Charles University in Prague
Faculty of Social Sciences

Institute of Economic Studies

MASTER THESIS

Executive Compensation in Theory and Czech Practice

Author: Jordan Gešev
Supervisor: Doc. Ing. MPhil. Ondřej Schneider, Ph.D.
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I hereby confirm that I have written my diploma thesis on my own and that all sources are given the full credit.

Prague, April 30, 2007

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Abstract

The thesis describes and analyzes incentives and motivation, an institutional background, individual characteristics and quality of corporate governance and their impact on a level and a structure of executive compensation. The principal-agent model, the managerial power approach and the stewardship model are analyzed and the comparative study is included. Moreover, multitasking and earnings management are discussed.

The practical part reminds the transition period and results in the description of some remains. The Czech compensation system is analyzed; the structure of pay is decomposed and commented. Moreover, the legal consequences and institutional characteristics related to executive remuneration are challenged and the approach of tax optimization supremacy criticized.

Abstrakt

Diplomová práce popisuje a analyzuje ekonomické aspekty motivace, institucionální pozadí a charakteristické vlastnosti manažerů a dále kvalitu správy na podnikové úrovni s ohledem na výši a složení odměn manažerů. Model zmocněnec-zmocnitel, model dominance manažerů a model správce prochází postupnou analýzou, aby byly nakonec kriticky srovnány. Dále jsou analyzovány dopady multiúrovňového rozhodování a provádění účetních operace za účelem obohacení.

Praktické části práce jsou zaměřeny na debatu efektů ekonomické transformace v České republice a současný vývoj. Podrobně je analyzováno složení celkové odměny manažera. Nakonec jsou diskutovány právní aspekty spojené s odměňováním manažerů, institucionální aspekty tohoto odměňování a faktická převaha daňové optimalizace odměňování nad motivační složkou.

PROJECT (Master Thesis)

Author	Jordan Gešev
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Preliminary title

EXECUTIVE COMPENSATION: THEORY AND CZECH PRACTICE

Aim

The thesis makes an effort to search for better understanding of the Czech executive compensation system using a comparative approach (US models) and qualitative and quantitative research.

Outline

First, we would like to summarize US literature on the topic while emphasizing and discussing some key points significant for further research (agency problem, CEO pay structure, incentives, managerial power, and the like). Then there would be a descriptive part concerning the Czech economy with focus on management development. Second, based on the descriptive part we would like to analyse specific marks of the Czech system theoretically and empirically and finish with concluding remarks and recommendations.

Hypothesis

We expect rather disparate systems of executive compensation resulting from different approaches to corporate governance both in the United States (dispersed ownership, a flexible capital market, a mature derivative market) and the Czech Republic (large shareholders, foreign ownership). Similarly, we do not expect stronger dependency of pay and performance (either in terms of bonuses or long-term incentives). We hypothesize as well that there is (have been) incomparable influence of peer groups in compensation settings (interdependent gradual rise in pay, so-called "ratcheting up") in the Czech Republic arising partially from economic transformation.

Sources

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Prague, October 2, 2006

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1. Introduction

1.1. Motivation

Executive compensation is a key point of corporate governance. On the one hand, executive labour is an economic factor with fundamental marginal productivity; on the other hand it brings extensive (and sometimes spurious) costs. Czech practice may well illustrate these substances. The expected full disclosure could push companies into the so-called stealth compensation structures that are ineffective and legally questionable. The growing derivative market in the Czech Republic asks for better understanding of mutual relations and risks between contingent pay and capital markets. Similarly, earnings management could become an important issue; even more important than it is today. We may assume as well that Czech transition environment indicates some specific institutional factors in executives' motivation and incentives; furthermore, empirical findings may help to adjust the code of best practice to these distinctive conditions. Noting just the above reasons, we are convinced that the research on executive remuneration in the Czech Republic is needed.

In concrete, we hypothesize that pay-for-performance relationship is not very tight in the Czech Republic. Moreover, the relationship itself is theoretically questionable – it is taken for granted in economics that a higher reward results in higher performance. Psychologists, as we will see, do not expect such a simple positive dependence between the reward and individual performance. Especially for the extrinsic reward, the relationship is not always non-decreasing; it does not have to be even positive as it is assumed in most remuneration contracts. We also believe that some parts of executive pay are the transition period residuum – in some respects resulting even from the planned economy period. Reminding the full disclosure once more, we are convinced that it is highly desirable; however, not appropriate at the moment in the Czech Republic. We hypothesize as well that whereas the theory concentrates on the incentives and motivation, the real world focuses rather on tax burden optimization and disclosure tricks. Lastly, we will indicate that the two-tier corporate governance model in the Czech Republic results in fact in multiple centres of control. Such model of control causes economic inefficiencies. Excessive executive pay is one of them.

Hence, the thesis aspires to work in particular with the two following facts – these are incentives and intuition. Levitt and Dubner (2005) write about incentives as economists' obsession. And they really are. It is not a coincidence that we normally talk about *microeconomics and behaviour* to emphasize the substance of economics *as* behaviour.

There are three basic incentives. Of course, they may be positive as well as negative; however, in the first instance, they are economic, social or moral. Only with the full definition you can understand behaviour for which economic (and intuitive) reasoning does not have answers. The authors presented an illustrative example of parents who regularly delayed picking up their children from a day-care centre. Surprisingly, after penalization was imposed on these parents, the delays have even increased.

That is the reason why we would like to go through intuition in economics, too. We believe that common sense is the best guide in every-day economic decision-making. But, economics bears a burden of what we call common knowledge. You do not know what string theory is if you are not a theoretical physicist, though, you know (or believe) that taxes are too high and petrol is too expensive. This common knowledge, on the other hand, brings intuition into decisions where more complex thinking would be useful as we could see on the example with the day-care centre.

Executive compensation theories are based on both our subjects of interest. A manager remuneration package is a set of incentives often biased with intuitive – but wrong – assumptions (e. g. a higher reward means more effort). Thus, we would like to search for working incentives and open a debate over those that are intuitively right, although in fact they decrease managers' performance.

In addition, executive compensation is a popular topic. We feel there is something wrong but we are not sure what it is, except that the level of pay is probably too high (without a clear definition of such excessiveness).

> *How much do CEOs of large companies earn and what for? These are the facts nobody knows precisely. However, this should change in the United States soon. The US Securities and Exchange Commission (SEC) reflects complaints of shareholders and struggles for new executive*

> *compensation disclosure rules. It offered a proposal of new stricter rules ... and wants the rules to come into use in 2007. This could also influence Europe which is traditionally less open-minded about compensation.*
>
> *Hospodářské noviny, 19 January 2006*
>
> *Although there is ample evidence that CEOs (and other employees) respond predictably to dysfunctional compensation arrangements, it is more difficult to document that the increase in stock-based incentives*[1] *has led CEOs to work harder, smarter, and more in the interest of shareholders.*
>
> *Kevin J. Murphy (1999)*

Reviewing the actual research, papers involving executive compensation in the Czech Republic are quite rare. There are three main reasons. Firstly, statistical data on Czech executives and their rewards are scarce. Secondly, foreign-owned firms usually just copy compensation structures of parent companies. And thirdly, there are more important topics which corporate governance research has taken into consideration (such as minority shareholders expropriation). The thesis aspires to be a starting point for further research.

1.2. Thesis Structure

After the introduction, chapter two opens with the presentation of basic models which describe the behaviour of key players in the compensation settings. In chapter three a compensation package is described, we comment on performance measures and their applications as well. Chapter four analyzes different approaches to motivation and behaviour, returns to the transition period and offers some explanations to the recent compensation development. In chapter five legal issues,

[1] We will show that this conclusion could be spread over all kinds of both contingent and non-contingent incentives.

accountability, liability and executive and board member responsibilities are dis-discussed. Moreover, tax optimization and disclosure consequences are analyzed. Chapter six concludes.

2. Models

Principal-agent, managerial power and stewardship models are the most influential approaches describing behaviour of key players in the executive compensation setting process. We will remind their basic features in the following subchapters, comment on some distinctions and conclude with the application on Czech reality.

2.1. Principal-Agent Model

Agency models assume risk neutral shareholders (principals) who delegate their authority to run the company to risk-averse senior executives (agents). Conyon (1997) emphasizes that the key point of the model is in the contracting process. Properly set contracts are supposed to align interests of both groups since these interests naturally differ. Moreover, both groups operate under existence of information asymmetries and moral hazard. One such contractual solution to the asymmetries is intentional dependency of the executive reward on shareholder returns.

Originally, the model appeared and was widely-spread by Ross (1973) and Jensen and Meckling (1976), respectively.[2] Jensen and Murphy (2004) remind that principals and agents exist in all situations in which more individuals or groups co-operate in collective activities. Agency costs consist of the sum of monitoring costs exercised by principals, bonding costs exercised by agents (in order to ensure principals about assumed actions) and residual losses. Körner (2005) sees two classes of the agency costs. They are caused both by principals and agents themselves and by the overall institutional environment. The former consists mainly of differences in principals'/agents' objective functions, in the level of their

[2] Cited in Abowd (1990): Ross, Stephen A.: The Economic Theory of Agency: The Principal's Problem. *American Economic Review*, Vol. 63, No. 2, (May, 1973) and Jensen, Michael C. – Meckling, William H.: Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure. *Journal of Financial Economics*, Vol. 3, (October, 1976)

risk aversion and free cash-flow reinvestment motivations. The latter is represented by information asymmetries and contract incompleteness. This division gives a nice picture of the nature of the principal-agent theory. It offers the ideal basis for description and better understanding.

Objective functions differ for both groups as for any other groups in the company. It is natural and it cannot be fully avoided. The theory expects that shareholders are much less risk averse than executives since they are assumed to be able to diversify their asset portfolios. Executives, on the other hand, are expected to be stuck in a given company with their human capital closely tied just to that company.

The problem of information asymmetries has two basic features. It is not just the natural assumption that one party (executives) has a better approach to information. The second feature is that executive have control over the information flows as well and, hence, they hinder access of principals to the information. Finally, the incompleteness of contracts is the most essential sign of the principal-agent relations (and business generally). It emerges from the uncertainty of future actions that may (or may not) be predictable.

One of the meaningful features of the principal-agent model is its strong mathematical applicability. The following example indicates the common reasoning.[3]

We assume risk-averse executives and risk-neutral shareholders. The shareholders' interest is to create an optimal compensation package $w(x,z)$, where *w* is total compensation, *x* is the stochastic stock price, and *z* is a vector of other measurable variables. This optimal compensation package has to be such that taking the simple form of $w(x) = s + bx$, where *s* is a base salary and *b* is the sharing rate,[4] the profit for shareholders under incomplete information $\pi(w,x) = x(a) - w(x)$ is maximized. The equation $a(e) = e + \varepsilon$, $\varepsilon \approx N(0,\sigma^2)$ shows the actions taken by executives. These actions are unobservable for shareholders. Further, we assume that the

[3] The presented model is based on Murphy (1999), Gibbons (1998), and Prendergast (1999).

[4] The so-called pay-performance ratio. The equation may have the form *w(z)* as well if the explanatory power of *z* is sufficient.

executive maximizes the utility function $u(w,e) = -\exp(-r(w, c(e)))$, where r is absolute risk aversion (assumed to be positive), and $c(e)$ is convex disutility of effort.

Then the optimal sharing rate is $b = 1/(1 + rc''\sigma^2)$. This equation shows the trade-off between risk and incentives. A common outcome is that the higher is the noise (or the higher is the executive risk aversion) the weaker should be the sharing ratio. Another key point of this reasoning is that the stock price is not the goal itself; rather, it is information which helps to find out which actions the executives have really taken.

2.2. Managerial Power Model

The managerial power model works with the same parties as the principal-agent model. However, it is weaker in its assumptions since the managerial power model does not understand the contracting process as exogenous. It takes the contracting as a dynamic endogenous power game. On the other hand, the model breaks the clear structure of principal-agent settings and, then, its explanatory power.

Bebchuk and Fried[5] (2003) call the principal-agent approach *optimal contracting* since compensation contracts are seen as a fundamental part of the agency problem solution. In contrast to the optimal contracting approach, in the *managerial power model* the executive compensation and its structure is viewed as both a partial solution to the agency costs problem and a part of the agency problem itself. The latter is the subject of their further research. The authors suppose that the managerial power would be naturally expressed in excess pay; moreover, the power may distort the overall incentive structure and, hence, corporate performance.

Interestingly, Bertrand and Mullainathan (2000) examined similar issues and got similar conclusions. Hence, for us the model naturally belongs among the

[5] The model has been developed and still is being promoted mainly by Lucian Arye Bebchuk and Jesse M. Fried. They especially lead the debate with principal-agent advocates such as Kevin J. Murphy. For reference see Bebchuk and Fried (2003) or Hall and Murphy (2003).

managerial power models. They called their approach *skimming view*. The model results from the separation of ownership and control when managers got control over the paying process itself and, hence, they skim shareholders' value. There are natural constraints for the extraction, such as the total value of a firm, takeover threats, or cautiousness about drawing the shareholders' adverse attention. Beyond these limits, the authors assume executives to pay themselves as much as possible.

The fundamental cause of managerial power is hidden in the process of director appointments, where CEOs play usually the most significant roles. The simple model of an agency relationship assumes just shareholders and executives. In reality, multiple levels of agency problems exist. The most important one is division of the above relationship into the shareholders–board and board–executives relations. Being a board member bears many positive values. They are expected to get attractive salaries and the position itself is tied to social status, prestige, and affiliation. Then, Bebchuk and Fried (2003) add that these members concentrate especially on the potential re-appointments. Thus, the basic implication assumes board members who want to be re-appointed and have control over CEOs pay and CEOs who have control over the board member re-appointment process (and, hence, their own pay). The authors found factors which significantly increase the CEO power. Firstly, it is the operational ineffectiveness of boards. Secondly, it is a higher dispersion rate of ownership. And thirdly, it is low institutional investors representation in boards. Among institutional shareholders, however, we have to distinguish between those with no other business relations to the company (pressure resistant), and those further involved in company businesses (pressure sensitive), such as banks in a simultaneous creditor position. Only the former may play a significant ethicizing role.

2.3. Stewardship Model

Contrary to the *economic model of man* as presented in the previous models, the stewardship model assumes a *self-actualizing man*. Davis *at al.* (1997) describe this approach as based on the premise that the economic understanding of man limits people from a full scope of needs satisfaction. The important conclusion is that imposing the economic view on executives (and workers generally) would lead to suppressing their level of aspirations. Selfishness is not assumed naturally, it results from the fact that people are treated as if they were selfish. Consequent self-interested behaviour is expected to spoil potential synergies in the company.[6]

The authors continue and describe steward's behaviour as pro-organizational. Stewards naturally maximize the shareholder value because while doing so, they maximize their own utility functions. This does not assume a full alignment of principal's and steward's interests; it just means that the steward places higher value on *cooperation* than on *defection*. Of course, stewards still have simpler, say, survival needs. However, generally we can expect to get over this limit and, thus, the pro-organizational behaviour naturally prevails. Only corporate governance settings which give executives higher authority and discretion may succeed under the stewardship approach.

