

## Balancing Act

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Establishing a connection between executive compensation and corporate performance is much like trying to show how the weather affects mood swings. Common sense says they should relate, but quantification is another matter.

Academic studies going back to the 1990s show only a slight positive relationship between chief executive compensation and performance. And not surprisingly, the studies found executives prefer basing performance on accounting standards, or some other internal measures of a company's performance, rather than externals such as stock prices, which aren't under their control.

"The link between CEO compensation and subsequent performance is really hard to make, because it's difficult to determine what is the CEO's contribution and pull it apart from everything else," said Tim Pollock, associate professor of management at Pennsylvania State University. "For the most part, pay is the consequence of performance, not an antecedent."

Arriving at a basis for executive compensation, while long an academic question, has gained importance on Wall Street as the debate over excessive executive pay has gained steam.

It's also an issue that resonates locally as the total aggregate compensation of Los Angeles' highest paid executives – especially if it includes cashed-in stock options accumulated over the years – has continued to rise sharply.

One obvious correlation is that the larger a company's revenues, the more the chief executive gets paid. In theory that should motivate chief executives to grow their companies, but gross revenues don't necessary translate into profitability or shareholder return.

For example, Home Depot Inc.'s revenues have grown at double digits every year since 2000, yet the company's total stock return declined 12 percent in the same period. Last year Chief Executive Robert Nardelli took home \$38.1 million.

No wonder that institutional shareholders, including the California Public Employee Retirement System, or Calpers, presented a resolution to shareholders at Home Depot's annual meeting last week that would require advisory shareholder approval of executive compensation packages.

"We have lost money on the inability of the company to align its interests with shareowners which, in this case, is egregious compensation for poor performance," said Charles Valdes, chair of the Calpers Investment Committee, in announcing the resolution. "Shareowners deserve the right to give an up-or-down vote on executive compensation practices."

### Controversial options

Much of the money received by modern CEOs, including those on the Business Journal's list of highest paid executives, comes in the form stock options. Most recently, the question of whether companies are manipulating options by backdating the threshold "strike price" has spawned Securities and Exchange

Commission investigations.

But even before the latest controversy, criticism of the practice abounded. According to a study by Kevin Murphy at the USC Marshall School of Business, "options are often an inefficient way to attract, retain and motivate executives," but they remain popular because of the perception by board members that they involve little or no cost.

The use of options and bonuses to provide incentives executives begs the bigger question of how much control a chief executive really exercises over a company's destiny.

Studies show that Americans generally see people as having more influence than impersonal markets or environmental factors. However, when things go poorly, they tend to blame external factors. When things go well, they credit leadership.

When applied to executive pay structures, this thinking leads to deals that compensate the executives in good times but insulate them when market forces turn negative. Stock options clearly fit this mold. If a company's stock price increases to the point it triggers the strike price, an executive stands to make a fortune. If, on the other hand, the price tanks, then the options simply expire.

"The problem with options is there is no loss, no downside," said Pollock. "Executives really don't have any skin in the game."

Pollock advocates restricted stock grants, rather than options, as a way to align the executive's interests with those of the shareholders. Restricted stock consists of regular equity shares that can rise or fall, but come with the condition that the holder can't sell them for a specified time.

In the past, companies have avoided restricted stock because they didn't want the expense of giving real stock, and the games possible with options were more open. But under new rules, companies have to expense options anyway, reducing the price differential between the two forms of compensation.

In fact, a study by executive compensation consultancy Frederic W. Cook & Co. found that between 2003 and 2005, the use of restricted stock increased from 49 to 66 percent among the 250 largest publicly owned corporations in the country. In contrast, the use of stock options fell from 99 percent to 90 percent of these companies.

"We're in the midst of a fundamental restructuring of long-term incentives for corporate executives," said Edward Graskamp, managing director at Cook & Co. "(But) the continuing resiliency of stock options is somewhat surprising, given the adverse accounting rule changes and continuing shareholder dilution concerns."

### **Whose motivation?**

Indeed, as recent option controversies and the Home Depot's experience shows, highly publicized executive compensation affects shareholders as well as executives.

Alexander Horniman, a professor of business administration who specializes in psychology at the University of Virginia, believes that the negative effects on employees can more than offset any positive motivation for the managers.

“When you see these vast compensatory differences, it has to have a negative effect on the rest of the organization,” said Horniman. “It creates cynicism and resentment. When that’s part of the worker’s psychology, you create problems (because) some of their day is spent in non-productive behavior, thinking about the unfairness. And the differences are so great, it’s hard not to think about them.”

A study by the Federal Reserve found that U.S. chief executives earn 170 times what their average worker makes, compared to a multiplier of 22 in Great Britain and 17 in Japan. At large firms the multiplier grows, with various studies putting them in the 300 range.

“American CEOs have a higher multiple of pay over average employee pay than any executives in the entire world,” said Alan Weiss, performance consultant and chief executive of Summit Consulting Group. “American CEOs are paid to protect themselves, not for performance, which is why we have so many golden parachutes.”

Based on historical data, Horniman believes workers don’t object to a chief executive making 20 to 40 times as much as they do. But at 300 or 400, it becomes untenable. Even in winner-take-all industries such as professional sports, the star athletes make only four to 10 times as much as the average players.

But Horniman doesn’t see executive pay dropping any time soon, given the ingrained power structure of boards and chief executives. “Change is not the dominant force; the status quo is,” he said. “Short of a crisis like a stock market crash, there’s nothing to turn around these ideas about compensation.”

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