board members are

handpicked by the family members which leaves considerable power for the family and CEO. Managerial talent may also be ignored when appointing a family member as the CEO. In these kinds of companies extracting minority shareholders wealth can be attractive for the family owners. Paying the family CEO excessively is one way to do so. This could then be masked as high performance based pay, however with easy to reach targets. Interestingly most public critique of CEO compensation is aimed at the larger firms. This is curious since in theory smaller firms are possibly more likely to overpay their CEO due to bad governance. However, as we argued that these effects are likely reflected in bigger firms due to inflated compensation levels. Information is also more available on larger firms which highlights the top payers, even if the high pay would be justifiable.

Considering the arguments in this chapter against high executive pay should be done somewhat skeptically. Some of the arguments find different results due to the use of different measures than the majority of the research. These points should still not be understated as they reveal and challenge some presuppositions related to the effectiveness of high executive pay.

3. Why is CEO pay generally so high?

Even though CEO compensation receives a lot of criticism from the public, it still has much support from research and usually isn't random or just a result from managerial power. There are many factors behind high level compensation for CEOs and why the pay has risen so much since the 1970s, and especially through the 1990s. Gabaix et al. (2008) argue that this can mostly be attributed to the increase in the market capitalization of large U.S. companies. Based on their research as the CEO pay increased six times higher through 1980 to 2003, the same growth happened to the big U.S. firms. They also find out that in countries where the firm size growth has been slower also the pay has increased less.

There are also other more or less clear reasons why companies pay their CEOs as much as they do. Many of them relate to dealing with the agency problem. Next we'll introduce some of the main arguments on behalf of the current executive pay and why it often actually might not be excessive even if many would think so. These factors include ownership structure, board characteristics, risks regarding the company, the position of the CEO and the pay

function, size/complexity of the company, U.S. market influence as well as the argument of attracting and retaining capable individuals (Fernandes et al.2013) (Core et al. 2010).

Overall the high pay is usually either a consequence of different mechanisms or structures that are beneficial for the company but lead to high CEO compensation or the compensation itself is used as a tool to for instance reduce principal-agency costs, motivate, attract talent, etc. As Gabaix et al. (2008) find out in their study, perhaps the biggest single determining factor regarding the amount of the pay for CEO is the size of the company in the sense that bigger companies generally pay higher compensations. Firms have gotten larger in the recent decades and so has the income of CEOs.

Performance-related compensation, especially equity based, generally leads to higher total pay levels too. It is used to motivate executives as well as to align their interests with those of the shareholders. In recent decades, since the late 1980s, the pay-for-performance sensitivity has increased greatly, thus resulting in higher average compensations (Gabaix et al. 2008). Also U.S., and so called Americanized firms are on average compensating their CEOs more, but when controlling for certain factors, the difference becomes economically modest as Fernandes et al. (2013) point out.

3.1 Value add of a CEO and performance based compensation

Most would probably agree with a statement that when the marginal costs of higher pay for the firm's CEO are smaller than the benefits from it for the company, additional compensation should be paid. That is if the company can "profit" from paying the CEO more either in the sense of more good work done or less opportunistic behavior practiced by the executive. It is, however, hard to evaluate the real effects of additional compensation or bigger proportion on performance and equity- based pay. It is still the goal when making decisions regarding the executive pay function.

Kaplan and Rauh (2010) look at CEO pay in a certain year and compare it with the firm's performance of the same time period. They find out a clear correlation with firm performance and CEO compensation. Companies whose Chief Executive Officers were in the top 20% paywise had also stock returns 60% higher than other firms within the same industry during the past 3 years. The results are qualitatively similar for 5 or 1 previous year/s as well. These

results indicate that CEOs are in fact paid for performance and the top earners have done a good job running business even though it's hard to evaluate which part of the success is actually their doing. The relation doesn't come as a surprise since as we know from many studies, the performance based proportion of the executive pay has become larger in the recent developments regarding for instance active ownership and more independent boards.
(Kaplan 2012) (Fernandes et al. 2013)

Furthermore, while the effects of performance-based pay have varied between the studies it can be argued that the majority of researchers as well as companies speak on behalf of performance-based pay. Studies arguing against it usually use different measures which do not reflect the effects accurately. There could be bias in these studies as their authors usually represent rival universities. Their arguments aren't as widely accepted as the studies finding clear correlation with performance and performance-based pay.

3.2 How to determine "fair pay"?

In the scope of this paper we are only going to touch on the aspect of fairness shortly. Determining whether CEOs' compensations are fair or not isn't straightforward. One would first have to come up with a definition of fair and use that to evaluate the pay levels. As Kaplan (2012) points out in his paper that according to multiple surveys it seems that only a tiny fraction of companies don't have majority of the shareholders' votes support for the pay policies of the firm. From this can be drawn a conclusion that shareholders are generally quite happy with executive compensation policies and it is rather the public that has problems with it. Still this isn't to say that the current level was fair or not but it somewhat implies the former.