Frey and Osterloh (2005) offer a simultaneous model of *common pools*. They emphasize that in stewardship-based models the optimal contracting – even if possible – could not help to solve the inefficiency by definition. The optimal contracting is no longer a solution to the agency problem. These models expect that (under the assumption of opportunity behaviour) the optimal contracting itself is the cause of agency costs since it treats executives as self-interested individuals who have to be bound by contractual constraints.

The authors see the firm as a set of common pool resources which are collective goods in the sense of firm-specific investments. These synergies generate a surplus; however, its composition cannot be expressed numerically, and, hence, distributed to individual employees based on their individual performance. If we admit existence of such synergies and believe that these effects are strong, we have to agree with Becht *at al.* (2005) who look for ways how to promote employees' investments in firm-specific human capital. Simply, it has to pay off for executives to invest in the firm-specific human capital.

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[6] The self-actualizing model of man was presented in Argyris, C.: Organization man: Rational and self-actualizing. *Public Administration Review*, Vol. 33, (Jul.–Aug., 1973), cited in: Davis *at al.* (1997)

The problem indicates a social dilemma within the firm. Beside under-investments in firm-specific human capital, Frey and Osterloh (2005) spread the list over free-riding and exploitation of information asymmetries. Thus, firms solve these social dilemmas within their own constraints; whereas in the outside world they face a common competitive environment.

Davis *at al.* (1997) summarize the assumptions under which the executives tend to behave rather as stewards than as opportunistic agents. Stewards are motivated by higher order needs, they focus on intrinsic incentives. They also identify themselves with the company and accept company goals. Moreover, stewards rely on personal power in conflicting situation whereas agents rely rather on institutional settings. For country-specific assumptions, they found out that stewardship behaviour emerges more often in less individualistic societies with a low power distance culture.[7]

Davis *at al.* (1997) use a classical prisoner's dilemma model for a description of possible outcomes. We will present that dilemma illustratively and finish with a few comments since the authors are quite inconclusive at this point.

PICTURE 1: PRISONER'S DILEMMA IN THE PRINCIPAL-EXECUTIVE RELATIONSHIP

Executives' pay-off

		co-operative	opportunistic
Principals' pay-off	co-operative	3 3	0 5
	opportunistic	5 0	1 1

If both parties decide to co-operate, they would achieve the only long-term Pareto-efficient outcome [3,3]. In case that one of the players decides to behave opportunistically and the other behaves in good faith, then the opportunistic player

[7] Power distance is defined by the personal justification and assessment of power differences in society.

gets the best possible outcome, however, the result is not sustainable in the long-run since the other player can see both pay-offs. Lastly, we get to the only solution to the prisoner's dilemma having assumed rational players (in a standard economics sense). It is the Nash equilibrium in the fourth quadrant which is sustainable but inefficient in the long-run [1,1].

As we have written, the authors are quite inconclusive about how to get and stay in the first quadrant in the long-run to support theoretically their model. They concluded that just the collectivist orientation of both parties could reach the desired outcome. Similarly, Frey and Osterloh (2005) called for the social dilemma to be turned into the solution where defection is no longer dominant at the firm level.

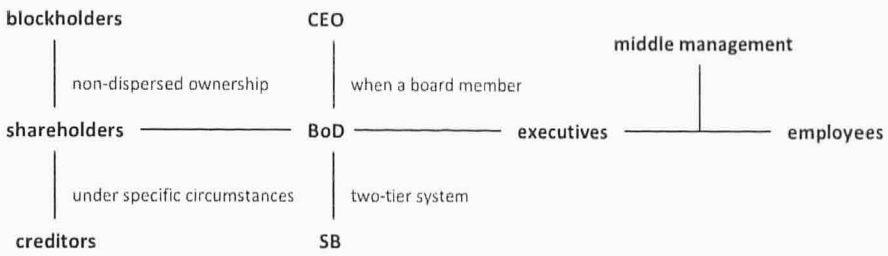
Nevertheless, there are theoretical explanations which could support their approach. The *super-rationality*, for instance, assumes that both parties realize the possible outcomes and even in the one-shot game choose co-operation. Another – classical – approach emphasizes repeated games as a possible solution to the prisoner's dilemma. Although it seems strange for both parties to repeat the action (contracting process) again, we may believe that being a lower-level executive in the company may simulate such repeated game for both parties and, thus, input the learning process.

2.4. Comments and Comparison

We have to realize that the models are to a large extent mutually exclusive. Their applicability relies on a given institutional environment and its compliance with assumptions of the model. In this respect, we have to concentrate mainly on executives' behaviour and board settings. The former would indicate tendencies to behave either as agents or as stewards and the latter would indicate power which executives may benefit from. Before concluding on Czech environment, we will remind both some common features and some characteristics of the models in general.

All the presented models focus primarily on two basic parties. This does not mean that no other parties exist. There are different constituencies involved in mutual relations beside shareholders and executives, such as creditors, employees, suppliers or clients. To be more descriptive, we have sketched the relationships in a simple diagram.

PICTURE 2: PARTIES RELATIONSHIPS



Thus, analyzing the consequences of executive compensation contracts, we have to be careful about possible dynamics among those involved. Besides, the picture indicates that any contractual solutions to the optimization of all interests are supposed to be imperfect.

Comparing the models, it is the principal-agent approach which focuses primarily on optimization. It is strongest in mathematical modelling; on the other hand, this is followed by limited assumptions on human behaviour. In the original version, executives were always assumed to be self-interested, rational and risk-averse and shareholders, on the other hand, were assumed to be risk-neutral. The model also suffers from the missing assumption about biasness in contracting process (managerial power). And, similarly, it suffers from its practical focus on easily measurable performance variables. The model works normally just with the monetary (extrinsic and numerical) reward and a direct pay-performance relationship. Thus, as we can expect, the strongest conclusions are most criticized. Nevertheless, because of its optimization and descriptive aspects, we are convinced that especially in economics this approach will keep its leading position among other models.

The managerial power approach reacts to the exogeneity of contracting process in the principal-agent reasoning. Then, the managerial power approach rather argues against the principal-agent model; it challenges some of its explanations instead bringing completely new ideas. Although it is presented as a separated model, in our view it is just a principal-agent-based offshoot. However, indication of how strong some principal-agent model assumptions are is one of the significant points of the managerial power model. It is the only approach which persuasively shows, for example, why executives are awarded for good luck while not being punished for bad luck.[8]

We may also expect that the managerial power approach would be accompanied by *camouflaging*. This process would be presented by efforts to legitimize and hide all excessive compensation practices (and especially those drawing attention).

The stewardship model opposes another shortcoming in the principal-agent model and it is the opportunistic approach to behaviour. Although its opposition is strong from many stand-points, it does not offer any solutions for one party to defend against potential counterparty's opportunistic behaviour. By definition, it plays permanently with open cards. Then it is not able to analyze any random or intentional counterparty's misbehaviour. On the other hand, it is positive that the model avoids the problem of easily measurable (and misbehaviour attracting) variables. In our view, the model correctly opens the important issue of benefits from possible cooperative behaviour. But, it fails in conclusive recommendations for practical applicability. We have made an effort to summarize and classify the basic aspects of given models in table 1.

[8] See Bertrand and Mullainathan (2000)

TABLE 1: MODELS COMPARISON

	Agency Model	Managerial Power Model	Stewardship Model
Executives	*Self-interested*	*Self-interested*	*Self-actualizing*
Rationality	*Rational*	*Rational*	*Bounded*
Behaviour	*Opportunistic*	*Opportunistic*	*Pro-organizational*
Information asymmetry	*Executives*	*Executives*	*Mutual*
Contracts	*Incomplete*	*Incomplete*	*Completeness not desired*
Accountability	*Shareholder model*	*Shareholder model*	*Stakeholder model*
Contracting	*Exogenous*	*Endogenous*	*Endogenous*
Incentives preference	*Extrinsic*	*Extrinsic*	*Intrinsic*
Performance measures	*Exogenous*	*Endogenous*	*Endogenous*
Psychological contract	*Transactional*	*Transactional*	*Relational*
Solution	*Pay-performance alignment*	*Board independency*	*Discretion and trust*
Prisoner's dilemma	*Nash equilibrium*	*Nash equilibrium*	*Pareto-efficiency possible*

For classification of the Czech Republic with respect to the presented models, we have used the approach of Davis *at al.* (1997) and the opinion survey from Večerník (1999). Davis *at al.* (1997) compared countries according to cultural characteristics and power distance. Japan, for instance, shows signs of a collectivist culture with high power distance. The US, on the other hand, are individualistic with low power distance. Thus, the expectations about principal-agent or principal-steward behaviour are ambiguous. For the Czech Republic, we found a clearer picture. Based on Večerník (1999), we classified the Czech Republic as the individualistic society. Respondents in the opinion survey on life success factors placed the highest marks on hard work (the highest value at all with more than 75 points from 100). This was supported by strong positions of ambitions (73 points), talent (68 points) and higher education (55 points).[9] Besides, the Czech Republic underwent large – adversely perceived – property shifts during the transition period. Therefore, we may characterize the Czech Republic as high power distance society. Then, there are no doubts about tendencies to principal-agent behaviour in Czech business. The above theoretical conclusions would indicate that wage differences are not understood as deserved and the opportunistic behaviour prevails. We may

[9] The remaining factor among the highest five was "good contacts" with 72 points. The data are from the year 1999, however, there was indicated the development in opinions from 1992 and the values do not change much (instead higher education which recorded 6-point rise).

assume transactional psychological contracts,[10] self-interested individuals and Nash equilibrium as the solution to given conditions. Moreover, pay-performance alignment may be more important in the reward-setting process.

And finally, we have marked the managerial power model as the offshoot of the principal-agent model with endogenous contracting. In our view, this combination reflects behaviour of Czech managers even better. They are not just agents – they are powerful agents. We will support the hypothesis by the board analysis later in the text. At this place we just remark the comparison to Switzerland. The managerial power was mentioned among reasons for high compensation levels there since tight social connections resulted in mutual representations of executives in boards of other companies.[11] This is the consequence of the country size and business interconnectedness. Only as an unconfirmed remark, we believe that these effects may be present in the Czech Republic as well. To summarize, we classify the Czech business environment as individualistic, principal-agent driven high power distance society with elements of managerial power.

3. Compensation Package

In this chapter we will decompose a usual remuneration package of Czech executives. Moreover, a relative compensation comparison and some functional relationships will be presented. Based on the literature review and international practice, we will conclude on specific Czech risks and characteristics of particular parts of the package.

Analyzing the Czech environment we will result mainly from dispersed data sources from newspapers and magazines, annual reports and as the major source from the set of publicly unavailable compensation surveys.[12]

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[10] Two fundamental classes of psychological contracts are the transactional contract and the relational contract. The former is defined by concrete assignments with a specified duration and low personal commitment. The latter is reversed.

[11] *Challenges to Executive Compensation,* Ethical Finance Research Series, Center for Corporate Responsibility and Sustainability, University of Zurich, (Nov., 2004)

[12] *Hay průzkum odměňování vrcholových manažerů* (for years 2000 – 2006, formally as *TOPEX, Průzkum odměňování vedoucích pracovníků*), www.haypaynet.com

3.1. Total Compensation and Base Salary

The compensation in general has two basic functions – attracting and incentive. After hiring the employee, the company has to motivate him/her to concentrate on best effort. For top executives this means to create the long-term company value.

A typical executive reward consists of base salary, bonuses, stock-based compensation and other non-cash rewards. Non-cash rewards include all kinds of internal perquisites (cars, equipment, offices) and external perquisites (associations' memberships, loans, vacation). Hall and Liebman (1998) emphasize that the base salary is determined at the beginning of an annual pay cycle (a fiscal year) whereas the bonus part of the compensation is defined at the end of the period. Hence, bonuses respond to the actual year performance while the base salary reacts to previous periods – if it depends on performance at all.

The following pay-performance relationship of executives in Komerční banka seems to confirm the usual compensation setting. Graph 1 shows that the relationship between average pay of a member of the board of directors for the given period (incl. bonuses based on the previous period performance) and the company profit for the same period are quite uncorrelated. However, having the pay composed of the base salary for the next period and bonuses for the given period, the correlation with the actual company profit is much higher. In fact, the correlation coefficients are 0,37 and 0,81, respectively. This could also indicate that the pay-performance relationship in the Czech Republic is quite strong. However, the following text reveals that the pay is not that correlated with performance of Czech companies in general (as it is in this company).[13]

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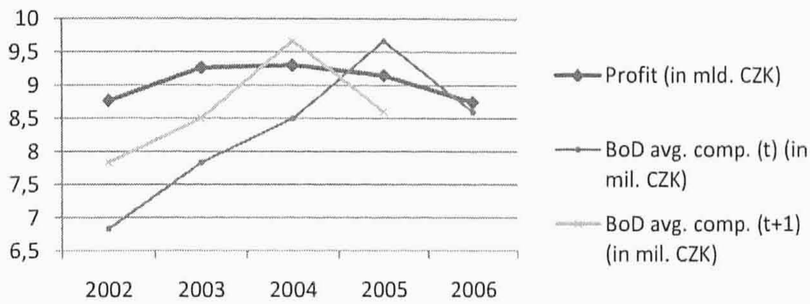
[13] Moreover, the data set in this example is poor and other comparisons (such as for ROAA, ROAE, sole contingent pay, and for executive committee (výbor ředitelů)) did not reveal stronger correlations.

GRAPH 1: PAY/SIZE RELATIONSHIP



Source: Komerční banka annual reports (2002 – 2006), author's calculation

The structure and level of pay is the result of many variables. The compensation depends on company performance measures, compensation plans of competitors, tax settings and the emphasis put on contingent pay. Besides, executive compensation is strongly dependent on the company size (measured as revenues, sales volume, or the number of employees). Murphy (1999) summarized some findings and concluded that the pay-size elasticity was between 0,25 and 0,35 in the 1970s and the 1980s in the US. Thus, an executive could expect the compensation as much as double when being in a 3 to 4 times larger company. Conyon (1997) confirmed the results while getting just a slightly lower ratio.

Graph 2 shows the relationship of the company size (measured as the number of employees) and the average compensation for Czech members of Supervisory Boards.[14] Thus, we may expect that company size is positively correlated with compensation. However, with respect to a small sample[15] and data variance, we cannot conclude how strong the effect is. Moreover, data in annual reports revealed that they are inappropriate for any conclusive quantitative studies. We have made an effort to confirm the relationship for executives and members of boards of directors as well. Moreover, we have collected also the value of assets as an alternative measure of the company size. All the comparisons did not showed

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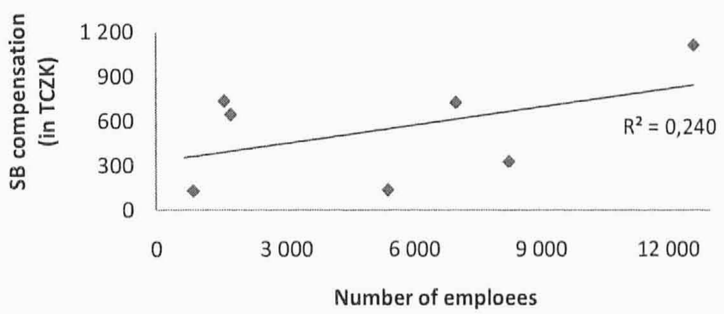
[14] Annual reports for the year 2003 were the latest with a sufficiently large sample from all we had access to.

[15] After further selection we used Český telecom, ČEZ, Čepro, Sokolovská uhelná, JME, Středočeská energetická, and Komerční banka.

any correlations. The annual reports also indicated that disclosure rules in the Czech Republic do not allow for unambiguous determination of individual pay of executives and members of boards of directors (and due to duality even for the bodies as a whole).

GRAPH 2: PAY/SIZE RELATIONSHIP



Source: Annual reports (2003)

Returning to the general pay decomposition, base salaries have two important functions. Firstly, the base salary is by definition fixed for a given period and it changes little. Thus, it creates the cushion against large pay variations for executives. Secondly, the base salary is used normally as the basis for other contingent payments (bonuses and stock options). However, the common approach to the base salary setting causes some significant difficulties. Murphy (1999) presents that the competitive benchmarking based on salary surveys keeps pushing the absolute level up since just base salaries over 50th percentile are understood as *competitive* while base salaries under this level are pejoratively presented as *below market*. Such benchmarking may often shadow (or make less sensitive) other important aspects of executive performance, such as age, education, experience, job complexity, and the like. Moreover, compensation adjustments to the company size both formalize and reinforce the relationship between size and pay; even if there are no other reasons than the size itself.

Analyzing the contingent part of pay, Agrawal and Mandelker (1987) pointed out that while providing a partial solution to agency costs between shareholders and executives, the contingent pay simultaneously increases agency costs between shareholders and creditors. Simply, if executives maximize their pay-offs based on alignment with the shareholders' value then these executives accept in many cases a higher level of risk than the creditors would prefer. It is caused by the shareholders' convex[16] pay-off structure which makes acceptable even projects with negative net present value. Similar risk shifting may be possible for other stakeholder groups as well.

Focusing on Czech executives again they prefer a high base salary with low bonuses to the sole base salary without bonuses or the minimal salary with high bonuses (preferred by just about 7 percent of executives). No executives would ask for contingent pay only. Thus, Czech managers may be characterized by a high level of risk averseness. They prefer a guaranteed fixed reward and just minor contingent remuneration.[17] (This minor performance related part of pay helps to promote perception of justice among employees – although a relatively small difference in the reward, higher effort means higher pay.)[18]

Eriksson (2005)[19] gathered data for 600 CEOs and looked for dependency of individual characteristics (such as age, sex, education) and firm characteristics (ownership) on the total compensation of Czech executives.

The results showed that CEO pay depends in the first instance on the education and ownership. A university degree may increase the compensation for as much as about 50 percent. Foreign majority of ownership is the second most influential factor (46 percent higher pay compared to domestic private firms). Besides, men are expected to get about 37 percent higher pay than women. (Since the values are controlled for other individual and firm characteristics, the numbers indicate persistent gender inequality rather than selection bias.)

In the following paragraph, we will focus on a foreign/domestic executive pay comparison. Table 2 shows data on the relative pay differences among selected levels of executives and the same with respect to their nationality. Thus, we may see that

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[16] Actually, there is no residual value for shareholders until all the creditors' requirements are met.

[17] The sample is biased to younger executives within both top and middle management. See www.pruzkumy.com.

[18] [15] Jana Bardyová, HR Management, 27. 1. 2006

[19] We have made a huge effort to update the data set as for the year 2006. The interview in Trexima, Zlin revealed, however, that prof. Eriksson's research was covered by a meaningful grant which enabled to detach given employees just for data mining and cleaning. Thus, we have failed in this respect.

being a foreign CEO means about 64 percent higher pay compared to Czech CEOs. Comparing the other managerial levels with respect to nationality, the differences get lower with a lower managerial rank. Moreover, the relative differences among Czech managers are lower than among foreign managers. Simply, the variability in pay is not that strong for Czech managers.

TABLE 2: DOMESTIC/FOREIGN PAY COMPARISON

	I level (CZ)	II level (CZ)	CEOs (CZ)	I level (foreign)	II level (foreign)	CEOs (foreign)
I level (CZ)	*100*	*80*	*63*	*68*		
II level (CZ)	*125*	*100*	*79*		*67*	
CEOs (CZ)	*158*	*126*	*100*			*61*
I level (foreign)	*146*			*100*	*78*	*57*
II level (foreign)		*150*		*128*	*100*	*73*
CEOs (foreign)			*164*	*176*	*138*	*100*

(in %)

Source: Hay Group 2006, author's calculation

Without going into detail, the domestic/foreign pay differences may be explained by the selection bias and different reference markets. The foreign investors naturally invest into more profitable companies which allows for higher pay levels. Table 3 then shows that the reference market for pay level setting for Czech managers is mostly the Czech executive market itself.

TABLE 3: CZECH EXECUTIVE PAY REFERENCE MARKETS

Benchmark	CEO	Top management
Czech Republic	*60*	*87*
Central Europe	*23*	*33*
Western Europe	*23*	*27*
Other	*10*	*10*

(not mutually exclusive, not 100 % in total) *(in %)*

Source: Hay Group 2006

The Western European executive market is much less in use for Czech managers. Foreign executives, on the other hand, have pay adjusted to their domestic countries.

3.2. Performance Measures

To begin, we will quote Nell Minow[20] who comments on motivational aspects of contingent pay. She confesses that contingent pay may be highly motivational:

> *We just have to be a little more thoughtful about what it is we're asking them to motivate.*

For principal-steward relationships based on trust, where non-contingent payments prevail, the significance of performance measures is lower. Where focused on a contingent part in the contracting process, the performance measures become much more significant. Then, two qualities have to be analyzed. Firstly, we have to find out if the performance measures are correlated with executives' effort and, secondly, how easily they can be manipulated. In concrete, we are particularly interested in their signal-to-noise ratio, targeting process settings, multitasking implications, and easiness of measures to be abused in earnings management.

We have to realize that performance measures are not primarily the compensation instruments. In companies, financial and accounting ratios and variables fulfil all possible duties (reporting, accounting, financial management and budgeting, planning, tax and other purposes). For their incentive functions the most important feature is the signal-to-noise ratio. The ratio captures information about actions the executives have chosen, thus, it captures information on performance purged from random noise. In addition to basic measures, a set of new accounting-based measures have emerged in financial management. Those are Stern Stewart's Economic Value Added (EVA), BCG's Total Business Return (TBR), or McKinsey's Economic Profit. Garvey and Milbourn (2000b) state that among other measures, such as ROC, ROE, or growths in EPS and cash flow, EVA was found to have the highest statistical correlation with the shareholders' value creation (dividends and capital gains). Of course, we could ask why just stock returns are not used as the perform-

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[20] Nell Minow from the Corporate Library specializes in corporate governance, cited in Becht at al. (2005).

ance measure. The reason for using measures like EVA is that stock returns are noisy and at least in short-term it is a misleading measure of value creation. EVA may also be useful for highly diversified firms for which a single stock price does not offer much performance information since it is too general. Moreover, not all companies are publicly traded.

We will discontinue the review at this place with some statistical data. Table 4 shows that performance measures in the Czech Republic are tied to three basic classes mostly – to company level measures, division or unit level measures and individual efficiency measures. At a company level net income, EBIT, turnover, market share, ROE, ROA, EVA and stock prices are the most applied performance measures. Safety in work, productivity or number of sick days belong among individual measures.[21]

TABLE 4: GENERAL PERFORMANCE MEASURES

Measures	2001	2002	2003	2004	2005	2006
Company level	*78*	*n.a.*	*88*	*89*	*82*	*83*
Individual	*22*	*n.a.*	*79*	*81*	*68*	*58*
Division/unit level	*x*	*n.a.*	*41*	*54*	*68*	*63*
Discretionary	*x*	*n.a.*	*8*	*12*	*9*	*8*
Other (parent company level)	*x*	*n.a.*	*8*	*3*	*0*	*8*

(Not mutually exclusive) *(in %)*

(Results for top management. CEOs give higher emphasis on company-level measures and lower on division/unit-level measures.)

Source: Hay Group 2001 – 2006

Garvey and Milbourn (2000b) add that whereas it is quite easy to measure noise (volatility) of a performance variable, it is much more difficult to catch the signal content. Supposing we could find measures that are perfectly correlated with executives' effort, we still face other important issues. Eisenberger and Cameron (1996) draw from learned industriousness theory and claim that individuals can (and do) learn the structure of rewards; they realize which dimensions of performance are preferred and allocate their activities based on such given preferences. Similarly, Prendergast (1999) claims the same for multitasking processes. We are at

[21] Based on interviews with HR managers.

risk that executives do not maximize the long-term company value. Instead, they tend to maximize the most compensated performance measures. Moreover, the inconsistency between accounting measures and economic reality pushes executives to invest in short-term projects with immediate returns and distant cost payments and the other way around. This is the case of R&D which brings costs immediately, however, the profit comes later, if ever.[22]

Further, it is important to emphasize that contingent compensation depends strongly on negotiated performance standards and budgeted values. Michal Jensen talks in this respect about executives' benefits from lying.[23] Negotiated lower standards and larger budgets mean less effort for executives when getting over these standards.

Discussing the performance measures in executive compensation, we have to realize one important aspect. We have to distinguish between maximization of the measures that bring the highest bonuses (and other contingent rewards) and earnings management. Where the former operates under legal limits, the latter goes beyond. Both activities are inefficient from a company point of view; but just the earnings management is fraud. Riceman *at al.* (2000) define the earnings management as a purposeful activity which pursues to get some private gains due to interventions in the external financial reporting processes.

Murphy (1999) summarizes all kinds of potential ways how to manipulate performance measures. Executives can bias the budgeting process to adjust performance standards. They can select such competitors' actions which decrease the peer group standards. They can keep shifting accounting results (this is especially the case of accounting accruals). Moreover, executives can adjust their daily actions to be at the top (or at a minimum level) when values of measures are recorded for compensation purposes. They can inflate or deflate earnings artificially. And they

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[22] Such behaviour was confirmed in Rehnert (1985), Riceman *at al.* (2000) or Jensen and Murphy (2004).

[23] Performance target negotiation at the firm level, in our view, will draw more attention in future. For more information see Jensen, Michael C.: Paying People to Lie: the Truth about the Budgeting Process. European Financial Management, Vol. 9, No. 3, 2003

also can invest in short-term actions with immediate returns and avoid long-run growth investments (such as the above R&D example).

But, Lev (2003) confirms that manipulations do not have to be the exclusive result of executives' self-serving. Managers believe by definition that their business, if in troubles, would get better again and they have to keep that alive until better times emerge. To continue funding and supplies, they have to report the numbers as for the firm in no downturn. The support of business partners is critical. Moreover, bonds and loans often include strict covenants which may enable creditors to take control over the firm. Jensen and Murphy (2004) also blame some institutional aspects of capital markets. When firm's earnings beat the consensus analyst forecast, the stock price increased by 5,5 %. On the other hand, non-beating meant fall by 5,05 %. Surprisingly, for perfect fit the stock price increased by 1,63 %. This indicates that capital markets punish firms which do not meet analysts' forecast with no respect to ill implications it may create. Nevertheless, executive's personal responsibility has to be always required. The fraudulent activities may lead to justifiable public regulations. This was the example of the Sarbanes-Oxley Act in the US, for instance.

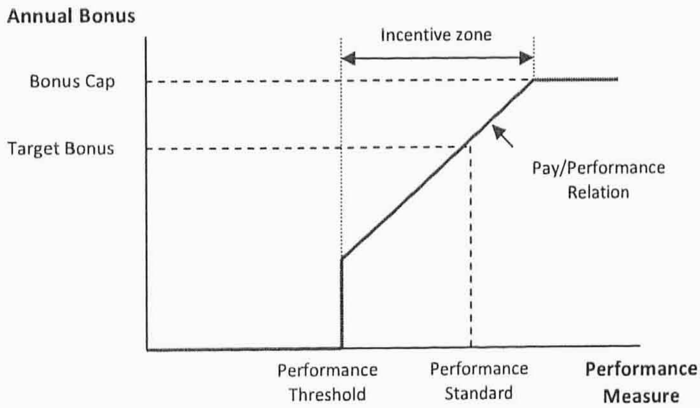
To sum up, we have to always keep in mind that contingent pay (based on different ways how to measure performance) is subject to multiple trade-off effects. We have indicated that instead of promoting effort, value decreasing (and even fraudulent) activities are often provoked. We may conclude with Kerr (1975) who summarized two basic causes of inefficiencies, in our view similar for both multitasking and earnings management. The above debate has shown that despite their simplicity they have still been valid. These are the fascination with an objective criterion and the overemphasis on highly visible behaviour. The former means looking for simple, quantifiable standards which may be efficient when rewarding elementary and predictable activities; however, they may cause goal displacements when applied on more sophisticated activities. The latter shows that rewarding hardly observed activities (such as team-building or creativity) in the same manner as those quantifiable fails.

3.3. Bonuses

Bonuses are the most usual and historically settled variable incentives. Although fine tuned for different companies, they are quite uniform and compact across economies (Murphy, 1999). Bonuses can be categorized based on performance measures, performance standards and functional relationships between performance and rewards.

Generally, most bonus plans are shaped around thresholds. Until a *bottom* threshold is achieved no bonus is paid. After reaching this boarder a given minimum amount is paid and the amount keeps increasing with respect to an increasing performance measure. The pay-off is usually frozen after achieving a *cap* threshold. The thresholds are expressed prevalently as a percentage of a performance standard. Further, the bottom and the cap levels are percentages of a target bonus. The varying part is often called the incentive zone. For better understanding, see the graphical illustration.

Picture 3: Bonus Structure



Source: Murphy (1999)

Usually, bonuses are a sum of sub-bonuses where each of them has its own performance standard and a specific functional relationship. The accounting performance measures are mostly revenues, net income, pre-tax income, EBIT or EVA. Often, ratios and growth measures are used, such as EPS, growth in EPS, ROA, ROE, or the income/sales ratio.