3.3 Factors behind the high compensation of CEOs:

3.3.1 Size and complexity of the company (firm size growth)

Companies differ in many ways but regarding compensation of CEO perhaps the most important characteristic influencing the pay is the size of the company. When a company becomes bigger, it also becomes more complex to run and adds the responsibilities of the CEO in the sense of tasks but also he/she is responsible for more people and company's stakeholders which can be a heavy burden to carry in the sense of workload, challenge as well as stress.

According to research by KPMG Lighthouse Global , increasing complexity is also associated with more significant risk management challenges for companies to address. Increased risks to manage emerged as the greatest challenge to both mature and developing markets as the result of complexity, with more than 80% of executives stating that complexity creates more risks for their organization to manage. It seems reasonable that CEOs are compensated for the increasing challenges and stress they encounter. Another rationale is that accelerating risk level would require talented individuals to tackle it, and higher compensation serves as a tool to attract talented executives. Therefore, generally the bigger size of a company leads to bigger compensation for the CEO (e.g. Core et al. 1999). Larger firms are also capable of paying more due to their better resources and can therefore pay more if they see it as a wise thing to do. In their analysis Gabaix et al. (2008) make similar findings that the main factor behind the increase in the executive compensation in the recent decades is the growth of the firm sizes. They show that the increase of the pay of CEOs seems to be quite well in line with the growth in the size of the companies as they have been growing almost at the same pace.

Ownership structure and firm size are also often related. Smaller firms usually have more concentrated ownership for example in the form of family ownership. Monitoring the management becomes easier which removes the requirement for aggressive incentives. Contrary to some of the arguments which would predict smaller firms overpaying CEO, it could also be the case that smaller firms are paid less due to the easier monitoring and aligned interests of the management. This however differs from concentrated institutional ownership in large firms which typically favor performance-based pay. The need to pay less to small firm CEOs would further explain the considerable pay differences between small and large firms.

3.3.2 Ownership structure and board independence

Based on a lot of research one of the important factors regarding the amount of total pay for the CEO is the ownership structure of the company. In their study Fernandes et al. (2013) analyze the differences in the amount of CEO pay in the U.S. and compare it with Europe and other non-U.S. countries. They find that in the U.S. high institutional ownership is much more common while insider ownership is significantly lower. Based on their research this is one of the reasons for the higher U.S. CEO pay and thus a factor of higher compensation for CEOs more generally.

Institutional ownership is also regarded as one of the factors for good corporate governance. This is because of their oversight role as they look out for their own benefits in the sense that the company is run well and operates in their best interests and thus reducing the agency costs and acting in the best interests of all shareholders. As Mitra et al. (2005) find out in their study, the institution's active monitoring mitigates corporate managers' opportunistic behavior as well as improves the quality of governance in the financial reporting process. Institutions also usually have long-time holdings in companies and worry about the long term success of the firm. Therefore higher compensation and performance-based pay are used to align the interests of the CEO with those of shareholders. Executive compensation packages with high proportion on performance-based pay are generally higher due to their risks, for which the CEOs demand risk premium, and the possibly very high compensations when targets are reached or exceeded.

Lately institutional owners have also increased their influence and have become some of the most active owners in companies. Therefore they have become even better or tighter controllers of the companies' operations including the CEO pay. This might have further increased the total compensation as more of it is linked to the performance. (Fernandes et al. 2013) (Dai, 2007)

Another factor leading to higher CEO compensation is board independence. Fernandes et al. (2013) suggest that outside members and the size of the board are important factors regarding board's independence. The smaller the board is, and the more outside members it has, the more independent it seems to be. These characteristics of the board are also universally thought to be good for the whole company, and to improve shareholder monitoring and corporate governance. Based on multiple studies such as (Schellenger et al. 1989) and (Chen et al. 2015) the proportion of independent board members improves company's performance.
Similarly to institutional owners, independent board members push for tighter links between executive compensation and shareholder value, thus increasing the proportion of performance-related and equity-based pay. (Fernandes et al. 2013)

Independent board members should also reduce the risks regarding misconduct of the executives such as stealing or shirking as they have no ties to the company and therefore ought to be only motivated doing the best job possible overseeing the management without any conflicting interests. And it also does seem to be the case that CEOs are getting fired more

often in companies with more independent boards. This way agency costs can be mitigated with the structure of the board.

3.3.3 Risks regarding the company and position of CEO

When making decisions regarding the level of one's compensation, risks the person faces should always be considered as well as the extent to which they can control those risks and their effects. Thus, it can be argued that the more there are risks, the more he/she should be compensated for carrying them. It is also known from performance management that people should not be held accountable for factors and risks they can have no influence or control on.