Performance standards are expressed with respect to budgeted amounts, growth levels vis-à-vis the previous year, or they are discretionary as set by the board. Sometimes, they follow peer groups performance or they are fixed for a given period. The incentive zone is usually described as the 80/120 plan. The numbers are percentages of the target standard as for the bottom and cap thresholds. There is a number of different approaches including 90/110, 70/130 and other ratios.[24]

As far as the Czech practice is concerned, executives receive the bonuses once a year usually, the actual level is expressed as a portion of the base salary in 90 percent of examples (in 80 percent of examples exclusively for CEOs).[25] Based on figures in table 5 we can see that almost all Czech companies offer a certain bonus plan.

TABLE 5: COMPANIES PAYING-OFF BONUSES

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Bonuses	*81*	*98*	*95*	*97*	*97*	*82*	*93*

(in %)

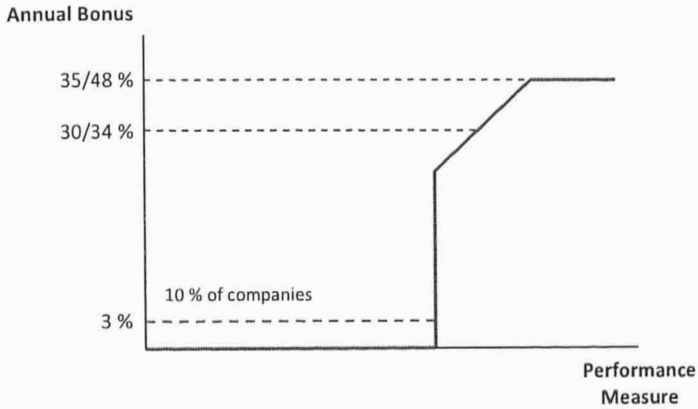
Source: Hay Group 2000 – 2006

In addition, about 30 percent of companies offer an additional payment of *profit sharing*. Contrary to common bonuses, the profit sharing is rather discretionary based on the decisions of a board of directors.

Application of a single measure bonus plan is exceptional; normally multiple-measure bonus plans are used. The full package then behaves as a set of single bonus plans.

[24] Most descriptions come from Murphy (1999) where you can find a comprehensive statistical part about percentages of standards and measures used.
[25] [6] Hospodářské noviny, 9. 10. 2006 and *Hay průzkum odměňování vrcholových manažerů* (2006)

PICTURE 4: CZECH BONUS SCHEME



A target median bonus for top management is 30 percent of the base salary (and 34 percent for CEOs). A bonus cap is just a little higher for top managers whereas for CEOs the range is more flexible (see picture 4).[26] About 10 percent of companies pay a symbolic value of about 3 percent of the base salary even if the bottom threshold is not achieved. Czech bonus payments are significantly lower compared to German top managers, for instance. Their target bonus is set at the 100 percent value of the base salary. On the other hand, in Norway or Sweden it is just about 25 percent.[27]

Besides the one-year bonus plans there are so-called long-term incentive plans (LTI, LTIPs) based on three to five years rolling-average cumulative performance measures. These bonus plans are considered to avoid some shortcomings related especially to earnings management. However, their usage in the Czech Republic is quite rare.

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[26] Based on the data from Hay průzkum odměňování vrcholových manažerů (2006)
[27] [2] Aleš Jirec, Ihned, 25. 9. 2006

TABLE 6: LONG-TERM BONUSES

	2003	2004	2005	2006
Long-term bonuses	*11*	*6*	*4*	*13*

(in %)

Source: Hay Group 2003 – 2006

Thus, for top managers the incentive zone is quite short and the payment scheme seems to be reduced largely to a bivalent zero-one model. We may expect that in this structure the incentive component diverts partly from promoting the long-term effort to a simple cross of a performance threshold. In this way, the usual bonus plan in the Czech Republic rather provokes than moderates the earnings management.

3.4. STOCK-BASED REMUNERATION

The level of compensation became a social and political issue at the beginning of the 1990s in the US. It did not seem appropriate for executives to get such high remuneration without stronger alignment of pay to company performance. Contingent pay began to be seen as the best cure. Among, stocks and stock-based incentive instruments became prominent.

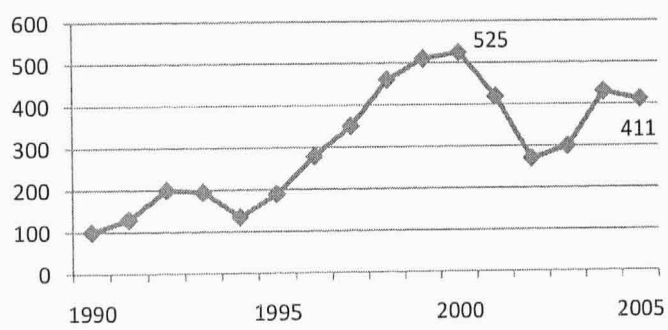
We had to wait one decade to realize that there are not just positive aspects and that adverse effects may be substantial. Stock options were identified as a typical biased incentive which substantially contributed to many corporate scandals (Enron, WorldCom or Xerox). Frey and Osterloh (2005) are convinced that the whole situation even changed public opinions on managers and their roles in companies and society.

At first, we will describe stock options in general. Option contracts in executive compensation allow managers to buy a given number of shares at a specified fixed (or conditional) price. Most often these are so-called American options with option rights exercisable any time before the maturity. However, the right to exercise the options before is strongly limited by *vesting* restrictions. Hall and Murphy (2003) also emphasize that after options are exercised, the company issues new shares usually; hence, the number of shares outstanding is increased.[28] Moreover, executives do not pay for call options often; rather they get the value of spread between the market price and the pre-specified exercise price when the option is vested.

In theory, the exercise price may be set relatively to the industry index, the maturity may be contracted for the expected executive tenure and the option contract may be forfeited unless a given stock price is reached (Murphy, 1999). Most often, there are no such specific conditions.

Especially due to stock options, the executive compensation in the US skyrocketed in the second half of the 1990s. The following graph offers a comparison of average CEO pay in 350 top companies with average worker pay.

GRAPH 3: CEO/AVERAGE PAY RELATION



Source: Institute for Policy Studies (in: www.csmonitor.com)

Then, there are two main questions. Why the increase in stock options had been so strong and why the options were not granted with the exercise price based on industry or other specific indexes.

Jensen and Murphy (2004) explained that the increase of options used in executive compensation followed debates about an insufficient contingent part of remuneration in the 1980s. Recommendations to change this practice from both scholars and (institutional) investors were a natural response. This was supported by the prefer-

[28] This stock dilution has drawn more and more shareholders' attention when the option contracts became substantial at the end of the 1990s.

ential disclosure and tax rules whose impact on both the increase in option contracts and use of non-indexed options was straightforward. Bebchuk and Fried (2001) also add that a significant part of the increase should be attributed to the managerial power. Although most probable, this is hard to be confirmed with conclusive data.

But, the problem need not be in the instrument itself; rather it is the set of excessiveness, underestimation of institutional factors and theoretical assumptions, and temporary negligence of other instruments and controls.[29] Healy and Palepu (2003) correctly showed the ample evidence of stock option influence on beating short-term stock price expectations. However, we are convinced that executives and markets could take the process just as a by-product of the complex environment for a long time. We simply do not believe that executives keep looking for *any* opportunity to grab the company profits as their prime goal which the whole debate could indicate. You can, as a manager, step into earnings management, insider trading, and other business misbehaviour. And it should cause an increase in your rewards. However, it may happen that you just reflect the requirements of the short-sighted market.[30] And this was the case, often, as we believe. Even if executive compensation would be fully non-contingent, managers could get into the same misbehaviour on behalf of their companies; simply, because atmosphere of the bull market of the late 1990s did not allow for not beating expectations. Jensen and Murphy (2004) indicated that especially in the technology sector, telecommunications and dot-com sectors the correct reporting could lead to a significant threat of default (increase in price of capital, losses in investment opportunities, and the like). In our view, the recent compensation scandals would be in a much lower scope without a generally biased pressure of the bull market environment on misreporting and earnings management.

As a result, stock options have become less applied in compensation packages. Tully (2006) shows that there has been a substantial substitution trend in stock options

[29] We will finish the debate which we have started when discussing performance measures at this place.

[30] We are far from justifying executives' misbehaviour or evident criminal activities; however, we are convinced that this systemic approach may shed more light on the issue.

for restricted stocks in recent years. This has been caused both by the corporate scandals and long-announced changes in reporting.[31]

In the following text, we will describe Czech practice and compare the situation with the above US case. As a result, some risks will occur.

Long-term contingent pay is subject to three significant forces in the Czech Republic. It seems to be a mixture of managerial power, camouflaging and copying of foreign compensation patterns (without more profound understanding and adjustments).

Using stock-based instruments assumes having a mature capital market. However, this has not been the case in the Czech Republic. The stock prices are still influenced rather by portfolio investors trading than by the intrinsic value of a company.[32] In spite of that about 20 percent of companies in the Czech Republic offer stock options. Discount company shares and shares given free of charge are less popular (see table 7).

TABLE 7: STOCK-BASED REWARD

	2003	2004	2005	2006
Stock options	*14*	*19*	*21*	*17*
Discount company shares	*8*	*6*	*7*	*7*
Company shares free of charge	*5*	*6*	*n.a.*	*n.a.*

(Not mutually exclusive.) *(in %)*

Source: Hay Group 2003 – 2006

In most cases Czech executives get at-the-money options. The maturity is about 2 – 3 years and the payment is not guaranteed (for the payment the executive is expected to be employed in the company at the maturity date for instance). In 2005 about 60 percent of required shares were bought in the secondary market. The

[31] In July 2006 SEC finally changed the reporting requirements. In brief, companies have to report the compensation of 5 highest paid executives, dollar value and grant date of stock options, perks for more than TUSD 10 and disclose retirement benefits. In December 2006 some additional changes occurred in stock option disclosure rules. In media it has still been discussing if these changes enhance or mitigate the rules (April 2007). Moreover, since 2006 US GAAP require stock options being fully expensed in accounting for reporting purposes. See www.marketwatch.com.

[32] [17] Erich Handl, Hospodářské noviny, 15. 12. 2003

remaining 40 percent were newly issued shares. Thus, the stock dilution exists and may be quite strong in some cases. Normally, the stock options are not indexed and executives may get even options with shares of a different company as an underlying asset (mainly companies in group).[33]

Thus, we may see that just common stock options are used in executive compensation. Their potential incentive functions are largely unrecorded. No indexed-like options are offered, we cannot see out-of-the-money options or options aligned to company performance measures. The question is if it results from managerial power of just from low awareness. If we realize that stock options bear higher risk of camouflaging their further expansion in the Czech Republic is debatable at the moment. Simply, we believe that it is desirable to keep the percentage of stock options in compensation at this low (or even lower) level before the institutional background gets more mature (this means especially development of the capital market, business ethics and awareness of stock option incentive functions in compensation).

In addition, using of stock options in executive compensation had some specifics in state-owned companies. There is a list of those which faced public critique with respect to the level and structure of compensation, such as Škoda Plzeň, Komerční banka, Český telecom or ČEZ. Some of their managers explained that working for a state-owned company brings distinctive risks. If a firm goes bankrupt it may be difficult for a manager to find a new job, moreover there is political risk of being made redundant without any economic reasons. However, we have to oppose since the risk of decreased human capital after unsuccessful mission is common for both the managers in state-owned and private firms. Moreover, the managers saw themselves partly as privatization managers which expects higher pay for a limited period. But, the remuneration also went up in those state-owned companies which were not expected to be sold in future.[34]

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[33] Hay průzkum odměňování vrcholových manažerů (2005, 2006)
[34] [16] Marek Pražák, Mladá Fronta Dnes, 16. 12. 2003

This was not the case of abovementioned companies; almost all have already been privatized. ČEZ is the most important from the remaining and may help to illustrate two distinctive features concerning stock-based instruments in executive compensation.[35]

Firstly, it is the role which may play consulting companies. The stock option plan was launched in 2001 in ČEZ and it was prepared by renowned lawyers White & Case. After the public objections, the case was described as standard with references that it was an external company who prepared the package. Thus, this proves that in some cases the external consulting firms just cover the debatable operations.[36] Secondly, it is the power of public opinion. After the issue started to be discussed publicly, the board of directors (as the state principal in the company) changed the rules of using stock options significantly. Nevertheless, the whole process was rather unsystematic. It indicated that the main effect was to muffle the public voice.[37]

3.5. Other Rewards

Composing the total compensation package you have two basic approaches. Firstly, the compensation may consist of the cash reward prevalently. However, the microeconomic utility function indicates that this composition would face a significant decreasing marginal utility. On the other hand, costs of service are low since the simple structure does not ask for sophisticated administration. Secondly, the package may be more complex, the cash reward would be supplemented with all kinds of especially non-cash remuneration. In its simple form the composed utility is expected to be higher than the utility of the sole payment.[38] However, we may expect that the costs of administration of such complex rewards would be much higher. Thus, the optimized ratio of cash and non-cash reward exists where both variables – the total executive's (employee's) utility and administrative costs – are in the

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[35] Short time before Český telecom underwent similar changes.

[36] [9] Ihned, 4. 1. 2007

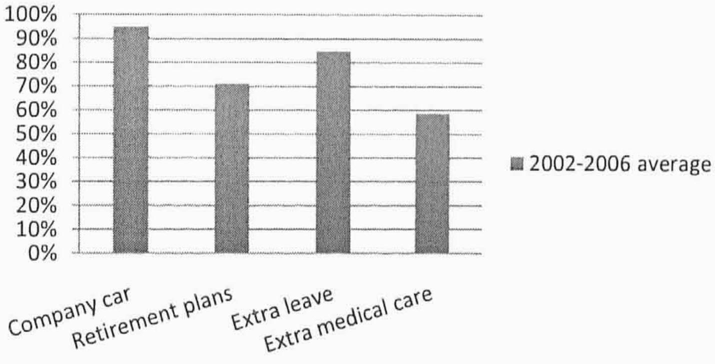
[37] [8] Ihned, 3. 1. 2007

[38] For a complex description see Skořepa, M.: Zpochybnění deskriptivnosti teorie očekávaného užitku. *IES Working Paper* 7/2006, IES FSV, Charles University, (2006)

optimal proportions.[39] The Czech practice follows the global trend of more and more complex compensation packages and composes the remuneration from different cash and non-cash rewards.[40]

In the remaining part of the chapter, we will just describe the structure of benefits in the Czech Republic. Graph 4 shows the most represented perquisites in use for Czech executives. A company car is a basic benefit for almost all top managers. Company cars belong among rewards where the direct comparison of Czech managers to the European ones equals largely.[41] About 85 percent of executives get an extra leave and 60 and 70 percent get extra medical care and contributions to state-subsidised retirement plans, respectively. Besides, about half of executives get contribution to life insurance and extra sick payments.[42]

GRAPH 4: PERQUISITES



Source: Hay Group 2002 – 2006, author's calculation

According to the Sarbanes-Oxley Act executives in the US had been forbidden to receive any company loans based on bad experience from the past. Kodex (2004) recommends the same practice for Czech executives, nevertheless, these are just recommendations and the corporate law allows for such operations after the general meeting's approval. Loans to executives in the Czech Republic are in 40 percent

[39] There is another key point in the real world and it is a given tax policy.
[40] Hay průzkum odměňování vrcholových manažerů (2003)
[41] [2] Aleš Jirec, Ihned, 25. 9. 2006
[42] Hay průzkum odměňování vrcholových manažerů (2006)

non-interest loans, the usual amount is TCZK 100 and the payment period five years. The rest of the loans are interest bearing loans, nevertheless, the interest rate is significantly under comparable market rates. In this case the median amount is TCZK 550.[43]

4. Executives

4.1. Intrinsic and Extrinsic Motivation

Analyzing the compensation package, we could notice that extrinsic rewards dominated any compensation considerations. Frey and Osterloh (2005) remind a simple fact of more complex incentives where intrinsic motivation is included. The intrinsic motives are a natural and permanent part of human consideration and behaviour. People may find utility in activities themselves, they may wish to comply with social standards as well. The key point is that institutions play a fundamental role in intrinsically motivated behaviour – in its quality and scope.

Davis *at al.* (1997) distinguish an extrinsic and intrinsic reward mainly from tangibility and valuation stand-points. Whereas extrinsic rewards are tangible, exchangeable commodities that have their market values, intrinsic rewards are rather immeasurable, hard to be quantified values, such as opportunities for growth and self-actualization.

We would not care much about mutual relations of motivation theories if they all show direct non-rivalrous positive effects. This is not the case, unfortunately. Standard economics uses the traditional behaviourist approach. Based on unpleasant or neutral activities (work), the disutility is balanced by positive rewards to produce required results (performance). Gneezy and Rustichini (2000) return to the cognitive psychology school which challenged this approach stating that intrinsic motivation, which is independent of extrinsic rewards, is in some cases partially replaced by these rewards. The overall effect may still be positive, nevertheless, if measurable, we get a traditional trade-off relationship once again. In extreme positions the

[43] Dtto. We will get to benefits later in the thesis in relation to tax rules consequences.

standard economics could face a highly undesirable implication where the (monetary, measurable) reward may result in the overall decrease in performance.

Kidder and Buchholtz (2002) present that executives work under relational psychological contracts, prevalently. They are responsible for running the entire company; their work includes all kinds of distinctive roles – decision-making, personal leading, information dissemination. The authors claim that violations of the relational psychological contract would lead to reduction in executives' stewardship.

As we have written above, extrinsic incentives may have a detrimental effect on the overall activity since they balance intrinsic motives. This effect is called *crowding-out*. Frey and Osterloh (2005) listed empirical tests which confirmed the existence of the crowding-out effect.[44] The authors presented that paying for blood donation may reduce total supply. It has also been tested that people reduced their support for a local nuclear waste repository after the monetary reward was offered. Similarly, environmental charges have little effects when destroying natural efforts to protect the environment. The reward may also disturb the social norm of reciprocity (the so-called partial gift exchange theory). And lastly, people show a lower participation in voluntary work when they are paid since this contradicts the social contribution needs. Davies *at al.* (1997) add that a simple fact of being controlled could have a similar impact on decrease in intrinsic motivation.

Nevertheless, based on the psychological contract there is *crowding-in* effect as well. People show that the pro-social behaviour may be reaction to other than extrinsically motivated responses. Frey and Osterloh (2005) claim that people adhere to laws generally and accept the decisions of legitimate authorities. (This example shows that board legitimacy and authority may play a significant role in duties settings.)

The authors also confirmed that crowding-out is stronger for monetary than for symbolic rewards. It is also stronger for expected rewards and for decisions which are more complex and, thus, require a higher level of discretionary behaviour.

[44] Remind the example with the day-care centre from the beginning as well.

There are also critiques which share our objections to the excessive generalization. Eisenberger and Cameron (1996) claim that the above results are highly conditional and could be avoided to a large extent. A more thorough approach to testing should bear less conclusive results. They came to the conclusion that the detrimental effects of rewards are confirmed for the only example of expected *performance-independent* tangible reward. For all, *quality-dependent* and *completion-dependent* expected tangible rewards and for *verbal* rewards the detrimental effects on performance were not verified. Moreover, in their later work the authors confirm that quality-dependent reward increases interest in the activity and has no or positive effect on time spent (attitudinal and free-time measures, Eisenberger and Cameron, 1998).

To conclude, intrinsic motivation seems to play a significant role (although different opinions of the scope exist). Moreover, there are likely to be immeasurable effects of breaking the relational psychological contract between executives and principals. Further, we found intriguing and useful results in Gneezy and Rustichini's (2000) empirical research. The authors show that there is a discontinuity of performance in rewards at the zero level. For small monetary rewards they found a reduction in performance in comparison to no compensation (or when no compensation had been suggested). Moreover, this result contradicts the assumption that higher rewards are accompanied by lower variance in the subsequent level of activity. The discontinuity indicates that the higher variance for lower rewards may be explained just by this discontinuity. The most striking fact is, further, that people are not aware about this zero-level discontinuity. Generally, people appear to take the pay-performance relations as monotonic where a higher reward means a higher level of performance. The examples presented in this chapter confirm that intuitively accepted compensation decisions may bring unexpected – even perverse – results.

4.2. Planned Economy and After

The Czech Republic has still been included in emerging countries.[45] Logically, we can expect that all kinds of markets have not approached the operational level in comparison to advanced economies. This is the case of the labour market with executives and other institutional aspects (mainly legal) as well. Thus, we may believe that based on *path dependency* some of analyzed issues are anchored in the process of transition.

Before 1990 executives did not focus on standard efficiency measures. In a word, they faced monetary and promotion incentives which depended on firm performance, plan fulfilment and political loyalty (Djankov and Murrell, 2002).[46] Moreover, Eriksson *at al.* (2000) emphasize that the centrally planned system in Czechoslovakia faced the highest wage-levelling among the CEE countries and, on the other hand, the highest inequality in earnings with respect to gender. The rigidity of economy resembled the Soviet planning system more than in comparable countries. For larger companies in our scope, there was the only possible pattern of proprietorship – the state owned-property. At the beginning of the transition period and shortly after starting the privatization process, there were few executives well-endowed with skills required for market economy (Claessens and Djankov, 1999). In addition, Clark and Soulsby (1996) remind that those managers who survived the initial change spread and internalised an artificial simplification which distinguished *professionals* (who could operate in any political systems because of managing skills) from the others (who could work only due to party affiliation). There is no surprise that just those who kept holding their positions included themselves in the former group and, hence, justified the survival. Without any judgements, for our analysis it is important to notice that the executives were able to prolong the economic privileges from the communist era to the period after. They converted the preferential access to property, goods and services into cash remuneration. The

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[45] See for instance Morgan Stanley Emerging Market Index, http://www.mscibarra.com.

[46] Cited in (Paligorova, 2005): Djankov, S. – Murrell, P.: Enterprise Restructuring in Transition: A Quantitative Survey. *Journal of Economic Perspectives*, 40, (2002)

economic benefits of managerial élite were always present, however, separation from the planning centre made it possible to monetarise them.

Večerník (1999) specified the conditions on the labour market and called the model as a *revolution of deputies*. Since the general manager positions were understood more political than others in centrally-planned companies, the second wave of leaders – the deputies – became a majority among new CEOs and board members. Moreover, the situation of transition economies faced an insufficient definition of property rights, thus, the Czech Republic became a managerial system where directors of banks and investment funds were able to shape the whole economy.

Clark and Soulsby (1996) collected data for one Czech industrial company[47] and showed that the compensation for senior managers increased by 102,5 percent in the period 1993–1994 in comparison to 31 and 34,5 percent for middle managers and workers, respectively. After further analysis, they concluded that the increase was relatively low compared to other enterprises.

Besides, we have to outline development of ownership structures in the Czech Republic in brief to understand a fundamental institutional background. Mejstřík (2005) reminds that voucher privatization was expected to create an environment of dispersed ownership which would gradually develop into the Anglo-Saxon corporate governance structures. Nevertheless, it became clear immediately that such development would not be probable with the emergence of investment privatization funds. Although there existed regulations[48] which should have lowered the ownership concentration, further development showed that no such thing happened. Later, two official privatization waves were followed by massive ownership changes in 1995 – 1996. This third wave was unregulated, uncontrolled, mainly beyond the official markets and led in huge swaps of controlling bulks of shares.

Mejstřík (1999) offered a model of shareholders' behaviour where *a large shareholder behaves as a single owner*. This zero-one model allowed just for two accept-

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[47] Jesenické strojírny.

[48] An investment privatization fund could not have more than 20 percent of shares in one company; moreover, it was not allowed to invest more than 10 percent of assets into one enterprise.

able forms of ownership – nothing or a controlling majority. This was confirmed by capital markets since after announcement of the received majority, the share prices fell down in most cases. The fall resulted from expected different ways of minority shareholders expropriation. Even in Kodex (2004)[49] we can read about a Czech vicious practice when majority shareholders appoint board members in order to follow their interests exclusively. Richter (2005) lists self-dealing, corporate opportunity capturing and direct stealing as examples of usurpation of private benefits of control.

In 2005 the median ownership percentage of the largest voting block reached more than 77 percent for 55 companies listed on the Prague Stock Exchange. The second largest (block of) shareholder(s), similarly, got incomparable 11 percent. Compared to developed countries, majorities were usual in Austria, Belgium, Germany and Italy as well. Nevertheless, the concentration never got over 60 percent (Mejstřík, 2005).[50] The analysis has shown that the ownership concentration is extraordinarily high in the Czech Republic and the ownership structure does not resemble the Anglo-Saxon model as it had been calculated at all.

Lastly, we have to mention the structure of shareholders from domestic/foreign point of view. At the beginning of transition, the model of domestic privatization was taken for granted. Nevertheless, diverting from further description we can conclude that foreign capital has become dominant in the Czech economy. Based on Czech Statistical Office (CZSO) data, foreign owned companies hold about 32 percent of enterprise units and creates about 54 percent of revenues.[51] Most investors are from Germany and Austria (even though statistically investors from the Netherlands keep the highest portion).[52]

To conclude with compensation data, during the transformation period the lowest percentile of employees with respect to earnings did not fall down compared to the

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[49] Kodex správy a řízení založený na Principech OECD, Komise pro cenné papíry, Praha, (2004)
[50] Data for the year 2001.
[51] For 2Q 2006, companies with more than 100 employees.
[52] Many companies are registered in the Netherlands just for tax purposes, the owners are in most cases different. [11] Lidové noviny, 9. 1. 2007

mean value. To the contrary, the highest percentile earns as much as 25 percent of total income.[53] This confirms the above comments on the rocketing increase in executive compensation.

4.3. Fluctuations and Relative Compensation

In this subchapter, we will theoretically support consequences of executive fluctuation and show on Czech data that this may be a significant force behind the recent compensation development. Moreover, a relative comparison of remuneration in the economy will be presented. In this respect, notice the lower order digits compared to the US compensation comparison presented above. In addition to data sources presented in the third chapter, Czech Statistical Office data and data collected for the Ministry of Labour and Social Affairs[54] are used.

Murphy and Zabojnik (2003)[55] confirmed empirically that CEOs hired from outside are supposed to get higher pay than those promoted internally. We may support this conclusion for Czech executives who specified in the opinion survey that the increase in pay must be significant when changing the employer. For all-level management the increase should be higher then TCZK 10. Accordingly, for top managers the increase has to be much higher. In a word, the turnover is naturally aligned with a positive jump in compensation (and stronger for external hiring than internal promotion).[56]

Table 8 shows that the structure of executives has been changing crucially in the Czech Republic in recent years. We may see a relative fall in the number of executives working at the same place (especially between 5 and 10 years) vis-à-vis those newly hired or promoted.

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[53] Logically, the mean value had to shift lower in the range. [3] Jiří Večerník, Lidové noviny, 1. 10. 2004

[54] Carried out by Trexima, Zlin. The wage collection includes all occupations including the executive positions.

[55] Cited in Jensen and Murphy (2004): Murphy, Kevin J. – Zabojnik, Jan: Managerial Capital and the Market for CEOs. USC Working Paper, October (2003)

[56] The sample is biased to younger executives within both top and middle management. See www.pruzkumy.com.

TABLE 8: TENURE AT A GIVEN POSITION

	2002	2003	2004	2005	2006
Less than 1 year	*13,0*	*16,0*	*19,0*	*24,6*	*35,9*
1 – 5 years	*54,0*	*68,0*	*54,7*	*54,4*	*47,8*
5 – 10 years	*25,0*	*12,0*	*17,3*	*14,7*	*11,3*
More than 10 years	*8,0*	*4,0*	*8,9*	*6,3*	*5,0*

(in %)

Source: Hay Group 2002 – 2006

Data in table 9 reveal a similar development for the sole external hiring. Newly hired employees have been growing relatively to longer employed executives.

TABLE 9: TENURE IN A GIVEN COMPANY

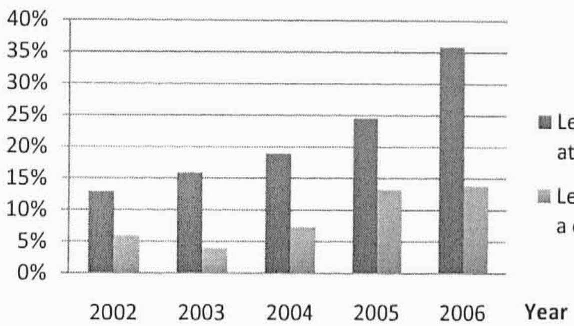
	2002	2003	2004	2005	2006
Less than 1 year	*6,0*	*4,0*	*7,3*	*13,3*	*13,9*
1 – 5 years	*31,0*	*42,0*	*37,4*	*25,9*	*28,2*
5 – 10 years	*38,0*	*29,0*	*28,5*	*26,2*	*23,3*
More than 10 years	*25,0*	*25,0*	*26,8*	*34,6*	*34,6*

(in %)

Source: Hay Group 2002 – 2006

For illustration, we may follow graph 5 which summarizes that both external hiring and internal promotions effects have been quite strong in recent years.