However, CEOs are responsible for so many affairs and there are so many factors affecting each other that the CEO can't possibly control all of them. Still they are held accountable and even fired quite easily if things go badly. Therefore they need to be compensated for this risk and as institutional owners and independent boards have been pushing even more performance-related pay and sanctions, the risks such as the likelihood of being fired have increased and so has the pay.

Also as more and more firms have adopted the U.S based compensation model, the risks for the CEOs of these companies have increased.

3.3.4 U.S. market influence and americanization

Generally the pay of the CEOs has been much bigger in the U.S. and it has been especially blamed for excessive executive compensation. This is mostly due to bigger average firm size, higher proportion of performance based equity pay and more independent boards (Fernanders et al. 2013). Lately however more and more non-U.S. companies have adopted a similar kind of pay function and convergence of the CEO compensation has been big and the development continues as markets get more global.

3.4 Attracting and retaining capable individuals

Companies want talented and capable individuals as their CEOs for the business to be in good hands and well run. To achieve this they need to attract those people to take the position and

try to retain them and for this compensation is probably the best tool. Competition for talent has been getting harder and to get the best people high pays must be offered.

When compared with other high level professionals that generally have high compensation, CEOs don't seem to be compensated exceptionally well. When comparing the pay levels, executive pay hasn't been growing in the 2000s, but rather it has perhaps declined in comparison to those other highly paid individuals such as lawyers, fund managers, investment bankers, etc. (Fernandes et al. 2013) (Kaplan, 2012). Also based on Bakhija's et al. (2012) study, public companies' executive pay has increased less than those of private companies' since 1980. Both of these perceptions lean towards the view that perhaps public companies' executive compensation isn't generally excessive.

Kaplan argues that the critics should be able to explain these relations before suggesting that the increased CEO pay is an outcome of managerial power or capture. He further continues to suggest that a significant part of the rise in the pay is a result of the competitive market for talent which has driven the increase in the pay. The votes in public firms also illustrates that in almost all companies the pay policies have received majority shareholder support. This further implies the issue of excessive pay being more of the public's view of the matter rather than a severe problem for corporations.

If the compensation of executives had been decreasing even more in relation to other highly paid professions, and would continue to do so, it could be argued that talent might leak elsewhere. The counterargument that the high pay doesn't work well to attract talented people might be partially right. Still on the other hand if the possibilities of CEOs were significantly worse financially than those of other highly paid and talented individuals, then the overall talent of CEO candidates could drop considerably.

4. Conclusion

The belief that CEOs are being overpaid for what they actually do has gained popularity among the general public. The critique of high CEO compensation has been centered around performance-based pay and attracting talented individuals. Performance based pay schemes

have been criticized for not actually improving the firm performance, but rather serving as a value destroying expense, which would be the case if the marginal cost of performance based pay is higher than the value it adds. The idea of increasing CEOs' payment to attract more talented individuals has also been criticized with the argument that many firms overstate the surge in compensation ultimately leading to a situation where it is not proportionate with the value added by more talented executives.

Based on our understanding, the majority of academic researchers studying the field of executive compensation have come to the conclusion that CEO compensation should be regarded to be fair and in accordance with the theory of effective markets. They have highlighted many different reasons for justifying the current compensation level of CEOs.

One of the main factors is the increase in companies' size and overall complexity, which leads to more CEO responsibilities. Thus, it would be rational that CEOs demand a higher pay to compensate for additional responsibilities and more difficult tasks. Furthermore, larger companies are also generally associated with an ability to offer higher executive compensation due to better company resources. This makes it possible to attract top talent CEOs with higher compensation packages.

The studies would, however, indicate that the higher compensation is mainly due to the amount of performance-based pay indicating that these CEOs may have "earned" their higher compensation. Contrary to the general belief that performance-based pay is overvalued, many academic studies have identified a strong correlation between the performance of firms and CEOs payments, indicating that CEOs are actually compensated for their good efforts in running the business and increasing shareholder value.

Another important factor contributing to high levels of CEO compensation is a change in corporate ownership structures. On a general level, these structures have moved towards a higher proportion of institutional ownership and more active ownership management. It could mean an intention to more long-term holding, and a focus on long-term success of firms, which leads to higher compensation and higher performance-based pay proportion to better align the interests of the CEO with that of shareholders. Executive remuneration schemes with a focus on performance-based pay generally lead to higher overall remuneration due to their inherent

risks, for which the CEOs demand a risk premium. Ultimately, there is also a possibility of very high compensations for meeting or exceeding the set targets.

The increasing trend of board independence can also be seen as important as it means the boards now have a better oversight ability and power, and similar to institutional owners, independent board members encourage a stronger correlation between executive compensation and shareholder value, which leads to the increase in the proportion of performance-related and equity-based pay, and therefore, a higher compensation packages.

Overall, there are many reasons explaining the seemingly high CEOs compensation, and thus better information disclosure from firms is necessary to offer the public a less biased perspective on CEO payments.

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