GRAPH 5: EXECUTIVE FLUCTUATION



Source: Hay Group 2002 – 2006

Based on the above discussion, we could expect that this fluctuation results in increasing managerial pay. The question is whether it is distributed among all executives or just a few of them participate on this pay increase.

Table 10 shows that the median pay for chosen executives has been falling relatively to median wages in the economy in recent years.

TABLE 10: MEDIAN COMPENSATION COMPARISON

	1	2	3	4	5	6	7	8	9
2002	*15 542*	*68 761*	*442%*	*88 400*	*569%*	*52 627*	*339%*	*57 684*	*371%*
2003	*16 707*	*74 923*	*448%*	*86 084*	*515%*	*56 654*	*339%*	*66 512*	*398%*
2004	*17 706*	*77 511*	*438%*	*90 332*	*510%*	*58 804*	*332%*	*65 030*	*367%*
2005	*18 589*	*78 299*	*421%*	*93 516*	*503%*	*62 555*	*337%*	*68 025*	*366%*

(1) median wages in economy (business and non-business), (2) m.w. of CEOs in big companies, (3) ratio of (2)/(1), (4) m.w. of CEOs in big industrial companies, (5) ratio of (4)/(1), (6) m.w. of CFOs in big companies, (7) ratio of (6)/(1), (8) m.w. of sales directors in big companies, (9) ratio of (8)/(1)

Source: CZSO, Trexima, author's calculation

However, table 11 shows a different picture. Especially in the years 2002 and 2003 the average comparison followed the opposite development to the median values. Analyzing the data in tables 10 and 11, however, we have to realize that the sample used for the comparison included both top and middle managers and that the executives at the same positions have different discretionary rights in different companies. The other (non-public) data samples show that the actual level of compensation for top managers is approximately twice as high (than presented in the tables for all-level executives).[57]

[57] Hay průzkum odměňování vrcholových manažerů (2000 – 2006)

TABLE 11: AVERAGE COMPENSATION COMPARISON

	1	2	3	4	5	6	7	8	9
2000	*13 864*	*78 325*	*565%*	*n.a.*	*n.a.*	*57 635*	*416%*	*63 627*	*459%*
2001	*15 033*	*84 788*	*564%*	*98 399*	*655%*	*61 900*	*412%*	*68 192*	*454%*
2002	*16 017*	*102 663*	*641%*	*111 247*	*695%*	*75 672*	*472%*	*77 703*	*485%*
2003	*16 951*	*111 372*	*657%*	*116 780*	*689%*	*80 694*	*476%*	*86 095*	*508%*
2004	*18 124*	*117 278*	*647%*	*121 658*	*671%*	*85 393*	*471%*	*90 289*	*498%*
2005	*19 045*	*117 805*	*619%*	*128 528*	*675%*	*88 336*	*464%*	*93 661*	*492%*

(1) average wages in economy (business), (2) a.w. of CEOs in big companies, (3) ratio of (2)/(1), (4) a.w. of CEOs in big industrial companies, (5) ratio of (4)/(1), (6) a.w. of CFOs in big companies, (7) ratio of (6)/(1), (8) a.w. of sales directors in big companies, (9) ratio of (8)/(1)

Source: CZSO, Trexima, author's calculation

With respect to a distinctive data distribution (the median value is significantly lower than the median value); we may conclude that top managers (including superstars) meaningfully increased their income relatively to both the whole population and the rest of executives. Nevertheless, we may believe that the managerial power was less involved than in the transition period since recent development was characterised by strong foreign hiring.

In brief international comparison, these wage relations resemble the Austrian ones at most. A lower spread may be seen in Scandinavian countries and higher in South European countries (and in Germany as well).[58]

5. GOVERNANCE AND LEGAL ASPECTS

5.1. MANAGEMENT ACCOUNTABILITY

Gillies (2006) asks a question in his case study whom a CEO is accountable to in day-to-day company leading? Is it just a board of directors? Even if s/he expects decisions that in his/her best opinion would have detrimental effects upon a long-term firm value inevitably? Do duties of care and loyalty entitle a CEO to ask directly chosen shareholders? And if so, where are the limits of his/her discretion placed?

[58] Dtto.

We would like to show that answers are in the ambiguous definition of property rights which arises from historical division of ultimate owners and their rights and liabilities.

Roots of the shareholding concept lie in capital inadequacy of individual owners in the period of overseas explorations. Richter (2005) talks about 19^{th} century and the industrial revolution that unconditionally asked for capital pooling. Joint stock companies naturally bound characteristics required for such capital cooperation – limited liability, liquidity, and specialization. We may say that joint stock companies defined themselves by their operational assumptions. The trouble emerges with the application of natural understanding of an owner as the ultimate decision-maker. And s/he really is so in a simple example of a sole trader. This natural understanding is correctly expressed in the unlimited liability of the owner. But, joint stock companies and the limited liability bring a qualitatively different entity. The phenomenon of the liability-ownership-control division blurs the subject of the ultimate owner whom a CEO is accountable to in a natural law sense. Management accountability then means looking for this ultimate owner.

Historically, joint stock companies seem to be the most viable competitive structure. Their legal form, as Richter (2005) emphasizes, has undergone long evolution of an institutional selection. Today most of advanced-economies production comes from those companies. This should indicate that limited liability is conditional to a capital concentration; hence, the limited liability is the most competitive *economic* structure. This does not mean that there are no other costs; it just means that the transaction costs are optimized. Richter (2005) continues in the same manner when embedding liquidity and management specialization into the trinity of a joint stock company definition, where the former allows investors to diversify their portfolios and the latter is the basis for large centralized corporations with professional administration. We would add that this approach indicates evolutional superiority of professional management over other management structures; gains more then balance possible higher costs concerning ownership-control division and other inefficiencies.

Shareholders have rights to dividends, a liquidation balance, and to take part in general assemblies. Thus, shareholders are not the ultimate owners in the traditional Roman sense. Since limited liability companies became more abstract entities, shareholders are rather some of capital providers (similarly as creditors, just with the above distinctive rights). Therefore, we divert from natural property rights to legally-based positive rights.

The shareholder model is based on two distinct characteristics. Firstly, a firm is seen as a nexus of *complete* contracts with creditors, employees, suppliers, and the like (Becht *at al.*, 2005), where just shareholder contracts are incomplete. Hence, Richter (2005) concludes that shareholders' voting rights are a natural response. Secondly, the model arose from the residual claimant definition. Voting rights could be delegated on creditors, employees, the management, shareholders or any of their combinations; nonetheless, the corporate law gives the privilege to shareholders who are the residual claimants. That is not the question of accountability; it is the question of economic rationality. In this view, Becht *at al.* (2005) see the maximization of the shareholder value as a reflection of economic efficiency after all contractual obligations have been settled. It is in the shareholders' best interest – more than in the interest of the other stakeholders – to control thoroughly the company. Of course, you could ask with Williamson (1984)[59] why we do not see only fully indebted corporations when debtors could get better legal (contractual) protection. While creditors get better legal protection, high leverage bears substantial costs of financial distress. Firm revenues seem to be optimized for different proportions of equity and debt based on a trade-off between costs of residual claimants and costs of financial distress.

It is the legal structure which may and do legitimate other than shareholders' controlling rights. Hermalin and Weisbach (2001) found that following poor performance financial institutions (especially banks) take control over running the corporations. Possible actions may include appointments of new board members (changes in managements would be the natural consequence). The example shows the role which the corporate law delegates on distinct stakeholders. Dodd (1932)[60] in then

[59] Cited in Becht *at al.* (2005): Williamson, O.: Corporate Governance. *Yale Law Journal*, (1984)

[60] Cited in Becht *at al.* (2005): Dodd, M.: For whom are corporate managers trustees? *Harvard Law Review*, 1932

famous disputation with Berle asked for even further legally defined rights for other constituencies – employees or customers. The case of Germany, for instance, indicates that his approach is not unique either today.

If we encompass the idea of mutual supplementing of shareholder/stakeholder models based on a given legal framework, elegantly stated *"[the] stakeholder firm would achieve almost as a by-product, what a profit-maximizing firm would achieve as an objective"* (Moore, 1999).[61]

To sum up, theory understands that relationships in modern corporations are ambiguous and uncertain in definitions. We are convinced that the controversy is rooted in the very division of the owner and his/her liability. Limited liability companies created a situation in which the need of the ultimate owner became critical. The shareholder theory found shareholders as residual claimants and substituted them for those ultimate owners. In our view, however, residual claims are not as general as the unlimited liability. Therefore, the shareholder and stakeholder theories are not mutually exclusive anymore; and they rather supplement each other in given legal frameworks. In a word, there are no ultimate owners and executives are accountable to those who were prescribed in law for each particular situation in the life of the company.

5.2. Legal Liability

The delegation of controlling power requires a clear definition of fiduciary duties. Richter (2005) reminds that the duties of care and loyalty should be binding for both executives and members of boards since they operate in the similar environment. Real applicability is, however, disputable. Radical proponents claim that the fiduciary duty of care[62] should be abolished since courts are not able to judge managerial skills. The duty of loyalty[63] seems to be a bit more efficient in striking executive misbehaviour. However, in countries with weaker shareholder protec-

[61] Cited in Körner (2005): Moore, G.: Tinged shareholder theory: or what's so special about stakeholders? *Business Ethics*, Vol. 8, No. 2, (Apr., 2002)
[62] The liability of corporate executives to keep an appropriate degree of managerial skills.
[63] Standards prohibiting executives' self-dealing and other transactions which would damage the company.

tion, collective action problems indicate once again enforcement difficulties (Rehnert, 1985). The author concludes that legal rules may be at least partly successful in looking for solutions to evident self-dealing or fraud, much less then in managerial inefficiency.

We would like to return to the question if mandatory or non-mandatory rules should be preferred in compensation relationships. We can agree with Richter (2005), who claims that it seems reasonable to have non-mandatory rules since a firm is generally understood, following our above discussion, as a nexus of contracts. On the other hand, and that is a notable point, we have to review the institutional environment correctly (local understanding of business ethics and customs, the corporate law and law enforceability, and the like). While we may agree that in the Anglo-Saxon countries it is justifiable to rely on non-mandatory rules, we believe that a reasonable level of mandatory rules in remuneration contracts may have its justification in the Czech Republic. Richter (2005) offers a few examples supporting the idea.[64] The process of collective action, for instance, could be perceived as a public good. Similarly, information asymmetries and moral hazard (in consequent contract breaking) are systematically inbuilt in the remuneration relations. Potentially better business environment could be understood as a positive externality. Moreover, rent-seeking managerial behaviour seems to be systemic to some extent; it cannot be diversified even with perfect capital and labour markets, accordingly. And lastly, mandatory rules are often understood as a public declaration about desirable moral values.

By law, just members of boards have been legally liable for losses caused to the company. This approach was logically opposed (Richter, 2005). Nowadays, corporate law prescribes the liability to other individuals who may significantly influence company operations as well.[65] Thus, executives do not have to be members of boards at the same moment any more in order to be subject to legal liability.

[64] Compared to the common law system, we do not expect that these legal practices may occur in the civil law environment.

[65] *Obchodní zákoník* (2006), § 66, (6). Executives as well as a large shareholder, for instance, may be made responsible and suited for losses caused to the company.

In reality, however, the aligning role of executives' liability for losses is limited. The corporate law forbids any contractual agreements which could avoid such liability; nevertheless, the process itself appears to be a typical example of possible private market solution. And really, the liability helped to create a specialized insurance market with statutory liabilities. This insurance has become common in the Czech Republic similarly as it is in advanced countries. Thus, abstracting from criminal actions (fraud) executives are not at risk with respect to liabilities for losses.[66]

Richter (2005) criticized also ambiguity in executives' duties prescription in corporate law. Although some changes occurred in law,[67] the explanation of *due care*[68] is still ambiguous in precise description of behaviour and duties. Nevertheless, Petrov (2007) tends to a broader explanation which naturally includes both the duties of care and loyalty. However, other comments such as the reference to the mandate contract in liability prescriptions and the non-mandatory basis of rules remain valid.[69]

To sum up, some of executives' liabilities were better reflected in the revised corporate law. Due care may finally be explained as including both the duties of care and loyalty. The liability for losses, moreover, is unambiguous nowadays. Its aligning role is, however, limited since almost all managers in larger companies are insured. Similarly, need for non-mandatory rules in the agency issues were taken into account although further prescriptions should be amended in this respect.

5.3. Boards

Board members should monitor a company management, they should hire and fire executives and, lastly, they should be responsible for firms' compensation policies. Becht *at al.* (2005) likened the theoretical expectations to shareholder democracy

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[66] [25] Jan Jírovec, Petr Plavec, www.ekonom.ihned.cz, 15. 3. 2007

[67] *Obchodní zákoník* (2006), § 194, (5)

[68] " ... vykonávat svou působnost s péčí řádného hospodáře ...", dtto.

[69] *Obchodní zákoník* (2006), § 66, (2) and (6). Liabilities, nevertheless, are subject to criminal law as well, see for instance *Zákon č. 140/1961 Sb., trestní zákon, ve znění zákona č. 253/2005 Sb.* (s účinností od 1. července 2006), § 125, (1) and (3) and § 255, (1).

where a CEO represents the executive branch, a board of directors is the legislative branch and shareholders are the general electorate.

The other level of control delegation between general meetings and executives bears additional transaction costs. Such costs must be balanced by economic benefits. Richter (2005) mentions limits, for instance, which are imposed on large shareholders' discretional behaviour. Simply, having boards responsible for business activities of the firm, they should be independent of (large) shareholders in day-to-day activities.[70] Hermalin and Weisbach (2001) point out that the institution of the boards is not the first-best solution. Boards are the second-best efficient solution to the whole set of transaction costs, including costs of roles specialization and collective action costs.[71]

The two-tier board system with an executive board of directors and a controlling supervisory board can be seen compulsory in Germany, Austria, Portugal, or the Czech Republic, and voluntarily in France or Finland. On the top of it, Germany demands a compulsory 50 percent employee representation in supervisory boards. Richter (2005) names just Austria and Portugal as the only European countries where the system of two boards is compulsory without any conditions. The examples of Germany and the Czech Republic are rather politically determined due to the employee representation. Furthermore, the two-tier system brings other transaction costs; hence, it is less efficient. This fact may be confirmed on the example of France where shareholders are obliged to choose between one-tier and two-tier systems. This has been valid since 1966 and, still, just about 1 percent of companies have chosen the two-tier system (Richter, 2005).

As far as the empirical findings are concerned, there is the sole consistent conclusion on the board structure and company performance – the board size is in negative relations to profitability.[72] Is it then reasonable to keep the boards as small as possible? It does not seem so. Hermalin and Weisbach (2001) ask why there are not

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[70] See Obchodní zákoník (2006), § 194 (5) for the Czech reference.

[71] Situations in which the costs of a legal action are exercised by a few players while the revenues from that action are shared by all the others. A special case of the free-rider problem.

[72] This conclusion is quite convincible across the authors. See for example Hermalin and Weisbach (2001)

just the smallest boards as allowed by law. The answer may be that there is no single optimal board composition for all firms. If the board structure (including size) is endogenous (i.e. there are other factors of the correlation between the board size and performance as well), we should not encourage artificial decreasing of board members as suggested by the out-of-equilibrium approach. Since there is not the sole common equilibrium, these efforts would lead to rather adverse results.

Focusing on the Czech Republic, we will describe the structure of boards and their responsibilities first. By law, a board of directors has at least three members unless there is the sole shareholder in the company. A supervisory board has at least three members as well and the co-determination asks from a one-third up to one half employee representation for companies with more than 50 regular employees.[73]

General meetings appoint boards of directors and supervisory boards. The law offers also a different model when just the supervisory board is appointed by the general meeting and the supervisors appoint the board of directors consequently. Besides, executive roles are played by a different body which consist of top managers. Both boards consist mainly of managers and shareholder and debtor (especially bank) representatives. The corporate law forbids being a member of both boards.[74]

A typical board has three members; hence just the minimal law requirements are met.[75] Nevertheless, for large companies the practice is different. Fahadová (2004) showed that the average number of supervisory board members is higher. In her sample the average was 8,5 members in 2004. However, she also confirmed that the co-determination is understood rather as involuntary since in all the cases just the minimal law requirements were fulfilled.[76] Richter (2005) reached a similar conclusion. The institution of co-determination is seen as a political instrument which helps to get a union support. Moreover, the author compares different approaches

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[73] *Obchodní zákoník* (2006), § 187, (1), § 190, (1), § 194, (3) and § 200, (1)

[74] Dtto, § 200, (4) and Kodex (2004)

[75] [24] KPMG Česká republika, 9. 11. 2005

[76] For Zentiva, Komerční banka, České radiokomunikace, Česká spořitelna, Pražská plynárenská, and ČEZ. Moreover, we have gone through annual reports of Komerční banka for the years 2002 – 2006 and found out that the practice has been persistent. In all the cases just the minimal law requirements were fulfilled.

(to banks and to joint stock companies in general) and claims that the ineffectiveness is well-known by legislators.

We have concluded above that the number of members in boards seems to be endogenous. Although empirical findings showed that smaller boards are aligned with higher efficiency, the endogenous approach indicates that we cannot prefer having the boards as small as possible. Moreover, the legal bottom limit of three members disables full optimization for companies which would find a lower number in any of boards more efficient. We offer three other variables for the endogeneity problem in the Czech Republic. Firstly, the transition emphasized the vulnerability of minority shareholders. Thus, having a representative in the boards could help to keep influence. Simply, a larger board is a naturally optimized result for companies with several smaller owners and worse institutional conditions. Secondly, more members may express the majority shareholder's usurpation of private benefits of control. Holding places in rather inactive boards may be a sophisticated (since legally correct) way of assets pocketing. And thirdly, a higher board may indicate the managerial power signs. Mutual executive representation in boards may increase their discretionary power.

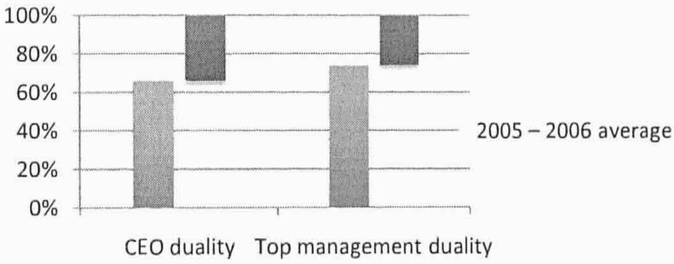
Boards of directors in the Czech Republic meet once a month usually; just one half of the boards of supervisors meets more than four times a year. Prevalently, the frequency is just once or twice a year. Generally, members of both boards claim that they are satisfied with the information they get from executives.[77]

The fundamental cause of higher agency cost lies, however, in the structure of roles. Board duties as prescribed in law appear not be internalized by companies. Then, they have two essential ways how to tackle the limiting structure. They may operate under the strict definition in law and accept the structural inefficiencies. Or, they may look for structures with lower transaction cost, although realizing that they balance the law requirements. This, once again, would bring other costs (both systematically since it increases uncertainty in economic decisions and internally with higher insurance, lawyer, governance and other costs). The latter approach

[77] [24] KPMG Česká republika, 9. 11. 2005 and Kodex (2004)

seems to be prevalent in the Czech Republic. Richter (2005) shows one possible solution. In many cases the supervisory board plays just a covering role without any executive and controlling decisions which reduces the system to a biased two-tier system. However, the controlling functions are weakened vis-à-vis executive functions since just the non-executive members of boards of directors remain to take care of the supervisory duties (although not supposed to do that by law). Graph 6 indicates another by-passing approach.

GRAPH 6: EXECUTIVE DUALITY



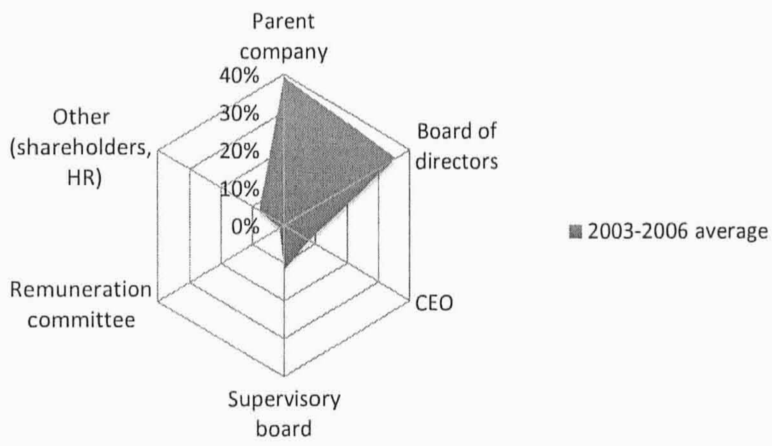
Source: Hay Group 2005 – 2006, author's calculation

In most cases, executive bodies (a managerial board and a board of directors) naturally overlap and create a complex decision centre. Then, once again the structure results in a biased two-tier system with one executive and one controlling body. Either way, in principle we get the system with insufficient supervisory functions.

Based on these conclusions, we have to refuse the recommendation from Kodex (2004). The Czech code of best practice does not hide the preference of the Anglo-Saxon corporate governance structures to the continental ones in general. Although logical in the US or the UK, the pressure on the separation of the CEO and the chairman of the board of directors in the Czech Republic is not supported by conclusive arguments (including duality of other top managers). More to the others, the above discussion indicates that such combination could make the system more efficient.[78] It is then quite interesting that in banks on the contrary the duality is compulsory by law.[79] This would assume, nevertheless, that the board lost the power to decide on (their own) compensation.

From the above we may see direct consequences for executive remuneration. Graph 7 shows who influence the level and the structure of CEO's compensation. With respect to the above numbers on duality, we may see the power which CEOs can use in their own remuneration determinations. In concern with other managers the CEOs themselves decide on their own pay often. Moreover, there is no balance for this since the influence of supervisory boards is much lower (and the remuneration committees are almost inexistent).[80]

GRAPH 7: CEOS REMUNERATION SETTINGS



Source: Hay Group 2003 – 2006

Graph 8 shows a similar view. The mutual influence of CEOs and top managers on their own pay through memberships in boards of directors appears to be evident.

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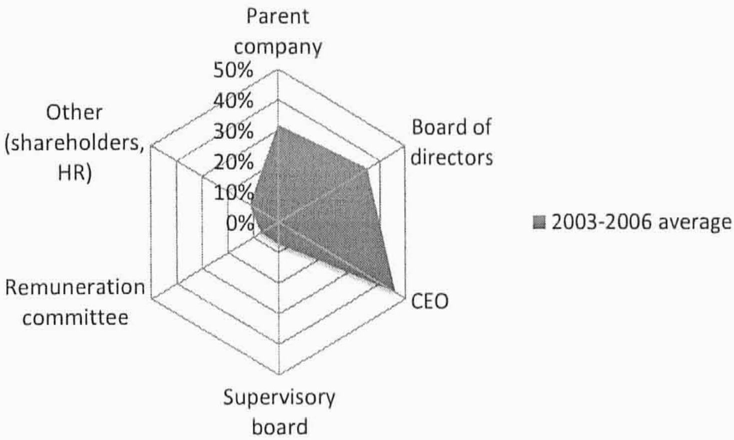
[78] In combination with other modifications, of course. We have to realize that the transformation of the whole structure into the one-tier system (see for instance Richter (2005)) is much less feasible than reasonable changes in the given system.

[79] The bank code, cited in Kodex (2004). For detail analysis of the issue see Richter (2005).

[80] Unfortunately, the influence of parent companies is difficult to be discussed without more details.

GRAPH 8: TOP EXECUTIVES REMUNERATION SETTINGS



Source: Hay Group 2003 – 2006

This indicates that a better system of balances is needed. Not just because of the overall corporate governance quality but also for remuneration purposes. In the given system there is the only body which can represent the balance to boards of directors and this is the supervisory board. The re-activation of its controlling functions is crucial.

We have also mentioned that the post-transition institutional environment may ask for larger boards. In this respect it should naturally be the supervisory board which should have more members and the board of directors, on the other hand, should be small with only mutual statutory-executive members. Then there is room for specialization within the supervisory board. Kodex (2004), based on the international best practice, recommends formation of auditing and remuneration committees. The former should concentrate on the accounting issues, a full and correct disclosure and cooperation with internal and external auditors, the latter then on the executive body compensation and cooperation with external consultants.[81]

The supervisory board has its importance for firms with both more and less dispersed ownership. The board should supervise the fair approach to the sharehold-

[81] Optimal settings are possible rather in larger companies.

ers as well as supervise the executives. Then, we would have to reconcile the structure of supervisory board members compensation. In brief, the board is supposed to disclose all information including adverse. Thus, contingent pay should not be used in supervisors' compensation schemes (they should not get extra pay when the company goes well but also lose money when it goes bad). An improper application of contingent pay in supervisors' compensation revealed for instance the case of ČEZ which led to reassessment of remuneration schemes.[82] But, consequently, the scheme would result in insufficient incentive power. The free-rider problem would likely occur more often. This is the weakest point of the proposed system. We are able to offer just a few inconclusive requirements – development of the labour market with supervisors and shareholders activism would have to be supported, for instance.

Interestingly, a step-by-step analysis has led us into the position which strongly resembles the Germen corporate governance approach. However, it appears reasonably since we have assumed that the overall system would not be transformed into the one-tier governance structure. This leads us into the conclusion that based on given institutional (and mainly legal) conditions the German-like model is a certain efficient point of the institutional evolutionary process. Richter (2005) supports this idea since he claims that a comparison of the German bank-driven governance and the US capital-market-driven governance is ambiguous – no system presents long-term supremacy in corporate governance efficiency.

5.4. Market with Corporate Control

There are two main ways how to reduce agency costs. In addition to the internal instruments (contractual settings), these are supposed to be competitive markets. The exogenous forces consist primarily of product, capital and labour markets. Richter (2005) summarizes theoretical comments and claims that product markets are the ultimate institutions which unveil executives' actions and quality of their decision-making. Companies which operate for a longer time under inefficient management would not alive in the long-run. This could lead to changes in owner-

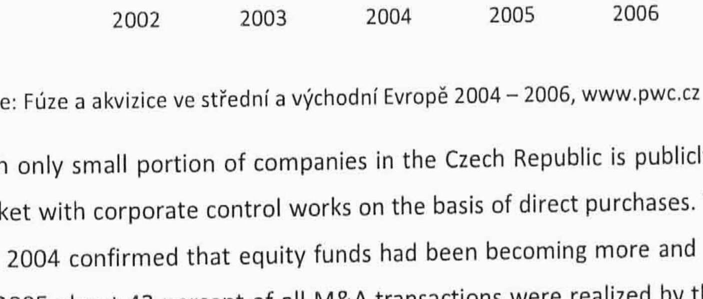
[82] See chapter 8.2.2. or [1] Ihned, 27. 1. 2007

ship/shareholdings, or at least to changes at an executive level. However, this may take much time.

If a company is publicly traded, capital markets are supposed to be much faster in information transfers than product markets. Any inefficiency is reflected in stock prices sooner than competitive problems occur. Moreover, capital markets create the market for corporate control which may be another streamlining instrument. Denis and McConnell (2003) confirm that the market for corporate control is especially active in Anglo-Saxon countries. Nevertheless, they found that even though the market as in the US and the UK absents in other countries, a different market with control exists. In Germany, following poor performance, outsiders make efforts to gain some control in existing ownership blocks. Changes in boards and management follow similarly as in the Anglo-Saxon countries.

The situation in the Czech Republic indicates that the whole environment resembles the German experience. Graph 9 presents the number of mergers and acquisitions in the Czech Republic between years 2002 and 2006.

GRAPH 9: MERGERS AND ACQUISITIONS



Source: Fúze a akvizice ve střední a východní Evropě 2004 – 2006, www.pwc.cz

Although only small portion of companies in the Czech Republic is publicly traded, the market with corporate control works on the basis of direct purchases. The PWC study in 2004 confirmed that equity funds had been becoming more and more active. In 2005 about 42 percent of all M&A transactions were realized by the equity investors. Moreover, it is important to notice that about 77 percent of transactions with disclosed price resulted in obtaining the ownership majority.[83]

Nevertheless, since M&A have been on the increase generally in the world (and poor performance of companies is just one of the reasons for ownership changes), the presented data cannot be analyzed in a quantitative way. Rather, it is a trend confirmation and a confirmation of the German-like approach to the market with corporate control.

5.5. Tax Treatment

Before concluding on the sole Czech environment, we will return to the US practice which helps us to reveal some general patterns.

It is a fascinating question for economists whether people and companies look for the overall efficiency optimization or if they focus more or less intentionally just on partial optimization. Surprisingly, it seems that in the real world companies concentrate on the second-best solutions to the economic efficiency problems. Naturally, it is the tax optimization which plays the leading role.

The significance of institutional settings is emphasized in La Porta *at al.* (1998b).[84] The legal system (including accounting and tax rules) is a crucial determinant of corporate governance mechanisms. The legal protection and law enforcement indicate how corporate governance and corporate finance evolve in the particular country. The authors do no claim that the institutional factors have to be the driving force at all operational levels; nevertheless, Abowd (1990) proves they often are. In reality, composing the compensation package means often minimization of the total tax burden of principals and agents. Accordingly, contingent pay is not primarily the motivational instrument. Simply, many parts of the compensation package may be implemented for the sole reason of tax burden optimization.

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[83] Fúze a akvizice ve střední a východní Evropě 2004 – 2006, www.pwc.cz

[84] Cited in Denis and McConnell (2003): La Porta, R. – Lopez-de-Silanes, F. – Shleifer, A. – Vishny, R.W.: Law and Finance. *Journal of Political Economy*, 106, 1998b

Option contracting in the US is a perfect example for such reasoning. The recent changes in accounting and reporting requirements for stock options (which resulted in a gradual diversion from the overwhelming use of options in executive compensation contracts as we have written above) confirm these findings.

Accounting rules in the US had been set in a way where the accounting charge equalled the spread between the grant-day stock price and the exercise price if the exercise price and terms were fixed in advance. Since there were two separate ledgers (revenues and expenses), there was no accounting charge for premium and at-the-money options with fixed terms. There is no surprise we could see these options prevalently.[85] Moreover, for non-qualified options there was even a more favourable tax treatment since the spread between the stock price and the exercise price (at the time when the options were vested) constituted expense for taxable reasons. This tax reduction more than offset the personal income tax for executives (Murphy, 1999; Hall and Murphy, 2003; Hall and Murphy, 2000).[86] As we have already mentioned, cancellation of this favourable treatment was one of the most important factors for relative fall of stock options usage in executive compensation.

Similarly, in 1994 tax law amendments were imposed. The executive compensation in excess of USD 1 mil. was labelled as the *non-performance related*. From a company's income tax point of view higher values became non deductible. Although the reason was to decrease high rewards which had drawn more and more public attention, the opposite happened. Companies increased both the non-contingent and contingent pay. The level of non-contingent compensation approached USD 1 mil. since this value seemed suddenly as governance-blessed. Moreover, labelled as performance related the contingent pay was also fuelled since excluded from the limits (Jensen and Murphy, 2004).

The most striking fact is as it seems from the above that principals value tax reductions higher than possible growth effects from pay-performance incentives. Intentionally or not, they do not believe in compensation incentives as much as the dis-

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[85] The options were just the off-balance sheet records.

[86] In comparison to qualified options where executives pay capital gain taxes and the expense is not tax-deductible for companies.

cussions about executive motivation indicate. This could really mean that executive compensation policies focus rather on tax and other optimization than on the incentive power, motivation and relationships building.

Moreover, this finding seems to be supported by comparison to the UK. Conyon and Murphy (2000) performed a thorough comparative study on the US and UK accounting and tax regulations and on public and governmental inferences in compensation processes. The study showed that until 1995 the popularity of stock options in the UK had been even higher than in the US. Nevertheless, in 1995 the situation changed completely and stock option grants became publicly highly controversial. Examples of excessive executive pay in then privatized electric utilities emerged and, afterwards, the stock options were treated as an inadequate way of the executive remuneration. Further, the UK capital markets growth was half as fast as in the US and executives' pressure on stock option grants were lower. Greenbury Report (1995)[87] then recommended substitution of stock options for LTIPs as a potential solution. Although not compulsory, the recommendations were generally accepted and supported by additional legal changes. As a result of changed public and tax and accounting environment, the ratio between stock options and LTIPs reversed.

In the Czech Republic the stock-based instruments are much less in use as we have presented. Therefore, we cannot follow the same reasoning as in the above text. Instead, since remuneration benefits become more and more common, we will concentrate on them. Thus, analyzing compensation benefits we would like to confirm that in the Czech Republic, too, tax optimization in executive compensation is more important than its incentive elements.

Firstly, we will go through pension contributions. On the employer side, contributions to state-subsidised retirement plans up to 5 percent of the basis for social contribution payments are tax exempted. For employees, the yearly limit of TCZK 12 is tax deductible. Although the limits are very low reflecting executives' total

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[87] Cited in Conyon and Murphy (2001): *Greenbury Report* (Study Group on Directors' Remuneration), one of the UK-created corporate governance reports on company codes and principles. Downloadable at http://www.ecgi.org/codes/documents/greenbury.pdf.

compensation, these values are applied mostly. Secondly, we will show the optimization on the example of life insurance contributions. Yearly, life insurance in the Czech Republic is not taxable up to TCZK 12 and 8 for employees and the employer, respectively. And once again, these values are used in most executive compensation plans, although very low in the relative comparison. Lastly, company loans up to TCZK 100 are exempted from the income tax. In previous text we have shown that it is the value which companies mostly lent to executives.[88]

To conclude, similarly as in the US and the UK (and we believe that generalization is possible in this case), Czech practice concentrates more on legal settings than on incentive power of particular instruments when structuring the executive pay. This is surprising if we realize the marginal product which is attributed to any changes in executives' effort. Therefore, from this point of view we may agree with opinions suggesting that removal of accounting and taxation rules which distort the decision-making of board members and consultants could be beneficial (Ferrariny *at al.*, 2003). In this manner, the essential incentive function of compensation would get a new impulse.

5.6. Code of Best Practice and Disclosure

A code of best practice is still a relatively new subject in corporate governance although it has been going through a rash development. In Europe, the first code of best practice was issued in 1992 in the UK. The following codes have been reflecting many of its points. Denis and McConnell (2003) draw attention to apparent cases of partial corporate governance system convergences. The US, Germany and Japan are often mentioned as representatives of distinctive corporate governance approaches. In authors' view, Germany and Japan have been drifting to a single-tier-like model with the insider and outsider representation and a relatively small number of members. The level of ownership concentration falls, financial institutions play less significant roles and cross-holdings do not deepen. To the contrary, large shareholders have become more common in the US. They also note that the codes of best practice – being on increase in the world – derive rather from Anglo-Saxon

[88] [23] Petr Bukač, www.mesec.cz, 16. 3. 2005, [22] Robert Jehne, www.jobs.cz, 23. 8. 2006, Hay Group 2006

corporate governance models. The authors emphasized that it was much more complicated for continental countries to comply with the codes since the controlling large shareholders understand the codes as instruments which limit their decision power.

The Czech code of best practice (referred as (Kodex, 2004)) is a revised version of the first code which emerged in 2001 as a joint document of the Czech Securities Commission,[89] expert groups and British counterparts. The revision reflected new OECD principles and mitigated the influence of the Anglo-Saxon-based recommendations which were evidently inappropriate for the Czech corporate governance structures (Mejstřík, 2005). Moreover, Kodex (2004) included conclusions and reasoning of the European Commission's suggestions published in its proposal focused on enhancing corporate governance systems in the EU countries.[90] Those responsible for the code emphasized its voluntary basis. Nevertheless, there were firms which included the reference on the compliance with the code into their annual reports.[91]

For us, just parts concerning executive compensation are important. Among other recommendations, Kodex (2004) pursued to implement a compulsory individual disclosure of executive remuneration (including the description of a given compensation system). Members of parliament, however, changed the rule into the group disclosure for both boards. Moreover, just publicly traded companies were included. In spite of the lower requirements, in 2006 about one fourth of the companies did not comply.[92] Basically, this approach is not consistent with the development in advanced economies. The use of disclosure is presented as a corporate governance reforming tool and it is accepted in both the major European governance systems (in the UK as well as in continental Europe; Ferrariny, 2003). Similarly,

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[89] The Commission ceased to exist and its agenda was transferred to the Czech National Bank in April 2006.

[90] Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward. A Working Document of DG Internal Market, COM (2003) 284, May 2003

[91] [13] Josef Bič, Ihned, 22. 9. 2004. This was the case of Český telecom, for instance. The compliance, however, did not prevent from public objections against a questionable compensation system soon after.

[92] [12] Lidové noviny, 31. 3. 2005, [18] Eva Hanáková – Marek Hudema, Ihned, 6. 3. 2006

the US decided to change 14 years old rules of disclosure in 2006 and, newly, publicly traded companies in the US have to specify in large detail individual compensation structures of five highest executives as we have written above.[93]

Nevertheless, we hypothesize that the full disclosure could lead to stronger tendencies to apply stealth compensation instruments. Abroad, the risk of a rocketing increase in the average pay and a detrimental effect on workers' motivation is ascribed to the full disclosure.[94] In spite of that the full disclosure has been applied in the UK, France, Italy, the Netherland, Sweden, or Spain among the EU countries. Newly, the same is true for Germany where the previous voluntary approach did not work well.[95] However, with respect to the above text, we cannot recommend the full disclosure in the Czech Republic at the moment. The reasoning differs from comments of corporate leaders which relate to the non-readiness of the Czech society. In our view, it is the corporate governance in the Czech Republic which does not allow getting closer to advanced economies in this respect. Neglecting the institutional background would push the corporate sector into the risk of a vicious circle of stealth compensation and earnings management since the actual structure of boards, procedures and labour markets is not able to absorb the potential full disclosure. We result from the above analysis of the board structure and board members' responsibilities in the Czech Republic. This analysis indicated that the supervision is too weak to balance the power of executives and executive members of boards of directors at the moment. Application of the disclosure would probably lead to fossilisation of the immature governance system and would deepen its shortcomings since camouflaging could institutionalize.

In general we remain to be advocates of the full disclosure. The impact of the information value on markets and its consequences for corporate governance justify even the mandatory basis of potential new corporate governance rules. Moreover, we believe that the information asymmetries do not allow for optimal development

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[93] More information in [19] Marek Hudema, Ihned, 19. 1. 2006

[94] *Challenges to Executive Compensation,* Ethical Finance Research Series, Center for Corporate Responsibility and Sustainability, University of Zurich, (Nov., 2004)

[95] [20] Lidové noviny, 3. 5. 2005, [19] Marek Hudema, Ihned, 19. 1. 2006

of institutions at present. However, before the structure of boards and authorities of its members are adjusted with respect to the above recommendation, we have to oppose the full disclosure with respect to the risk of institutionalization of adverse effects.

6. Conclusion

We have made an effort to show that executive compensation is a complex institutionally-based issue. Realizing that Czech data sources do not allow for a comprehensive quantitative research, we have focused on a comparative analysis of qualitative aspects of managerial remuneration.

We have shown that limited liability of joint stock companies does not allow for unambiguous addressing of the ultimate owner. Thus, it is the corporate law and the general institutional environment which distribute discretions and rights for all possible business contingencies.

We have seen that the principal-agent model is strong especially in its descriptive part. It clearly and illustratively analyzes involved parties and their roles and responsibilities. Based on the self-interested economic man it makes an effort to establish the rules for optimal contracting which is seen as the prime solution to agency costs minimization. For its theoretical applicability, the model uses strong assumptions which do not allow for versatile empirical applicability. On the other hand, we are convinced that especially in economics this approach will keep its strong position among other models. In principle, it is the sole approach which unambiguously works with incentives in a direct causal sense. Summarizing the assumptions, the model suffers from three main shortcomings. Firstly, it is its opportunistic reasoning; secondly, it is a missing assumption about biasness in the contracting process, and; thirdly, it is its practical focus on easily measurable performance variables.

The managerial power model reacts to one of the strong assumptions of the principal-agent model since it claims that the contracting process is not exogenous. In its reasoning, executives may apply their power on potential re-appointments of board members who, in return, positively influence executives' pay.

The stewardship models reacts to yet another assumption of the principal-agent model. The model assumes the self-actualizing man who does not tend to behave opportunistically. More to the other, this model claims that the economic understanding of man limits people from their distinct needs satisfaction. Based on that, the principal-agent behaviour is supposed to spoil potential synergies which naturally emerge in co-operation. At the end, however, the stewardship model is quite inconclusive in its recommendations.

Having analyzed the models, we have attempted to classify the Czech Republic according to social preferences. We have concluded that the Czech society is individualistic and reveals signs of high power distance. This would indicate that the principal-agent behaviour prevails in Czech business. Since contingent pay is assumed to be a partial solution to such type of behaviour, we have to be especially cautious. The contingent pay is subject to multiple trade-off effects. In the first instance, executives realize which dimensions of performance are preferred (and rewarded) and allocate their activities based on such given preferences. Thus, analyzing performance measures, we have indicated that instead of promoting effort, contingent pay may provoke value decreasing and even fraudulent activities.

Understanding of the systemic bias in reporting and executive behaviour led us to the conclusion that the re-assessment of compensation rules in the Czech Republic is needed on the mandatory law basis. Nevertheless, we have revealed that some of persistent objections to corporate governance rules are better reflected in the revised corporate law. This includes for instance the explanation of due care and executives' liability for economic losses.

We have also shown that the company size is positively correlated with the compensation of supervisory board members. However, this conclusion was not statistically significant and other comparisons demonstrated that data sources on executive (and board member) compensation are insufficient for more complex quantitative studies.

Describing the prevalent bonus schemes, we have concluded that the incentive zone is quite short and the payment scheme seems to be reduced largely to a bivalent zero-one model. This reward structure may suppress the long-term effort. Rather, it is supposed to intensify efforts to simply cross performance thresholds. In a word, average bonus plans in the Czech Republic may provoke goals displacement or even the earnings management.

In the consequent debate about stock options we have indicated that their further expansion in the Czech Republic is questionable at the moment. We have resulted from the realization that the stock options are a perfect instrument for camouflaging. Moreover, Czech practice illustrated that the use of stock options is rather unsystematic without more profound understanding of their benefits and risks.

The analysis of data on fluctuations showed that both external hiring and internal promotions effects have been quite strong in recent years. With respect to the theoretical background, we have summarized that this is one of the reasons why top managers meaningfully increased their income relatively to both the whole population and the rest of executives.

Discussing the structure of boards, we have rejected the empirical conclusion about the board size and its negative relation to profitability. As far as the Czech practice is concerned, we are proponents of the endogenous explanation which indicates that there is not the sole common equilibrium and that decreasing of the number of board members may lead to adverse performance effects.

A similar analysis led us to the conclusion that the pressure on separation of the CEO and the chairman of the board of directors (and on the presence of other executives in the board) in the Czech Republic is inappropriate. We are convinced that the structure of boards and a blurred definition of the executives' accountability is the fundamental cause of higher agency costs. In given institutions, companies seem to look for structures with lower transaction costs, although their leaders probably realize that they balance the law requirements. One of the most striking facts is that the supervisory boards are inactive and often just cover executive decisions.

This structure has also a straightforward impact on compensation. Since it is the board of directors and the CEO who normally decide on remuneration plans, it means in a word that top managers decide on their own pay often. In our revised corporate governance structure, this should be the exclusive discretion of the supervisory board. In fact, step-by-step we got to the model which strongly resembles the German corporate governance system.

Although being advocates of the full disclosure in general, we have also opposed that with respect to the risk of institutionalization of adverse effects. Before the full disclosure, the above adjustments to the structure of boards and better distribution of authorities are needed.

Finally, we have heretically indicated that the whole thesis may have little justification since the Czech (as well as international) practice concentrates rather on accounting and tax optimization than on motivational aspects of particular compensation instruments.

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